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Key takeaways

- On an after-tax basis, certain types of life insurance may outperform traditional investment portfolios with similar risk characteristics. The key to using life insurance as an asset class lies in indentifying the right type of insurance for the client and understanding the liquidity limitations inherent in life insurance products.

- Clients should carefully assess their life insurance needs and balance those needs within the context of their overall financial plan and asset allocation and the underlying investments therein.

- Human capital is critical to comprehensively understand an investor's assets and liabilities, and in determining net worth. Human capital has powerful implications for asset allocation and insurance decisions.

Life insurance as an asset class—Why it makes sense

Most clients understand the benefits of life insurance for protection purposes. Life insurance can meet a client's planning need by replacing the income of a primary breadwinner in the event of a premature death, or providing liquidity to pay estate taxes. Despite its obvious attributes, however, life insurance often is perceived as being expensive as some believe it has excessive built-in fees and costs that have a negative effect on the overall return on premium dollars. Contrary to that perception, on an after-tax basis, certain types of life insurance may outperform traditional investment portfolios with similar risk characteristics. The key to using life insurance as an asset class lies in indentifying the right type of insurance for the client and understanding the liquidity limitations inherent in life insurance products.

Life insurance is primarily attractive to a client who is able to make a long term financial commitment with minimal need to access the cash value of a policy during their life. It is necessary to note, however, that although this article may analyze life insurance as an "investment," it is not an "investment" in the traditional sense. Although it is acceptable to consider the investment performance of life insurance, and to consider life insurance as an asset class, life insurance should be purchased primarily for its death benefit feature, and not be bought by clients solely as an investment, savings, or retirement plan.

A primary benefit of life insurance is the tax treatment of the death benefit. As a general rule, the death benefit paid on a life insurance policy is exempt from income taxes. Life insurance proceeds may also be exempt from estate taxes if structured in a trust outside of the client's estate. These significant benefits differentiate life insurance from traditional investment portfolios. The chart below details various characteristics of different types of life insurance policies versus investment portfolio assets.

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Characteristics	Whole life insurance	Universal life insurance	Variable universal life insurance	Investment portfolio assets
Access to cash	Yes	Yes	Yes	Yes
Death benefit	Yes	Yes	Yes	No
Availability of minimum returns	Yes	Yes	Yes, if fixed account chosen	No
Credit risk	Concentrated exposure to insurance co.	Concentrated exposure to insurance co.	Concentrated exposure to insurance co.	Based on portfolio holdings
Possible to exclude from taxable estate	Yes	Yes	Yes	Limited to estate tax exemption ($5.25M)
Proceeds generally income tax-free	Yes	Yes	Yes	No

Types of life insurance

This article discusses three types of life insurance policies: whole life, universal life, and variable universal life.

Whole life and variable universal life may be attractive to investors who are willing to take on investment risk or the risk that insurance costs will fluctuate due to their dependence on markets, the performance of the insurance company's general account, and mortality costs. These risks can impact the viability and health of whole and variable universal life policies.

Whole life insurance

Whole life policies are typically purchased for two primary purposes: the death benefit and cash accumulation. Many buyers of these policies view the cash value component as an additional retirement savings vehicle that they can draw from when the funds are needed to meet future retirement expenses. The death benefit provides liquidity to meet family expenses upon the death of the insured. The value of both components may increase over time but there are some risks associated with owning this type of policy (discussed below).

Whole life insurance most often is designed so that premiums are paid each year for the insured's lifetime. The policy often builds up significant cash value over time as well. The death benefit and premiums most often are fixed in whole life insurance policies. If the cash value builds significantly, the death benefit may increase over time (so long as loans are not taken from the policy). The premiums may also be structured to be paid for a fixed number of years, usually 10 or 20 years, and in some cases may even be structured as a single payment.

Whole life policies may also pay dividends. The dividend levels of the policies are dependent on investment returns of the insurance

company's general account, administrative expenses, and mortality costs. Dividends can be received as a cash payment to the policy owner, accrue as cash value, buy paid-up additions (additional fully paid-up insurance), purchase a term insurance rider on the policy, or be used to reduce or pay premiums.

Whole life policies may also offer a guaranteed death benefit that may be much lower than the non-guaranteed death benefit and cash value projections provided by the insurance company. This difference is due to the assumptions used in the non-guaranteed dividends and mortality costs. Therefore, it is always best obtain illustrations using conservative assumptions like a lower dividend relative to the current dividend scale to evaluate the impact of any changes in the non-guaranteed dividend rate.

