

5 Reasons Not To Buy Indexed Universal Life Insurance

My June Column at Physician's Money Digest is a basic piece on [Indexed Universal Life Insurance](#) (IUL). This piece is fairly basic, but provides information that is very important for someone considering the purchase of this type of a permanent life insurance policy to understand. I have two more posts coming up on the subject which go into more depth, including an analysis of a fairly good IUL policy.



Indexed universal life insurance (IUL) is an insurance product that seems to promise you can have your cake and eat it, too. Unfortunately, as with most things in life, there are no free lunches. The devil is in the details, and when you really examine them, it becomes clear that these are products designed to be sold, not bought.

IUL is similar to the more familiar whole life insurance policy in that it is composed of 2 basic pieces: First, a permanent insurance policy that will pay a death benefit whether you die young or old; and, second, a cash value account from which you can borrow money tax-free (but not interest-free) in order to pay for expensive items, educational expenses, or your retirement. The difference lies

in how the cash value account grows.

In a whole life policy, the insurance company determines the dividend rate. Each year, this announced rate is multiplied by your cash value and the product is added to your cash value. The insurance company is the sole determinant of what that rate will be, but it is generally considered to come from a combination of the insurance company's portfolio returns, surrender fees, and the extra money available when people live longer than actuaries project.

With IUL, the crediting rate for your cash value is determined by a formula, instead of being at the insurance company's discretion. The specific formula is outlined in the policy documents, but, in general, is related to the performance of the stock market.

Unfortunately, if you don't listen and read carefully, you'll misunderstand how the policy works and assume you're going to get stock market-like returns on your cash value or, worse, on your premiums, not all of which goes to the cash value account due to the costs of insurance. The basic premise is that when the stock market goes down, you're guaranteed a crediting rate of zero to 3%. When it goes up, you get to "participate" in that increased return.

Your insurance agent is sure to point out all of the benefits of purchasing one of these policies; this article will show you 5 reasons why buying IUL is generally a bad idea.

5 Reasons Why Buying Indexed Universal Life Insurance is a Bad Idea

1. You don't need a permanent death benefit

The vast majority of Americans, and especially high-income Americans like physicians, will, at some point, no longer depend on their earnings from work in order to live. This is called financial independence. Once you reach this point, you generally no longer have a need for life insurance.

IULs are, by definition, permanent life insurance policies. Term insurance is very inexpensive: less than \$350 per year for a \$1 million, 30-year level term policy bought on a healthy 30-year-old. The reason it is so inexpensive is that people are unlikely to die before 60. If everyone died before 60, those policies would be much more expensive.

Since everyone eventually dies, permanent life insurance must be priced so that there is enough money to pay a death benefit to everyone. As such, the insurance component is very expensive. The portion of your premium that pays for the insurance component cannot go into your cash value account. The more the insurance costs, the less you'll have in the cash value account. You don't need a permanent policy to insure against a temporary risk.

2. Complexity does not favor the buyer

IULs have many moving parts. The more complex the policy, the less likely you are to really understand how it will work in the future. The less you understand, the more likely you are to be disappointed when you eventually compare the steak to the sizzle you were sold. Also, the more complex the product, the fewer competitors it will have, and competition drives prices down.

Like any insurance/investing hybrid product, you need to hold a IUL for the rest of your life to achieve even a low return, and you are far less likely to do this when it turns out you

bought something that isn't what you thought it was. Those who sell these commissioned products are highly trained, but not in finance. Their training is in sales, and they are generally very good at what they do.

You may have noticed that the best products in life generally sell themselves. If a highly-trained sales force is the only way to sell something, buyers should probably wonder why.

3. IULs don't count the dividends

You have probably heard that "the stock market returns 10% in the long run." While this figure is approximately true—at least on a nominal (non-inflation-adjusted) basis—it includes the stock dividends, not just the change in the index value. IULs, however, only pay you based on the change in the index.

"So what's the big deal?" you ask.

The big deal is that if you go back to 1870, the average dividend yield of the stock market is over 4%. Even now, at historically low yields of around 2%, the dividend still accounts for one-fifth of the market return. So if an index mutual fund goes up 10% (including a 2% dividend), an IUL may only credit you 8%.

4. IULs have cap rates

To make matters worse, IULs usually have a cap rate. That means if the stock market has a really great year, such as the 30% index return in 2013, your return is "capped" at some lower figure, often in the 10% to 15% range.

How much does that matter? Well, imagine if your policy had a cap of 12%. Any time the S&P 500 index returned more than 12%, you just get 12%. How often does that happen? Since 1928, the S&P 500 has had an index return over 12% 44 times, or about 52% of the time. It happens more often than not.

Even if you only go back 15 years to 1999, during this supposedly terrible period for equities, it has happened 7 times. If that cap wasn't in place, an IUL purchaser in 1999 would have had 69% more money than he really ended up with.

5. IULs have participation rates

If that wasn't bad enough, there is also something called a participation rate. If your participation rate is 80%, that means that if the stock market goes up 10% (not counting dividends) you get 8% credited to your cash value account. After 30 years, a nest egg growing at 8% instead of 10% ends up 42% smaller.

Adding It All Up

So how can IULs offer "market returns" while still guaranteeing you won't lose money, at least on a nominal basis? They don't.

You simply don't get anywhere near the market returns due to the costs of the insurance, the additional fees, the loss of the dividends, the cap rates, and the participation rates. These products don't pass the common sense test.

How can an insurance company give you most of the upside of investing in stocks while eliminating the downside? They don't have any magic investments; they have to invest like anybody else. In addition, they have to generate enough money for profits and to pay hefty commissions to their sales force.

These policies are likely to provide a return very similar to that of whole life insurance (with the possibility of much worse performance), which is easily seen to be in the 2% to 5% range long term for a policy bought today and held for life. While it may have the word "index" in its title, an IUL has much in common with whole life insurance and almost nothing in common with a high-quality index mutual fund.

While guarantees are always nice, you don't want to overpay for them. With IUL, you are doing so in the form of much lower returns.

Do you own IUL? Are you happy with your purchase? Why or why not? Comment below!