

Misunderstanding Variable Universal Life Can Lead to Adverse Consequences

By Peter Katt

Article Highlights

- Constant investment yields from a variable universal life policy are treated as a given until bad market conditions cause cash value to be much lower than forecast.
- A variable universal life policy can be used as an investment asset for retirement income and wealth transfers or if there is no need for additional retirement income.
- A six-step process for revising existing or acquiring new policies is presented.

I have been skeptical of variable universal life insurance policies (VULs) since they became popular enough to show up on my radar screen in the late 1980s.

In the beginning my skepticism was just instinct. Then experience proved that it wasn't misplaced. Though I have been consistent in my published columns, I continue to refine how we should think about and treat variable universal life. This article is probably my bottom line on this type of insurance policy.

Almost all clients view variable universal life as similar to whole life and universal life, buying these policies for family protection or associated with estate planning. But as we will see, variable universal life policies are very different.

Virtually all variable universal life policies I have reviewed have these characteristics: a.) illustrated (represented based on hypothetical assumptions) to have level death benefits from the day purchased until death; b.) invested in risky sub-accounts [primarily stocks]; and c.) a premium that the client believes is his or her "policy's premium." Buyers of variable universal life are very loyal to their premium. The premium is based on an assumed constant investment yield that the selling agent selects during the sales process, which they justify based on some construct of historical data. The constant investment yield is mandated by regulators.

Annual premium statements for variable universal life



arrive, the check goes out, and life is good. Then a bad market period like 1929 through 1932 or 2000 through 2002 occurs and sometime during the crash, the policyholder panics and orders a refreshed illustration. This new illustration has a current cash value that is dreadfully lower than the pre-sale illustration had "predicted," a result of the policy performing much worse than originally represented. The refreshed illustration also has illus-

trated premiums (typically to age 100) that are overwhelmingly large. The policyholder then moves the stock sub-account investments to bond funds or the fixed account. My phone rings and it's the policyholder with equal parts anger and fear that his or her life insurance seems to have blown up.

Okay, let's think about all that is a variable universal life insurance policy—both large features and important tidbits.

No one should think bond funds are not as volatile as stock funds. Moving from stock to bond funds is jumping from one pond with alligators to another with crocodiles. The only true move to safety with variable universal life is the fixed account, which provides a guaranteed minimum rate of interest through the accumulation phase.

The annualized return for large-cap stocks since 1926 is 10.1%. Does this mean that the only thing between the policyholder and a successful variable universal life policy is the guts to stick it out? No, for two reasons. One is statistical; the other is practical.

Statistically, understanding stock performance since 1926 sets no precedence for future returns. We don't know

whether crashes will have a similar, better or worse effect on returns. Not only is the length of time measuring this too short, but political, economic and financial circumstances change (sometimes drastically).

On a pragmatic level, we know that stock crashes will cause most variable universal life policyowners to panic. This is because many thought they just purchased a better version of permanent life insurance and didn't make the connection between the potential solvency of their policy and stock crashes.

After the crash, what are the policyholder's options? While in a panic state, it is unlikely he or she will "keep on keeping on," so there are three possibilities.

1. First, he or she can replace the variable universal life with whole life, universal life or guaranteed universal life—all policy types without investment volatility. Typically, the replacement policy will have the same level death benefit as the variable universal life policy.
2. The second possibility is not what the policyholder would want to do, but would have no choice. If his or her health has deteriorated, making policy replacement impossible, he or she will have to keep the variable universal life policy and use the fixed account. This thereby turns it into a quasi-universal life policy. Another unwelcome situation is being unable to replace the variable universal life policy because of significant surrender charges. In that event, the policyholder would stay in the fixed account and attempt to replace the variable universal life when the surrender charges are gone.
3. The third prospect is for the policyholder to switch horses and view the variable universal life policy as an "investment" and not part of his or her life insurance. This can be coordinated by addressing the policyholder's life insurance needs with whole life, universal life, universal life guaranteed or term life insurance and drastically restructuring the variable universal life policy so it effectively

functions as a stock "investment" for which the policyholder has completely different expectations.

Persons investing in stocks (individual stocks, funds, within and without a qualified (e.g., retirement) plan, buy-and-holders or market timers) are prepared (or should be) for heavy losses to go along with big gains. They know their stock investments won't go to zero. However, variable universal life used as insurance (i.e., level death benefits) can go to zero because of the ongoing insurance expenses, making the "rescue" illustration's premium amounts appear to be the equivalent of a "margin call."

When Variable Universal Life Makes Sense as an Investment

Though I believe variable universal life policies should be off the table as a life insurance asset (level death benefit), it does make sense as an "investment" asset in two circumstances for clients that want stock investments and not the more tranquil performance of participating whole life.

