A Fresh Look at Life Insurance in Periods of Uncertainty

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A PROPERLY BALANCED planning strategy can allow clients at any stage of their financial plan to capture the significant long-term appreciation of the equity markets while thoughtfully apportioning assets in cash or cash alternatives for liquidity needs. These liquidity needs start with death, continue with emergencies and the inevitable bear market, and extend to distressed investment opportunities such as buying a piece of real estate amidst a market crash. Theoretically, a properly balanced, long-term financial plan will include cash and/ or cash alternatives to avoid the need to sell shares in a down market, and hence should outperform the alternative plan without adequate cash-equivalent assets.

Most financial planners recognize that the benefits of liquid cash for various purposes are high. However, we must further recognize that the cost of this liquidity premium is high: yields on short-term liquid investments are relatively low, and interest-bearing investments generally translate into ordinary income tax.

Once inflation and ordinary income tax is considered, the cost of these investments is high. For example, an investor might have liquid investments paying 3 percent interest. Assuming a 35 percent tax bracket, the post ordinary income tax interest on these investments is 1.95 percent. As a result, at 3 percent inflation, the investor's liquid investment has a negative return relative to inflation.

Unique Characteristic

Life insurance is an asset whose unique and most important characteristic—the death benefit— provides certain cash to heirs at the policyholder's death. Irrespective of the market and the values of assets in the client's portfolio, the appropriate death benefit allows the survivors to create an orderly disposition of the family assets to meet liquidity needs. If the insurance amount is large enough, the survivors might not see a financial case for selling any of the invested assets. In this case, the life insurance death benefit represents choice. Having an ability to choose whether or not to dispose of assets could allow the family to maximize the overall legacy for generations to come.

Living Benefits

What about the living benefits of life insurance? How might these fit into a client's overall portfolio in periods of distress? Our clients use traditional, high-quality, dividend-paying[1] whole life insurance contracts as an efficient means to accumulate cash value over long periods of time.

The concept is intuitive. For the moment, put aside the costs of insurance and other factors that impact individual product performance, and consider:

Whole life insurance contracts rely on the performance of the life insurance company and its general account[2]. That general account is invested in primarily corporate and government bonds. It is very difficult for the individual investor to replicate this blended diversification on a risk-adjusted basis.

Most of these life insurers are highly rated and some have been incorporated since well before 1900.

The insurance company dividend

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scale interest rate[1] is not directly subject to market volatility. Some companies boast that they have never missed a dividend through every bear market in history and even through the Great Depression and Great Recession. For a relatively recent example, we can look to 2009, the year following the Great Recession of 2008. In that year, the following insurance companies had these dividend-scale interest rates:

Mass Mutual: 7.6 percent
Guardian: 7.3 percent
MetLife: 6.25 percent
New York Life: 6.14 percent
Northwestern Mutual: 6.5 percent

This historic reference helps to illustrate the relatively low volatility of insurance companies' dividend scale interest rate in times of high overall market volatility. Because of the mortality and expense charges, the dividend scale interest rate should not be used as a measure of the policy's internal rate of return; rather it is one factor used in determining a policy's total dividend. The method an insurer uses to determine the total dividend paid on a policy can vary from company to company.

Traditional whole life insurance contracts have a guaranteed set of cash surrender values at contract inception. Once a dividend is earned and reinvested by a policy owner, it becomes part of the guarantee. As a result, the cash value can never go down.

Life insurance is not subject to tax as the cash value grows. Further, borrowing against or surrendering additions from a non-modified endowment contract policy via loan/surrendering dividends up to the cost basis are not subject to tax and can be received quickly. For example, a policy owner could have had a lion's share of their insurance cash value available within a week in the most perilous periods of 2008–2009.

Lastly, and perhaps most importantly, life insurance offers flexibility. The life insurance benefit itself allows clients the flexibility within their financial plan to help them meet their goals before and after retirement with some certainty.

Most clients don't plan on using life insurance cash values in the future, but they do find opportunities over time where it can be useful. Our clients often borrow from the insurance company[3] using their cash value as collateral to help meet liquidity needs. When they are flush with cash again, they repay the loan. This may allow them an option to avoid having to liquidate equities, bonds, real estate, or other investments in a down market, providing the opportunity for those investments to recover. Of course, loans taken against a life insurance policy, surrendered values, or withdrawn values can have potentially adverse effects if not managed properly.

Traditional dividend-paying whole life insurance on its own can be a compelling asset to own in any market environment. When you factor in the benefits of its unique liquidity characteristics at death and during life, it can have a significant impact on an individual's overall portfolio performance. ■

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Important disclosures:

[1]Because of the mortality and expense charges, the dividend scale interest rate should not be used as a measure of the policy's internal rate of return, rather it is one factor used in determining a policy's total dividend. The method an insurer uses to determine the total dividend paid on a policy can vary from company to company. Due to the size, predominantly fixed income composition, and long term nature of insurance companies' general accounts, short term market volatility typically does not have a significant immediate impact on the dividend scale interest rate of the respective insurance company. Rather the dividend scale interest rates tend to lag the trends of the bond and stock markets as a whole. The dividend scale and the underlying interest rates are reviewed annually and are subject to change. Future dividend policies are not guaranteed on life insurance policies. The dividend scale and the underlying interest rates are reviewed annually and are subject to change.

[2]Policyowners are not investing in the general account portfolio when purchasing insurance or annuities. They are buying products that are backed by the financial strength of the insurance company that issues the product.

[3]Loans taken against a life insurance policy, surrendered values, or withdrawn values can have potentially adverse effects if not managed properly. The death benefit will be reduced by any outstanding loans, surrendered values, or withdrawn values.

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