Death Benefit as an Asset Class

Managing Estate Investment Objectives with Life Insurance

By **Bill Boersma**

Some years ago an advisor approached me after a presentation I made to an Estate Planning Council meeting asking for my advice on some life insurance policies on her parents. This was an everyday request and the result of a thorough analysis showed that a few policies were doing fine and others were not. At the outset of the ensuing meeting she asked the following question: "We bought these policies for estate tax liquidity but under the new tax law the estate has no tax liability so do we need the policies?"

If the purpose of the insurance was for something that no longer existed, there is only one answer to that question: No. But... was that the best question to be asked? Though the original need for the insurance no longer existed, was the insurance no longer useful? I believe the question should be more along the lines of "Is there a current role for life insurance in the estate portfolio to help accomplish other estate, family or philanthropic objectives?" By asking that question we can evaluate life insurance similarly to how we evaluate other estate assets.

The concept of life insurance as an asset class has gained traction in recent years though the discussion more often centers on cash value. I want to focus on life insurance death benefit and how it relates to other estate assets and will refer to this as Testamentary Investment Planning.

When our clients die they die with stuff; personal assets, business assets, personal and corporate real estate, traditional investments, private equity, retirement plans, etc. Another thing they can die with is life insurance. It is simply another class of assets which is cash at that point; no taxes, no liquidity discount, no market risk and non-correlated to any other asset class.

Conventional Wisdom Regarding Life Insurance: Need vs. Opportunity

This conversation is specifically applicable to clients with discretionary income and assets on which they are not dependent for standard of living. The greatest opportunity lies at the feet of those who have the luxury of discussing *opportunity* rather than focusing on *need*.

When discussing life insurance it is important to recognize that perception and conventional wisdom are exceptionally influential forces which affect our decisions. My experience in the professional advisor community tells me that attitudes regarding life insurance are powerful and understandably molded by the industry and through personal experience. I encourage an open mind.

The decision to incorporate life insurance is often as simple as deciding if it is needed or not; if you don't need it, you don't buy it. I want to challenge that. Clearly there is a long list of things people don't need but they procure anyway. Luxuries fall into this category but so do many more mundane purchases. Products and services are chosen and strategies implemented in our attempt to accomplish objectives and we pick and choose what we expect to achieve those goals. One doesn't need a particular private equity investment or business acquisition but it may provide an opportunity for gain. The same could be said about the sports car or watch I have my eye on though the opportunity may be more emotional in nature. With life insurance I am going to suggest that even when there isn't a need, there may be an opportunity if we view it in a non-traditional manner.

Let's revisit the family referenced above. The money committed to the insurance portfolio was discretionary capital and it was already in the irrevocable trust. But was there a reasonable purpose for it beyond the original goal of providing estate tax liquidity? Could the insurance originally implemented to satisfy a need morph into presenting an opportunity? Further discussions focused on a cottage which was a property nothing short of a family heirloom. Maybe the insurance could be utilized to fund the property costs and management for generations to come but did the economic dynamics of utilizing life insurance make sense, as much sense as alternate investment options? Now was the time to evaluate the insurance assets the same way we would any other asset. The points of discussion included projected return, opportunity cost, risk, time lines, benchmarking and so on. There were a lot of questions to ask and numbers to crunch.

As part of the process for this family I created a scatter graph and plotted their actual assets along with a point representing the average risk and reward of the portfolio. I then overlaid that graph with another one which incorporated life insurance death benefit as an asset with a new average point. The result for this family showed that incorporating life insurance shifted the average point up and to the left which represents a higher portfolio return with a lower portfolio risk.

After analyzing the remediation options for the underperforming policies and looking at market alternatives, we discovered the internal rate of return at actuarial 50th percentile life expectancy to be greater than 7% net, after tax, guaranteed. In another family situation the numbers may be higher or lower, guaranteed or non-guaranteed, but they will be net of income tax, estate tax and potentially generation skipping tax if structured properly.

The family decided this was a good use of money to accomplished their goals so they decided to maintain a life insurance portfolio even though they weren't forced into it by need. They viewed it as an opportunity. In a very real way, this life insurance portfolio represented an asset class with desirable characteristics their comprehensive portfolio lacked without it.