Although legal restrictions prohibit the sale of whole life policies as an alternative retirement vehicle, some investors think of them that way because the cash value of the policy grows on a tax-deferred basis. Investors also may retain the option to utilize the cash value in the future. In order to access the policy cash values during life, policy owners may withdraw dividends, to the extent available, up to cost basis or through policy loans without income tax. These withdrawals will have an impact on the death benefit and adverse income tax consequences may occur if the policy lapses during the life of the insured.

How does the performance of a whole life policy compare to a typical moderate investment portfolio?

Life insurance illustration:

- Second-to-die whole life policy.
- Husband and wife are both age 60.
- Husband and wife have a "preferred" underwriting classification.
- $1 million of life insurance death benefit coverage.
- Dividends within the policy are held at a constant current dividend rate (7%, the 2012 dividend rate for MassMutual).
- Premiums for this couple will be $21,490 per year for a 20-year period. At the 20 year point it is projected that the dividends paid on the policy will be sufficient to cover the annual premium.

The final two columns in the chart below highlight the internal rate of return ("IRR") of the life insurance policy. In this example, the IRR is the annual return needed on the yearly premiums paid in order to obtain the stated death benefit in the "life insurance proceeds" column in a given year.

Male and female, age 60, preferred, whole life

Year	Male age	Female age	Insurance premium	Life insurance proceeds	Tax-free IRR	Taxable equivalent (39.6%)
1	60	60	-21,490	1,000,278	4554.62%	7540.76%
5	64	64	-21,490	1,005,642	86.80%	143.71%
10	69	69	-21,490	1,035,956	27.57%	45.65%
15	74	74	-21,490	1,120,508	14.47%	23.95%
20	79	79	-21,490	1,266,108	9.45%	15.65%
25	84	84	0	1,277,946	6.79%	11.25%
30	89	89	0	1,325,541	5.41%	8.96%
32	91	91	0	1,350,902	5.04%	8.34%
35	94	94	0	1,392,454	4.58%	7.59%
40	99	99	0	1,477,077	4.04%	6.69%
41	100	100	0	1,521,025	4.01%	6.64%

Age 91 is the joint life expectancy based on the 2008 Valuation Basic Table.

The illustration below of a moderate portfolio assumes an allocation weighted 50% towards a diversified bond portfolio and 50% in a diversified equity portfolio. The chart below compares the returns of a moderate portfolio (50th percentile) versus the whole life policy described above at assumed joint life expectancy of age 91. The moderate portfolio return assumptions are based on UBS capital market assumptions.

Moderate portfolio pre-tax return over 30 plus year period:	6.08%
Whole life policy taxable equivalent IRR @ 39.6% tax rate:	8.34%
Whole life policy taxable equivalent IRR @ 33% tax rate:	7.52%
Whole life policy taxable equivalent IRR @ 25% tax rate:	6.71%

When examining the tax-equivalent returns, the whole life policy significantly outperforms the moderate portfolio. Clients may consider incorporating whole life insurance as a part of their overall portfolio based on the projected returns.

The returns of both the whole life policy and moderate portfolio are not guaranteed and may be subject to undesired volatility. The performance results are subject to a variety of factors that include:

- dividend paying capacity of the life insurance company
- mortality costs associated with the life insurance policy
- equity and bond market performance for the moderate portfolio

The choice to include a whole life policy in a client's portfolio will depend on the client's comfort with the risks inherent in this type of policy and their need to access any of the cash value.

Variable universal life insurance

Variable universal life insurance is permanent life insurance, meaning that it is intended to be effective for the insured's entire lifetime. It also is designed to offer more flexibility as to the timing and amount of

premium paid. There is a suggested amount of premium to be paid to maintain the policy. Other than the first year when a minimum payment is required, the policyholder has complete discretion over how much is remitted. Payments can be reduced or even skipped. However, not paying the scheduled premium may negatively impact the amount and potential growth of the policy's cash value, and eventually the death benefits. Unless a minimum amount of cash value is maintained, the policy will lapse and the holder will lose the entire cash value and death benefit on the policy. In addition, depending on the policy's investment returns, additional premium payments may be required to make up for lack of investment performance even if the originally suggested premiums have been paid as suggested when the policy was first purchased.

