THE DO'S AND DON'TS OF BUYING VARIABLE LIFE INSURANCE POLICIES

By Peter Katt

Volatile equity performance can have an adverse affect on variable life insurance, but there are steps you can take to manage and minimize potential problems.

Variable life allows policyholders to control how their policies' premiums are invested by selecting from various mutual funds available. The number of funds available range from less than 10 to as many as 35. Some companies offer only in-house funds, other companies offer only outside funds, and some companies offer a combination. Among the funds offered, you will find the usual range of funds: managed equity, indexed equity, international equity, balanced bond and equity, investment grade bond, below investment grade or high-yield bond, fixed account, and money market. The more funds available, the more variety within a category. For example, the managed equity category may have separate funds dedicated to medium and small-cap stocks.

Deciding how variable life premiums are invested is very different from whole and universal life because those policyholders have no say in how their premiums are invested. Whole and universal life policy premiums are invested in the insurance company's general account, which is predominately invested in investment-grade bonds held for yield and that have maturities that currently average about seven years. Therefore, investment results for whole and universal life will change relatively slowly and are backed by a minimum guarantee. This means that whole and universal life policy performance is predictable. In contrast, variable life policies invested in equity or equity-combination funds will have investment results that are volatile and unpredictable, causing policy values to be unpredictable.

Soaring equities in the U.S. have caused great enthusiasm among insurance companies, agents, and consumers for variable life, and sales have increased dramatically. As occurs in many aspects of life, enthusiasm can inhibit unbiased examination. The purpose of this column is to examine several critical issues associated with variable life that are too often overlooked by variable life sellers; specifically, the adverse effect that volatile equity investment performance can have on life insurance. This article will give you some steps that can be taken to either minimize potential problems or manage their effects, including the management of policyholder expectations. These are important issues because they are largely hidden from potential variable life buyers.

MISLEADING ILLUSTRATIONS

The primary understanding clients get about permanent life insurance policies is obtained by viewing an illustration provided by the insurance company. Illustrations show how a policy is *projected* to perform based on the premium pattern shown and associated pricing factors that remain constant throughout the illustration.

The most important pricing factor is investment results, with mortality of less importance. For whole and universal life illustrations, companies use their current investment and mortality experience. Variable life illustrations use an *assumed* investment return that must remain constant for the duration of the illustration. The primary reason most consumers are interested in variable life

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is the ability to invest in equities. Therfore, an illustration showing a constant investment return fails to convey to prospective variable life buyers the effect that volatile and unpredictable equity performance has on their policy. This is especially true for the defined-benefit type of policy design.

DEFINED-BENEFIT DESIGNS

Broadly speaking, there are only two basic life insurance policy designs—one is a defined benefit and the other is a defined contribution. A defined-benefit policy design features level death benefits until policy maturity. At the time of purchase, premium payments should be structured so that the policy's cash values are projected to equal the death benefits (known as endowment) at policy maturity (age 95 or 100, depending on the policy) based on an assumed investment factor.

All permanent life insurance is priced to the market because future investment and mortality experience will change, and as such we know that actual policy performance will be different than projected. Therefore, it follows that the actual premium costs to properly fund a defined-benefit type policy will be different than what can be projected.

In theory, as the actual investment performance is booked and expectations about future investment performance is established, target premiums should be periodically adjusted. But in reality, few insurance agents monitor policies, and the need to monitor and adjust premium costs apparently doesn't register with most variable life policyholders. The primary understanding they have of their policy is obtained by viewing the pre-sale illustration, which doesn't prepare them for the effect fluctuating investment results can have on their policy. Like ducklings who become attached to the first thing they see as being their mother, the variable life illustrated pre-sale premium is usually imprinted in the mind of the policyholder as being definite—IT IS NOT!

Monitoring and adjusting premiums is a challenge for all defined-benefit policies, but premium adjustments for variable life policies invested in equities is much more difficult because of investment volatility. A case study of the ghost of variable life past will be useful.

A 55-year-old non-smoking male purchased a $1 million defined-benefit variable life policy with a target premium of $14,700, projected to generate a cash value of $1 million at age 95, based on a gross investment return of 10%. Using randomly selected fluctuating year-to-year investment results that averaged 10% (with a high of 34% and a low of –30%), I adjusted premiums every five years by comparing the simulated actual cash value to a benchmark needed for the policy's cash value to equal the death benefit at policy maturity:

- The benchmark cash value in the fifth policy year is $65,000, while the simulated actual cash value is $53,000, because the simulated actual performance has been below the assumed average of 10%. Therefore the premium is adjusted to $15,900, a rather minor amount because there are 35 years left to policy maturity.
- The 10th year benchmark cash value is $150,000, while the simulated actual cash value is $152,000, so the premium adjustment of $14,525 is nearly back to the original target of $14,700.
- The 15th policy year's simulated actual cash value of $300,000 is considerably above the benchmark cash value of $241,000, so the premium adjustment to $7,500 is substantial.
- The 20th policy year's simulated actual cash value of $479,000 is way above the benchmark of $338,000, so the new projected premium goes to zero. But the client is advised to begin a side fund of the premiums that aren't being paid in case the trend of higher simulated actual cash values falls below the benchmark, which is exactly what happened.
- The 25th policy year's simulated actual cash value of $239,000 is not only way below the $443,000 benchmark, but also well below the simulated actual cash value from just five years before. Big investment losses were suffered. The new adjusted premium is $47,675.
- The premium adjustment in the 30th year is to $38,500, with premiums going to zero by the 35th year and cash values growing to $1.5 million by policy maturity.
- The premium range is a dramatic $0 to $47,675.