A Market Divided

I want to touch on the comments in Michael Lewis's writings I have referenced before regarding the market being divided into a class system of the Haves and the Have-Nots, meaning the informed and the uninformed. Also, I recently heard the statement "The people who don't know how the system works subsidize the ones who do." I believe this is important because it neatly meshes with the perception issue.

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An anti-insurance attitude is often firmly imbedded due to experience. Those with a negative experience regarding life insurance, due to underperforming policies in a declining interest rate market, suspect sales practices or other reasons, generally find themselves there because they are among the Have-Nots. These are people who have unfortunately been taken advantage of by insurance or by the players in the insurance market in part because they don't know how the system works. Mind you, some of these Have-Nots are exceedingly wealthy, even billionaires. However, others are firmly entrenched among the Haves; people who understand the system and have been subsidized by the losers. These are people who take advantage of insurance. There is a substantive difference between "take advantage of" and "taken advantage of".

Portfolio investment planning generally incorporates the discussion of various asset classes and possibly hedging strategies, both of which are fundamental aspects of our continuing efforts to mitigate risk. Since the concept of life insurance inherently centers on the mitigation of risk, the door should be open to discussing it relative to estate investment objectives and Testamentary Investment Planning.

We are all trying our best to manage assets as effectively as possible for a variety of purposes; minimizing risk, producing income, asset growth, tax efficiency, etc. Often it is about maximizing value during life but even those individuals who have more than they could ever spend are still trying to manage money as astutely as possible. Why? Maybe because that is "what you do" or it may be for the next generation or for philanthropic goals. Successful people have often gotten to where they are by making a lifetime habit of seeking out advice and making astute decisions. As advisors, our job should be to help them continue that habit.

Why Life Insurance?

Life insurance possesses distinct characteristics relative to other assets which make it particularly relevant to a discussion regarding estate investment management. Likely, though, many haven't thought of life insurance in this manner as it is often overlooked due to conventional wisdom. When we talk about asset classes and how they relate to each other, there are a number of factors to consider including risk, return, correlation, time frame and taxation to name a handful.

As a hedging tool life insurance is incredibly effective though the hedging benefit of life insurance is only a part of the story. This goes back to the need perception of the decision making process. Hedging the risk that a business owner could die with a lack of liquidity or before the estate planning strategies have time to season has often forced the decision maker's hand into incorporating life insurance when an objective evaluation would show it also offers meaningful opportunity. As an estate investment asset, life insurance also hedges against the underperformance of other assets while reducing risk. The projected return of a well crafted insurance policy may also be attractive in its own right, not only as a hedge when things go wrong. In some circumstances it can even be considered a portfolio driver.

Though I am an "insurance guy" there is a calculated reason my wife and I own life insurance in our family foundation and a similar reason we own life insurance on our parents though they will likely not have estate tax liabilities. We are among the informed, the Haves, and we can ascertain precisely what it offers us relative to our philanthropic and retirement goals.

To understand how any asset affects portfolio risk we can consider common assessment tools like standard deviation and the Sharpe ratio. Standard deviation is fundamentally a measure of an investment's volatility while the Sharpe ratio is a tool used to compare investments by adjusting for risk.

The death benefit of a guaranteed life insurance contract doesn't have any variation, only a known return at given durations, with life expectancy as an unknown variable. It is common to look at the known return at the 50th percentile life expectancy as a data point for making decisions but no one can know with certainty if the return on a given transaction will be higher or lower due to a nearer or more distant point of death. It can be argued that while there is an unknown, there is no variability. Additionally, calculation of risk adjusted return shows life insurance has an anomalistic death benefit return relative to risk when compared to other assets classes.

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Risk correlation is an integral component of an asset allocation discussion with the goal generally to incorporate non-correlated risk in an attempt to reduce overall portfolio volatility. While potentially effective, recent investment experience has shown that during volatile markets, asset class correlation may increase exactly when the benefits of non-correlation are most important and hedging costs may spike simultaneously. Death, however, is independent of changing economic, political and market conditions. It doesn't care about jobless claims, housing starts, the price of oil, election results, who is invading what country or the exchange rate of the Yen or the Euro. It doesn't matter if your client dies in the next 2008 when the balance of the portfolio has taken a meaningful hit. Life insurance will flow in at full face value, offsetting portfolio losses or bolstering favorable experience and its cost as a hedge does not change with market conditions.