Generally, variable universal life policies do not provide any minimum cash value or guaranteed minimum rate of return. The policy owner is able to direct how the policy's cash values are allocated among a group of investment options provided by the insurance company, one of which is usually a fixed account. This variable feature shifts the investment risk from the insurance company to the policy owner. Increases and decreases in the investment accounts directly impact the cash value in the policy. Unlike a direct investment in the market, investments within the policy are subject to mortality charges to provide for the death benefit feature, which will impact overall returns.

Variable universal life may generate significant cash value with tax-deferred growth. However, interest rate and equity market volatility can impact the cash value, premium payments, and/or death benefit.

How does the performance of a variable universal life policy compare to a typical moderate investment portfolio?

To illustrate the utility of a variable universal life policy, we assumed the following:

- Second-to-die variable universal life policy.
- Husband and wife are both age 60.
- Husband and wife have a "preferred" underwriting classification.
- The policy provides $1 million of life insurance death benefit coverage.
- The net underlying rate of return for the portfolio investments of the cash value in the policy is 6.08%.

Based on these assumptions, the annual premiums for this couple are $13,949 per year for a 20-year period and the $1 million death benefit is projected to stay in force through age 125. This is a much different result than the moderate portfolio, as noted by the following returns and IRRs over approximately a 30-year period:

Moderate portfolio pre-tax return over 30-year period:	6.08%
Variable universal life policy tax equivalent IRR @ 25% tax rate:	7.81%

Whole and variable universal life insurance may be good investments, but they come with their own risks. The performance of these types of policies may be impacted by the markets and/or the insurance company. Additionally, if the underlying investment performance is poor, the

death benefit may be reduced to keep the policy in force, or the premiums may need to be increased to maintain the intended death benefit. Under a constant set of assumptions, whole life and/or variable life policies may be good investments. Given some of the inherent risks – risks that investors are trying to mitigate or avoid – these policies may not be ideal. Whole life and variable universal life policies do have certain advantages that may make sense depending on an investor's circumstances. If a client is most interested in optimal death benefit and reduction of market and interest rate risk, another type of insurance, universal life insurance, may be a good choice.

Universal life insurance

A universal life ("UL") policy including a guarantee that the policy will not lapse (commonly referred to as a "no lapse rider") most often is designed with level premium payments and death benefit throughout the life of the contract. Essentially, if the owner pays the required premium each year in a timely fashion, the guaranteed death benefit will be paid. The death benefit guarantees are not dependent on the returns of the market, interest rates, or the performance of the insurance company's general account. UL policies do not have the same risks as whole life and variable universal life, with the primary risk being the credit risk of the life insurance company.

Universal life offers the policy owner the ability to purchase a death benefit that is guaranteed to a certain age or for the life of the insured. UL policies are not designed to accumulate cash value. Rather they are designed to provide a permanent death benefit at a low cost. Unlike a variable universal life policy, if a scheduled premium is not paid or reduced for a UL policy, the guarantees on the death benefit likely would be compromised. While this impacts the flexibility for the policy owner, it also removes the uncertainty on how much will need to be paid to prevent the policy from lapsing. Investment risk is passed on to the life insurance company where the life insurance company is guaranteeing the death benefit. The risk with this type of policy may be seen as similar to the risks of corporate bonds. Below is an analysis of a UL policy as an investment.

How does the performance of a universal life policy compare to a typical moderate investment portfolio?

This illustration assumes the following:

- Second-to-die universal life policy with a no-lapse rider.
- Husband and wife are both age 60.
- Husband and wife have a "preferred" underwriting classification.
- $1 million of life insurance death benefit coverage.
- The purpose of the policy is to provide additional wealth to the insured's two grown children upon their death.
- Premiums for this couple will be $13,260 per year for a 20-year period.

The chart below highlights the internal rate of return of the policy. The IRR can be equated to the annual investment return necessary to accumulate $1 million of assets at each point in the future. The IRRs decline over time because the $1 million death benefit stays constant throughout the life of the contract.

