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Life Insurance in Times of Uncertainty

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Many years ago an old man gave us a blessing: "May you live in interesting times." Well, we thought it was a blessing. It turned out to be a curse.

As we write this column, financial markets are struggling to recover from a spectacular free-fall. The Dow fell below 7,000, losing almost 4 percent of its value in one day; unemployment reached historic highs; credit became virtually unavailable; and housing values plummeted. Despite attempts by Congress and the administration to ease the blow, almost all economic prognostications indicate that things will get worse before they get better.

Interesting times, indeed. But these interesting times give us an opportunity to review some fundamental principles of financial planning, including life insurance.

The Olden Days of Life Insurance

Through the 1970s, there were two primary types of life insurance policies—term and whole life. Term allowed an insured to purchase inexpensive protection for a specified period, usually one year. Whole life offered permanent protection at a fixed rate throughout the insured's lifetime, in contrast to the increasing cost of term insurance, provided that the premium is paid. Whole life provided an added benefit—the ability to save within the policy on a tax advantaged basis.

Inflation in the late 1970s caused whole life policies to fall out of favor. Crediting rates were far less than market rates of interest, due in part to the long-term nature of the insurers' investment portfolios. The growing rate gap between whole life policies and alternative investments caused disintermediation—people withdrew money from their whole life policies and invested it elsewhere. Insurers were forced either to act or to disappear. They chose to act.

UL to the Rescue!

We have a yellowed *Wall Street Journal* article dated May 4, 1981, in which the introductory paragraph of the article was: "Where can you get one of the highest tax-deferred—or tax-free—yields on your savings? Try life insurance." The author proceeded to discuss "two products that truly advance the state of the art" and were "real breakthroughs for consumers." They were called—ahem—universal life and variable life. Yes, there really was a time when these two life insurance staples were exciting new products.

Universal policies were less costly than traditional whole life policies because they did not provide the same guarantees, but did allow purchasers to accumulate cash inside of the policy. Universal policies are similar to whole life policies in that the insurance company invests the cash contributed to the accumulation account, and credits interest on the cash value of the policy. Unlike whole life policies, universal life policies only stay in force as long as there is enough cash in the policy to pay the term insurance cost.

> "The primary reason for purchasing life insurance should be death benefit protection."

Variable universal life insurance policies provide a very attractive option to many investors—the ability to choose investments for the cash value of their policy, permitting the owner to experience high yields when times are good, and, conversely (although not likely to be on the minds of investors when stock markets are rising), losses when times are bad.

The *Wall Street Journal* article mentioned previously provided an instructive illustration of a universal life policy offered by Life of Virginia with a then-current interest rate of 10.88 percent. Life insurance veterans with 30-year pins will recall that 10.88 percent wasn't even the peak.

So, how long did that 10.88 percent last? Not very. The cash values projected would never be achieved. It was the life insurance version of Florida swamp land, but without the eco-cachet. Further, inflation for the prior year had been 13.5 percent, so the real rate of return was negative. Although the vast majority of life insurance agents told their clients that the rate wasn't guaranteed, it is unlikely that clients understood the significance of a precipitous drop in rates on future cash values. And how happy was a client a few years later, after the interest rate on the policy plummeted? Not very.

A particularly interesting aspect of the article was an information box that included market data. The average yield for AA-rated

bonds was 14.8 percent, and the average conventional mortgage on new homes was 15.47 percent. Oh, yes, and the Dow Jones Industrial Average was 995.59. That's nine hundred, not nine thousand.

And you thought we lived in interesting times today!