The simulation here is not an aberration. I collaborated with New York-based insurance consultant Glenn Daily on the probability that an unattended defined-benefit variable life policy whose assumed average investment results and simulated actual investment results are identical would lapse before maturity. Using a large number of random simulations based on a 10% average investment result and 15% variation in returns, we discovered that about half the time such a policy would lapse.

You might think that setting the initial target premiums higher might allow a defined-benefit variable life to go unattended, but this is no solution at all because most of the time this strategy would result in overpaying for the life insurance coverage, and we found that 21% of the time, such a policy would lapse (based on setting the initial target premium 400 basis points lower than the simulated average results with a 20% variation in return).

My recommendation is that if you wish to purchase defined-benefit type policies, either stick with universal life or buy variable life, but don't allocate much to equities to avoid the premium management problem. However, if you really insist on combining a defined-benefit

variable life policy and large allocations to equities, make sure you are aware of how difficult it is to manage the premiums—be prepared to handle the uncertainties, and make sure you have the resources to pay much larger premiums.

DEFINED CONTRIBUTION

Defined-contribution designed policies establish the amount of fixed premium payments with the minimum amount of initial death benefits that are projected to increase significantly over time. In sharp contrast to a defined-benefit type of design where changing investment results affect premium payments, defined-contribution policy premiums are not affected. Instead, changing investment performance affects cash values and death benefits. Using the same initial premiums of $14,700 and investment results from the defined-benefit simulation, along with an increasing $250,000 death benefit, the simulated actual values are $1 million by age 78, $2 million by age 88, and $3 million by age 95. Because defined-contribution variable life policies' premiums are not affected, allocating premiums to equities is appropriate.

PREMIUM DESIGN

The examples described above were based on continuous annual premiums being paid. However, the insurance industry has heavily marketed variable life policies that feature a limited number of premiums, or so-called vanishing premiums. Using vanishing premiums associated with a defined-benefit variable life policy design and allocating premiums to equities produces even more uncertainty because a limited number of premiums concentrates the expected policy funding, magnifying the premium adjustment problem. However, paying a limited number of premiums is no problem for defined-contribution type policies.

FUND SELECTION

- *Equity Funds:* Because investment results are volatile and unpredictable, premium management for defined-benefit policies is very difficult. Ideal for defined-contribution policies.
- *Bond Funds:* Investment or non-investment grade can work equally well for defined-benefit and defined-contribution designs.
- *Balanced Funds:* Not as volatile as an all-equity fund, but still volatile, making premium management for defined-benefit policies difficult. Ideal for defined-contribution policies.
- *Fixed Account:* Most variable life policies offer a fixed account that is usually the company's general account, which is invested primarily in bonds held for yield. As such, fixed account yields should be predictable and without volatility, making defined-benefit policy premium management relatively easy. Also fine for defined-contribution type policies.
- *Money Market Funds*: The most efficient use of a money market fund is a place to temporarily park monies based on a market timing strategy or to move monies from the fixed account (usually limited to 25% per year) during times of increasing interest rates because money market rates will go up more rapidly. The long-term use of a money market fund is probably a mistake because in periods of declining or stable interest rates the fixed account will very likely have higher yields.

POLICY EXPENSES

Reducing policy expenses by selecting the right company and policy is money in your account. Policy expenses can be reduced in two ways: First, by reducing the selling expenses; second, by having very competitive fund expenses.

Fortunately, there are low-load, no-commission variable life policies available from direct writers Ameritas (www.ameritasdirect.com, 800/552-3553) and USAA (800/531-8000); their policy expenses are very low. You can judge the quality and variety of funds available from them for yourself by obtaining their prospectus. Currently, neither Ameritas nor USAA has a second-to-die variable life policy available for sale.

VARIABLE LIFE TIPS

- Buy low-load, no-commission policies if the quality and variety of funds meet your standards.
- When buying a defined-benefit type policy design with the premium allocated to equities, don't be misled by the pre-sale illustration showing a constant assumed investment return.
- If the policy design desired is of the defined-contribution variety, any variable life investment strategy will work.
- If the policy design desired is defined-benefit coupled with investing in equities, you must accept premium uncertainty and have the capacity to fund much larger premiums if necessary. If you can't handle the premium uncertainties and/or don't have the resources to come up with much larger premiums, avoid equity investments.
- Variable life is an excellent life insurance policy if you handle complexity and options well, but is a poor choice if you don't handle complexity and options well or don't want to be bothered.
- Variable life can do anything whole or universal life can do but with considerably more flexibility.
- Last year, the Clinton administration made an unsuccessful run at changing the taxation of variable life by requiring that any gain be recognized when moving from one sub-account to another. Be alert to this coming up again. ✦