Male and female, age 60, preferred, 20-Pay UL

Year	Male age	Female age	Insurance premium	Life insurance proceeds	Tax-free IRR	Taxable equivalent (39.6%)	Taxable equivalent (33%)	Taxable equivalent (25%)
1	60	60	-13,260	1,000,000	7441.48%	12320.33%	11106.68%	9921.97%
5	64	64	-13,260	1,000,000	109.58%	181.42%	163.55%	146.10%
10	69	69	-13,260	1,000,000	35.41%	58.62%	52.84%	47.21%
15	74	74	-13,260	1,000,000	18.51%	30.65%	27.63%	24.69%
20	79	79	-13,260	1,000,000	11.46%	18.97%	17.10%	15.28%
25	84	84	0	1,000,000	8.23%	13.62%	12.28%	10.97%
30	89	89	0	1,000,000	6.36%	10.54%	9.50%	8.49%
32	91	91	0	1,000,000	5.83%	9.65%	8.70%	7.77%
35	94	94	0	1,000,000	5.17%	8.56%	7.72%	6.89%
40	99	99	0	1,000,000	4.35%	7.19%	6.49%	5.79%
41	100	100	0	1,000,000	4.21%	6.97%	6.28%	5.61%

Age 91 is the joint life expectancy based on the 2008 Valuation Basic Table.

Assuming this couple lives to age 100, the equivalent annual return on a portfolio with an addition of $13,260 per year for 20 years necessary to accumulate $1 million at age 100 would be 4.21% per year. Many would consider this a reasonable return for an asset that has many of the same return characteristics as a zero coupon bond (minus the lack of liquidity during its duration). What is even more attractive about the return is that life insurance proceeds generally are income tax-free. The tax equivalent yield at age 100 would be 6.97% assuming an effective income tax rate of 39.6%. Assuming an effective income tax rate of 25%, the tax equivalent yield would be 5.61%. These are meaningful returns given the risk characteristics of life insurance.

How are life insurance companies able to provide these returns?
The following factors influence these returns:

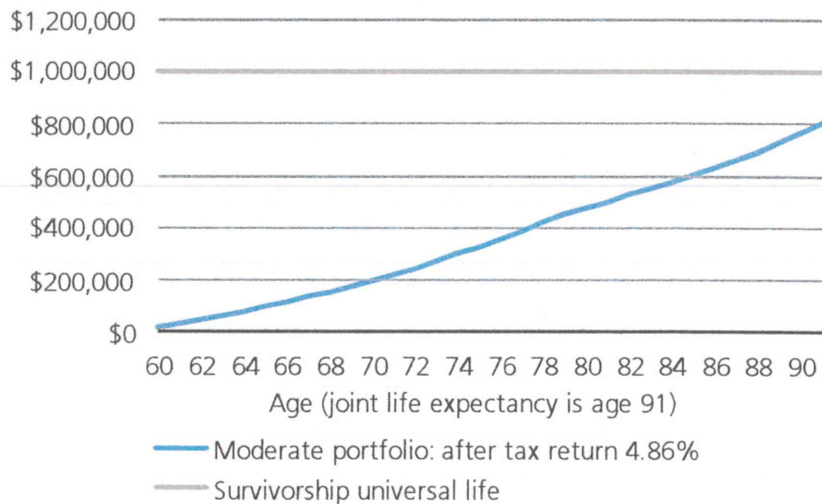
- *Portfolio management*—Life insurance companies may manage their general account more effectively than other types of investors. The current typical life insurance company's general account is composed of high quality bonds, real estate, and policy loans. The overall five-year insurance industry average return in the general account is about 5.15%.[1]
- *Policy lapse*—Every year some policy owners do not make their premium payments and the policies lapse. The lapse rate is currently around 6.4% (3-year average lapse ratio for largest 25 life insurance companies).[2] As a result, premiums paid on those policies are added to the life insurance company's general account, and the life insurance companies structure these lapse assumptions and experiences into the premium cost.
- *Due diligence*—Life insurance companies get to "check under the hood" and obtain medical records, blood work and family history on the insured. Since they are dealing with a large pool of individuals, they also have the ability to conduct actuarial studies to help them

[1] Data provided through Vital Signs. Vital Signs compiles data from statutory statements filed by insurance companies. Data is as of year ending 2010.
[2] Ibid.

forecast more accurate mortality rates, making the pricing model in turn more accurate.

