

Is life insurance an alternative asset class?

Insurance

By Robert M. Heinrich
and Bradley K. Feldman

Attorneys may need to take a fresh look at how we evaluate life insurance policies that our clients own or may consider buying.

Historically, life insurance served a number of critical needs: protection for a family from untimely death, funding for buy-sells, liquidity for estate taxes and, in some cases, accumulation of cash value for a rainy day. While all these needs still exist and are important, the financial markets (notwithstanding the current crisis) have become increasingly more sophisticated in providing financial products to meet specific needs and life insurance companies have been forced to follow suit.

Ultimately, permanent life insurance, as opposed to term life, is a financial product based upon the underlying performance of either fixed assets (generally bonds) or equities in the case of variable life insurance products. The addition of mortality risk provides an aura of mystery to it.

We submit that fiduciary standards and modern portfolio theory require advisors to analyze permanent insurance as an alternative asset class that must fit into the overall portfolio of the client. This approach can lead to surprising conclusions about the value of life insurance in particular settings.

Evidence of the efficacy of this approach is supported by the extent to which the financial markets have embraced "life settlements"; there are the sales of existing life insurance policies for amounts greater than their cash surrender values, but less than their death benefits.

According to Conning Research and Consulting Inc's 2008 report on life settlements, in 2007, approximately \$12 billion worth of U.S. life insurance was settled and approximately \$23 billion of U.S. settlements were in force at year end. Hedge funds in particular have embraced this "asset class," as it's viewed it as a non-correlated asset (an asset whose performance is not linked to the equity or debt markets).

In addition, this asset class is considered capable of producing above-market returns. Regardless of one's views on the life settlement industry, the regulatory climate and the industry's response, the fact that life insurance has drawn the attention of speculative investors requires a careful look at the underlying investment.

The traditional approach of the industry to permanent life insurance had been to focus on the tax-deferred growth of cash value within a life insurance product and the ability to access that growth through loans in the future. While this can be important for many situations, the focus of modern insurance portfolio analysis is the return on the premium invested upon the death of the insured. Specifically, what is the internal rate of return (IRR) on premiums paid at death and can the policy be structured to maximize this return?

If a permanent insurance product cannot provide a competitive return on dollars invested at death, then alternative investment of the premium dollars must be considered.

There are several components to this analysis. First, consider the source and alternative use of the funds that will be used for premium. If the alternative use for premium dollars is a fixed-rate bond portfolio, then the insurance policy considered should be a fixed product and the comparison of the return on premium should be to the current long-term rate for bonds of a similar credit rating. The right question is: "How will the client invest assets that are proposed to pay premium?"

An investment scenario that will beat an alternative if the client is willing to take the risk (for years, this was real estate) can always be created. This is only relevant, however, if the client would be pulling assets away from high-risk, high-return assets. Conversely, comparing equity returns under a variable life product to fixed-market returns would be equally faulty. Bottom line: make sure the comparison is apples to apples.

Second, returns of alternative investments must be analyzed on an after-tax basis. This must include income, gift and estate taxes. The death benefit of a properly structured life insurance policy will not be subject to income taxes. The extent to which gift or estate taxes are relevant will depend on the strategies available to the client to move assets.

If the client is comparing annual exclusion gifts to fund insurance in an irrevocable life insurance trust with annual gifting of interests in the family business, one needs to factor in the overall tax effects. If the situation involves more complex strategies such as sales to grantor defective trusts or charitable lead annuity trusts (CLAT), the calculations must include all relevant tax costs and benefits.

Third, the life-settlement market has created opportunities to access information that

previously was difficult to obtain. For example, a client can obtain the same life-expectancy reports that are used by brokers and funders to determine life-settlement offers. In analyzing whether to buy, sell, retain or fund a new or existing life insurance policy, this data can be critical.

From a fiduciary standpoint, insurance must be analyzed based upon the specifics of the individual client. While the life insurance industry operates on the law of large numbers, clients must focus on their individual situation. Generalizations about life insurance products are not relevant to an individual case.

Fourth, because the industry operates on the law of large numbers, anomalies can exist that create opportunities for clients. Be open to these opportunities. Certain carriers may have different underwriting perspectives with regard to certain medical conditions resulting in unexpectedly attractive offers.

For older individuals, the mortality tables used for single premium-immediate annuities (annuities that pay a fixed sum annually for the life of the client) are different than those used for life insurance. This inherent difference in rates creates an arbitrage where the mortality risk of the annuity can be offset through life insurance and the resulting annual net cash flow can exceed market fixed returns. The annuity and the life insurance are separate contracts, so they can be owned separately creating a host of alternative planning options.

Finally, obtain complete information from the insurance agent and the carrier. Internal rates of return on cash value and death benefit are available on all new products and should be requested. The same analysis can be done with a spreadsheet on any existing policy. An effective insurance advisor should provide the analysis you need to review with your client.

Your client's existing and future life insurance policies represent a portfolio of assets requiring the same level of analysis and care as their investment assets.

Robert M. Heinrich, J.D., and Bradley K. Feldman, J.D., are experienced in life settlements, life insurance portfolio management, and wealth transfer strategies for high-net-worth clients at Birmingham-based Schechter Wealth Strategies. Contact them at (248) 731-9500 or rheinrich@schechterwealth.com and brad@schechterwealth.com.