The correlation and variability attributes of life insurance make it very effective in lowering a portfolio's volatility. Building a portfolio of uncorrelated assets isn't the challenge as much as finding another asset with the unique attributes of life insurance which offers a portfolio similar benefits.

One of the unique features of life insurance has to do with timing. Time horizon is a meaningful aspect of any conversation about investing and we generally expect returns to increase as the time horizon increases. With life insurance, the return increases as the time horizon decreases which defines it as negatively correlated to time as opposed to most other asset classes. I've often viewed life insurance as the ultimate Put Option in the sense that one party can unilaterally force another to the table under a specific circumstance. Is there another asset class which has an absurdly high return when things go wrong in the worst imaginable way, in this situation defined as premature death? Other assets count on time to fulfill potential while life insurance doesn't care about time. From a hedging perspective, the death benefit of a properly managed and funded life insurance contract is simply a question of when. It's ready to deliver full contractual benefits at a moment's notice, possibly even decades before expected.

Far from considering the benefits of life insurance nebulous, we can quantify potential results of incorporating life insurance through financial modeling. A family may experience a meaningfully improved risk adjusted return on its cumulative portfolio by reducing variability, diminishing correlation and minimizing aberrations due to unexpectedly short time horizons or market crashes. Subject to the particulars of a given estate, layering in life insurance offers the potential of increasing average expected returns while substantively limiting downside exposure.

The return on a given life insurance transaction, as a net number and guaranteed when built around a guaranteed product, is an unduplicable financial transaction which may very well serve a role in a portfolio to which a certain amount of discretionary capital should be committed. Note I did not state that life insurance is an unbeatable financial transaction rather, on a risk adjusted basis, it is unduplicable and that may be exactly what is missing in some estates from a Testamentary Investment Planning perspective. Even in circumstances where the raw IRR is underwhelming, its inherent bent as a hedge, guaranteed nature, tax efficiency, non-correlation attributes and indifference to time makes it an attractive estate asset.

As the life insurance industry and astute players in it get more sophisticated, the professional advisors perception of life insurance has started to change. The transformation from the need transaction to the opportunity transaction is gaining traction.

The concept of implementing something which is not needed relies on a more nuanced estate portfolio management approach. The traditional approach understandably focuses on the needs of the clients and allots investible assets accordingly. Considering family or philanthropic aspirations, an alternate approach of dividing assets may offer the succeeding generation or charity what it is looking for given potentially different objectives. Without segregating discretionary income and assets, an estate may forgo returns if they allocate the portfolio to traditional investment classes which focus on income and asset preservation. Life insurance can provide a guaranteed base for heirs and charities which may allow for taking measured risk with discretionary assets and income to experience the upside potential of investing to alternate goals.

Though this may sound partisan, comments such as "There is plenty of liquidity in the estate to pay the $20,000,000 of estate taxes so there is no reason for the life insurance" have always left me scratching my head. It's a cliché to recount the other insurances these individuals maintain though they can surely afford to forgo them. How utilizing the assets of a taxable estate, liquidating them in unknowable market conditions and at an unknown point in time makes any sense has always been beyond me. Some agents may too quickly run to life insurance before utilizing the myriad estate planning opportunities available to mitigate taxes, but the unparalleled positive aspects of properly procured and astutely managed life insurance are all but undeniable for those fortunate enough to obtain it on a favorable basis.

Conclusion

Life insurance is simply one of many complementary tools and techniques available to open minded consumers and advisors, an asset with unique risk, variability, correlation, yield, timing and tax attributes which is also a self-completing estate planning strategy. Though life insurance may always be a bit of a black box to some and others may never be able to segregate perception and conventional wisdom from facts and figures, the decision regarding asset class inclusion in an estate portfolio should be anything but emotional. Far from the almost magical attributes fostered by some, the benefit of well designed life insurance is as measurable and quantifiable as any other assets.

Layering life insurance into an estate investment portfolio is a way to introduce a low risk, non-volatile and non-correlated asset, coincident with an independently attractive return, hedging qualities and tax efficiency while removing time from the equation. I can only wonder if another asset with the same qualities would be implemented more frequently if it wasn't called life insurance.

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