When comparing the average moderate portfolio return (50th percentile) of 6.08% pre-tax to the IRRs on the previously described universal life second to die contract, the life insurance policy IRRs are very compelling as depicted below. Even lowering the effective income tax rate from 39.6% to 20% on the moderate portfolio, the results are still compelling. Having invested the annual premium into a moderate portfolio and assuming an after-tax return of 4.86%, the face value of the life insurance contract would not be achieved at joint life expectancy (age 91). In fact, the break even after-tax return would need to be 5.83% which is 7.28% pre-tax (assuming a 20% effective tax rate). Please note that the chart below assumes death occurs each year. *One major difference to note in this comparison is that an investor will have access to his or her diversified portfolio during life; however, since life insurance proceeds are not accessible until death, the investor will not have similar access during their life. See chart below.*

After-tax moderate portfolio vs. universal life insurance policy (assumes death occurs in each year)



Moderate portfolio after-tax return @ 20% tax rate:	4.86%
UL IRR on death benefit (income tax free):	5.83%

The moderate portfolio results are not guaranteed. Our analysis assumes that clients do not let short term volatility and emotions change their investment strategy which oftentimes leads them to make investment decisions at inopportune times. In actuality, investors typically are swayed by the ups and downs of the markets and often let their emotions alter their investment strategies. In order to achieve the same returns that a UL policy may provide, investors would need to stay with a disciplined investment approach over a lengthy period of time. Historical experience shows us that they often do not.

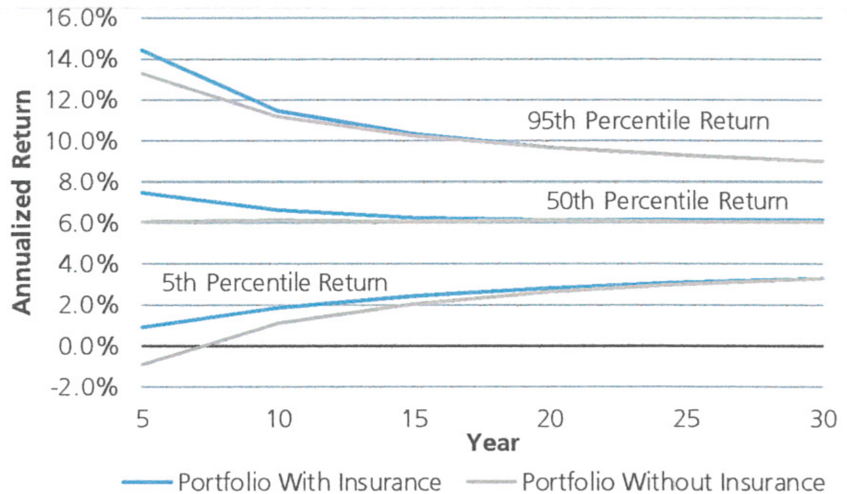
With a universal life insurance contract, the risk is transferred to the life insurance company and the company bears the burden of achieving the returns. Although payout is guaranteed by the company, it is important to note that the contract is still subject to default risk of

the life insurance company itself. However, given that state regulators set reserve requirements for insurance companies, this default risk may be lower than the risk inherent in a moderate portfolio. Even under very extreme economic circumstances, like we saw in 2008 and 2009, life insurance contracts held up in a time of great uncertainty. However, that is not to say the future will provide the same outcomes for these carriers.

Another attractive aspect of the UL policy is its non-correlation to the broader markets. Whether equity markets or interest rates go up or down, there is little to no impact on the insurance contract. We certainly do not suggest that, even given these attractive features, a prudent investor should invest solely in a UL insurance policy. This analysis, however, makes a compelling case that life insurance should be considered as one component of your overall portfolio.

Incorporating universal life insurance will improve the overall expected return, especially in the short-term, and provide a reduction in portfolio volatility. The chart below assumes a moderate portfolio purchases a second-to-die universal life insurance policy based on two 60-year-olds with a preferred underwriting classification. The life insurance policy death benefit has a face value equal to 10% of the starting portfolio value and death occurs in each of years indicated.

Moderate portfolio with and without universal life insurance (face value equals 10% of portfolio allocation)



Over approximately the first 15 years the portfolio with life insurance notably outperforms the portfolio without insurance due to the death benefit provided by the insurance contract. The guarantees of the life insurance also reduce the volatility of the moderate portfolio and provide a potentially greater return over the first 15 years.

When considering an extended period of time (e.g., 30 years) the performances of the portfolios converge and the difference becomes minimal. However it is important to note that the features of the life insurance policy narrow the range of potential outcomes and reduce the potential volatility. Additionally, the policyholder has achieved an added benefit when incorporating life insurance by ensuring the

liquidity and funds are there for their family if unexpected events occur. All of these benefits come without compromising the potential long-term performance of the overall portfolio.