Anyway, whole life insurance policies lost their luster as increasing stock values and expanded investment options lured many individuals away from whole life in favor of the higher potential returns of variable universal life. For many, this was an appropriate and rational decision, but the financial turmoil that markets experienced over the past year highlights the advantages offered by traditional whole life policies. In retrospect, after experiencing the dramatic downturn in the markets over the past year, many insureds would have preferred the slow, steady rates of whole life policies to the sometimes negative rates of VUL. Through the lens of today's equity and credit markets, crediting rates on whole life insurance policies look attractive even when compared to bank CD rates. Interestingly, LIMRA reports that life insurance premium payments fell significantly in the first quarter of 2009. At a time when households appear to be seeking higher yields, security, and safety for their investments, this trend seems counterintuitive.

As usual, when nothing seems to make sense, it's time to get back to basics.

Financial Planning Uses of Life Insurance

The primary reason for purchasing life insurance should be death benefit protection. Most individuals will need to employ life insurance as part of an overall financial plan to ensure their family is taken care of due to the early death of a breadwinner. Both term and whole life insurance provide death benefit protection, but whole life has the advantage of providing a tax-advantaged savings vehicle for the insured.

An emergency fund is a hallmark of good financial planning. Emergency funds are often used for three purposes: (1) provide funding for sudden, unexpected, and costly events (such as periods of unemployment or uninsured casualty losses); (2) lower property casualty insurance premiums by increasing risk retention through higher deductibles; and (3) provide liquidity for purchasing investments when opportunity is present. The cash value of a permanent life insurance policy addresses all of these emergency fund needs.

The loan features on whole life policies allow the owner to access cash value at favorable interest rates that, when paid back, are credited to the owner's cash value account. The cash value buildup is available to fund unexpected events. Cash value can also be used to lower a family's lifetime insurance costs by allowing them to self-insure against small risks (for example, increasing their property-casualty insurance deductibles) and borrowing from cash value to cover self-insured losses. An added benefit of using life insurance cash value for emergency fund needs is that the accumulation is not as easily accessible as, for example, bank deposits, a fact that might discourage the owner from impulsively spending the emergency fund.

While the crediting rates on whole life cash values might be lower than crediting rates on alternative investments in inflationary environments, in today's market, with low interest rates and declining market conditions, whole life crediting rates may exceed the rates of return available in the CD or bond markets. The guaranteed death benefit protection of the whole life policy combined with the lower, but steady, accumulation rate on the cash value may also seem attractive when compared with the losses experienced by those who purchased equity investments in variable life policies.

Furthermore, investment specialists emphasize asset allocation, and in most cases recommend at least some allocation to fixed income investments to find the optimal risk-return trade-off. The cash value of a whole life policy could be considered part of the owner's fixed-income asset portfolio. In fact, life insurance provides a benefit that most fixed income securities do not—the potential for tax-free growth, provided that the policy stays in force for the life of the insured.

Fixed income investments also provide an opportunity for investors to take advantage of temporary down market cycles by creating the liquidity to purchase attractive equity assets at low cost. In down market cycles, the owner of a whole life policy may borrow from the policy's cash value to purchase attractive investments, thereby taking advantage of opportunities unavailable to those without access to cash.

When cash value is used for these purposes, but fortuitous circumstances preclude the need to draw on it, excess cash accumulated over the owner's lifetime can be borrowed from the policy to supplement retirement needs. Furthermore, given increasing life expectancies and greater asset accumulations, the use of permanent life insurance (compared with term insurance, which is likely to lapse prior to the death of the insured) to cover liquidity costs and taxes at death is a prudent and safe planning strategy.

When viewed in the context of an individual's overall financial plan, cash value life insurance policies, including whole life policies, are extremely useful tools. And we haven't even addressed business uses of permanent life insurance.

A Final Thought

Whole life insurance policies are not appropriate for everyone, especially for those with critical death benefit needs and small budgets. However, the use of whole life insurance products to cover mortality risk and serve as either an emergency fund or fixed income portion of a client portfolio should not be overlooked. Trying times change people's perspectives on appropriate planning techniques. As the events of the last year or so have demonstrated, in low interest rate and down market environments, whole life insurance policies are an attractive alternative to other funding vehicles.

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