First, if the investor wants an asset for retirement income and wealth transfer at death, an "investment" variable universal life is a good option. If the cash values have a positive investment return, the income and capital gain taxes are deferred (and, if used correctly, tax-free). Specifically, the policyholder can withdraw cash values during retirement, not to exceed his or her cost basis (if there is a gain) with no taxes. Then the policyholder can let the policy continue until his or her death and the death benefit is free of taxes. Loans should never be used because if there is a market crash, the policy could implode—having no value, but incurring taxable income.

The second situation is if the policyholder has no need for additional retirement income, an "investment" variable universal life can be used for pure wealth transfer to his or her heirs at death. The variable universal life allows the policyholder to market time if desired and to incur no income or capital gain taxes. And, again, the death benefit is free of income and capital gain taxes.

The "investment" variable universal life should only use an innovative design (such as mine) that manages it to reduce the dangers of market crashes as much as possible. This design has been gleaned from hundreds of simulations I have done over 20 years.

"Investment" Variable Universal Life Methodology

Here is my "investment" variable universal life methodology that can be used for revising existing policies or acquiring new ones.

- A. Help the policyholder determine the amount of premiums and the duration he or she wishes to pay them.
- B. I determine the amount of level death benefit this amount of premiums can fund based on a 3% illustrated net yield. That is, I "back into" the death benefit amount once the premiums are known, not the other way around.
- C. I create a table showing the ratio of cash value to death benefit for every year. This ratio increases a bit each year until at policy maturity it is 100%. These percentages (e.g., at age 65 the illustrated cash value is \$500,000 and the death benefit is \$1 million; this is a 50% ratio) are the stabilizer for my method. At all times in the future, I want to make adjustments so the ratio is approximately maintained (explained below).
- D. After steps A, B and C are done (for a new variable universal life), a life insurance agent (licensed to sell variable universal life policies) completes the underwriting for the policy having an increasing death benefit that is based on the death benefit amount obtained in step B, plus the cash value. A client that is committed to variable universal life will know what sub-account(s) he or she wants to use and the agent just complies with this.
- E. If the policy is already in force, the same steps are used and applied to the existing policy.

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Enterprise value is shown in *Stock Investor Pro* for the entire company. If the enterprise value for the entire company is used, total revenues should be used as well. If sales per share is used, the enterprise value should be divided by the number of shares outstanding.

Conclusion

Revenue-based valuation methodologies can be a useful tool for determining if a stock is inexpensive, fairly priced or expensive. Because these measures are less commonly used, they

may lead you to stocks whose bargain valuations have not been uncovered by other investors.

Like any valuation measure, other factors should be considered, including profitability, to ensure the stock truly is a bargain and is not cheap for a reason. ▲

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Stock Strategies

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CR: If I remember correctly, you don't think that conventional bonds themselves offer as much diversification as people think. You think people should look outside a traditional domestic stock/domestic bond allocation.

RA: Exactly. We liken the classic way of investing to a two-pillar model—mainstream stocks and mainstream bonds, with a little dabbling around the fringes. But it makes so much more

sense to build a third pillar—assets that have higher yield, higher growth or both. Assets that are diversified, not very highly correlated with your mainstream stocks and bonds. Assets that are positively correlated with inflation. Because if inflation reignites, mainstream stocks and bonds will struggle. It's going to be a real disappointment. So I look on the notion of building that

third pillar as the most important thing an investor can do for their long-term prosperity. ▲

Bonus audio of Charles' interview with Rob Arnott can be accessed through the online version of this article on AAI.com. Arnott gives advice on creating stock screens and reveals the investing lessons he has learned throughout his career.

Robert "Rob" Arnott is the chairman and chief executive officer of Research Affiliates, which specializes in smart beta and asset allocation strategies. Find out more at www.aai.com/authors/robert-arnott. Charles Rotblut, CFA, is a vice president at AAI and editor of the AAI Journal. Find out more about Charles at www.aai.com/authors/charles-rotblut and follow him on Twitter at twitter.com/CharlesRAAI.

Financial Planning

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F. Each year, the investment results will show either a gain or a loss. A gain large enough to cover the policy's expenses will increase the death benefit because the cash value shows a gain. A loss will reduce the cash value and likewise the death benefit. As this is going on, I check the ratio (from step C). A variable universal life policy with positive compound earnings will be close to the cash-value-to-death-benefit ratio, or it could be higher. Being higher is no problem.

However, if the cash-value-to-death-benefit percentage is below the calculated ratio because of a market crash, after conferring with the agent and client it is usually decided to wait a year or a few years to see if gains will correct the low percentage. If it remains low, the death benefit can be reduced to bring the percentage back into line with the calculated ratio. This step is the key to eliminating, as much as is possible, the risk of a policy lapsing.

This variable universal life methodology allows the death benefits to increase as long as compound earnings are high enough to cover the policy's expenses. It also provides a release valve by reducing the death benefit to keep it properly funded during periods when the compound earnings have not covered the policy expenses or when they are negative.

Clients who are not willing to set variable universal life policies up in this manner should forgo participation in these products. ▲

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