Summary

Clients should carefully assess their life insurance needs and balance those needs within the context of their overall financial plan and asset allocation and the underlying investments therein. Based on the analysis contained in this article, when evaluating the return on premium dollars in the payment of the death benefit, life insurance as an asset class is a viable alternative to traditional asset classes with the added benefits of providing the liquidity needed for heirs should unforeseen events occur. A portfolio with an allocation to life insurance, particularly universal life insurance, can outperform the same portfolio without insurance over a short time frame as well as an extended period of time.

– *Richard Scarpelli*
Co-Head of Advanced Planning

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Life insurance, asset allocation, and the human capital component

Michael Crook and Stephen Freedman, the UBS Co-Heads of Investment Strategy, CIO Wealth Management Research, study and write about the importance of including human capital as factor in portfolio construction and asset allocation. Their findings consistently show that financial asset portfolios perform best when human capital is incorporated into the equation that is used to determine the appropriate investment mix. The following summarizes their ideas.

Crook and Freedman are encouraging financial advisors to change their thinking about how to build portfolios so as to incorporate holistic investment advice. Holistic investment advice encourages advisors and their clients to think of investments, planning and insurance in a coherent and interconnected way. One step in this holistic advisory process is the integration of the concept and value of human capital. Crook and Freedman, who define human capital as the present value of an individual's future earnings, model it as a "shadow asset" because it does not appear on any financial statement. However, they believe that human capital is critical to comprehensively understand an investor's assets and liabilities, and in determining net worth. For most individuals who are not yet retired, human capital may well be the single

largest asset they hold. It is probably the most overlooked asset as well. This is unfortunate, because human capital has powerful implications for asset allocation and insurance decisions.

Under a holistic investment advisory framework, an investor's total wealth is equal to (i) their human capital (i.e., future earnings), plus (ii) their financial assets, plus (iii) their real assets. When young, most of an individual's wealth is stored in the form of human capital. Human capital is usually the largest portion of a person's wealth until they are over 50. Through the passage of time, as income is earned human capital declines and, so long as a portion of that income is saved, total wealth grows. In effect, through the process of earning and saving income, human capital is transformed into financial wealth over the course of an individual's working life.

Understanding the unique character of each investor's human capital is crucial to developing an asset allocation of financial assets for that investor. Two key questions must be addressed:

1. Is human capital linked to a specific employer or more generally to an industry; and
2. What are the risk and return characteristics of an individual's human capital (i.e., employment situation): bond-like or stock-like?

Regarding question 2, bond-like human capital arises from secure employment with a predictable earnings stream (e.g., a tenured professor or a civil servant). Stock-like human capital applies to many private sector jobs with less job security and variable compensation (e.g., commission-based sales jobs). The implication is that the more stock-like an investor's human capital, the more he/she should diversify away from equities into less correlated investments. In other words, individuals with uncertain earnings and low job security would be better advised to view their human capital as equity-like and accordingly invest financial assets more conservatively. Conversely, individuals with highly predictable earnings and high job security could view their human capital as bond-like and choose to invest their financial assets more aggressively.

Job loss is one risk affecting the value of human capital, but it is not, however, the greatest risk. The greatest risk is the risk that death or disability will prematurely put an end to an individual's earning capacity. Fortunately, this is an insurable risk. From a holistic investment perspective, life insurance (as well as disability insurance) essentially provides a hedge against the loss of the investor's human capital (the loss of his/her future income). To the extent that human capital is greater than financial assets, life insurance should be considered a critical component of holistic planning.

The savvy client expects holistic investment advice. Crook and Freedman agree that life insurance is an asset class that should be considered when constructing an investor's optimal portfolio. To incorporate life insurance into an investor's asset allocation, consider that a portfolio combining human capital and life insurance (i.e., the net human capital) decreases risk more than a portfolio with unhedged human capital. By reducing the risk associated with the human capital

shadow asset, life insurance may make it appropriate to invest liquid financial assets more aggressively. Without life insurance, liquid assets may need to be invested less aggressively in order to partially self-insure against impairment or depletion of the human capital portfolio component. Your UBS Financial Advisor can discuss with you a personalized holistic investment framework and how risk to your human capital affects your overall risk and financial situation.

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