

An Index Universal Life Insurance Illustration

An insurance agent who is a “believer” in the value of index universal life insurance recently set me an illustration for what he considered to be the best Index Universal Life Insurance (IUL) policy out there. “Best” was defined as having the best annualized return on the cash value. I thought it might be interesting to look at it. I’ve written before about IULs, and I’m not a big fan. There are a lot of moving parts, and the devil is in the details. I’m not a big fan of cash value life insurance of any type, but if you want guarantees I think whole life is the way to go. If you want the maximum possible growth in a life insurance policy, I think a good VUL is the way to go. If you just want a permanent death benefit, a guaranteed no-lapse universal life policy is probably best. Most people, myself included, have no need to purchase one of these policies, and once they understand how they work, usually no desire to purchase one. At any rate, let’s look at IUL.



How IUL Works

The theory behind IUL is that you get some of the benefit of investing in stocks with none of the downside. So if the market is down, you get some guaranteed interest rate applied to the cash value (not the premiums paid) of your policy. If the market is up, you get some portion of the rise. The problem is that portion may not be anywhere close to what the stock market actually delivered since these policies generally don’t consider the dividends, have a cap on the maximum rate, and sometimes (although more commonly with annuities than

insurance) have a “participation rate” less than 100%. In addition, there are many different ways that these policies “lock-in” stock market gains, and since they haven’t been around very long, hypothetical results rely heavily on back-testing, with its numerous methodologic issues well-known to physicians who have looked at retrospective studies.

Add in the costs of the insurance (not insubstantial if you’re older, sicker, or have dangerous habits like I do), the fees, and the commissions, and you’re looking at returns that are likely to be similar to a whole life policy, but could either outperform it or underperform it. That means, if you’re one of the 20% of people who actually hold on to the policy for the rest of your life, that your returns will be somewhere between the 2% guaranteed and the 5% projected returns.

The big selling point of these policies is “stock-market like returns without any downside risk.” Wouldn’t we all like that? There’s a reason it sounds too good to be true.

The Illustration

The illustrated policy sent to me demonstrates this well. This is a Midland National XL-CV4 policy, which is designed to get you as much cash value as possible. This particular illustration is for a healthy 30 year old male making annual premiums of \$5500. It has a guaranteed crediting rate of 3% (note that this guaranteed rate is much lower than the typical non-guaranteed 6-8% crediting rate in a whole life policy.) Also remember that the crediting rate (similar to dividend rate on whole life) is NOT the return on your premium dollars. The illustration also shows that the current cap rate on the policy is 14.5%, but that the company has the right to reduce that as low as 4% at their sole discretion (that seems fair, right?). This is NOT a bad policy, by the way. It’s a pretty good one as these go. There are plenty out there that are much worse. The minimum participation rate is 100% (so you get 100% of the change in the index up to the cap rate.) It also only

costs you a net 1.25% to borrow your own money in the first five years, and then 0% after that. Many policies charge more. And of course, the crediting rate is benchmarked to the index return only, not including dividends. So, what returns can you get out of this policy?

Guaranteed Returns

People buy IULs for the guarantees. If they were willing to take on the risk of losing money, they'd just buy index funds. So what minimum return does the company actually guarantee?

Year	Premiums Paid	Cash Value	Return
1	5500	1341	-75.6%
5	27500	21940	-7.44%
10	55000	50671	-1.50%
15	82500	83074	0.09%
20	110000	116739	0.56%
25	137500	154043	0.86%

So, after the first year you have a 76% loss. That's pretty typical for life insurance. That money is paying for insurance but mostly going to the agent who sold it to you as the commission. What is astounding, however, is that it takes 15 years just to break even, on a nominal basis. Even after 25 years you haven't broken even on an inflation-adjusted basis. Heck, you can get that kind of a return out of a high interest bank account even at our historically low interest rates. Basically, the guarantee they're selling ("you can never lose money") isn't worth much at all. Now, I'll be

Why pay more on
medical school
student loans?

Refinance with DRB
to lower your rates.

- Low rates
- Easy application process
- No origination fee
- No prepayment fee

www.drbank.com/student

VIEW RATES



the first to confess that you'll probably do better than the minimum guarantee, but it wouldn't surprise me to see you a heck of a lot closer to minimum guaranteed return than to the return of a good Total Market Index Fund. Let's look at how much better you might do with this policy. The illustration has two other categories, one with a consistent 4% crediting rate and one with a consistent 8.6% crediting rate, both using current insurance charges (which the insurance company is also allowed to change, by the way.) Here's how they stack up over the same time periods.

Possible Returns

4% Crediting Rate

Year	Premiums Paid	Cash Value	Return
1	5500	1472	-73.2%
5	27500	22938	-5.99%
10	55000	50671	-1.50%
15	82500	99345	2.29%
20	110000	153083	3.05%
25	137500	218859	3.41%

All right. I tie my money up for two and a half decades to get a return of about the rate of inflation, and I'm underwater, even on nominal terms after the first decade. Forgive me for not getting excited.

8.6% Crediting Rate

Year	Premiums Paid	Cash Value	Return
1	5500	1712	-68.9%
5	27500	26852	-0.79%

10	55000	71479	4.71%
15	82500	146800	6.91%
20	110000	259954	7.63%
25	137500	432603	7.98%

Now we're getting somewhere. There's no reason someone can't be excited about a 7-8% return. It isn't guaranteed, but it might be all that many people earn on a traditional stock/bond portfolio.

[Amazon.com Widgets](#)

There are a few things we can learn from these two illustrations. First, you still have a negative return for years, even if you get a better crediting rate. With a 4% crediting rate, it's still going to be 12 years to your break even point. With a 8.6% crediting rate, it'll be about 6 years. They say "you can't lose money" but apparently that doesn't include the first 6-15 years. Second, even with the higher 4% crediting rate, you're still only looking at long term returns around the rate of inflation. Even with the maximum rate they're allowed by law to illustrate, 8.6%, your long-term returns are still under 8%. Long-term returns on the Vanguard 500 Index Fund (since inception) are currently 11.05%. The difference in your money growing at 7.98% vs 11.05% over the long run is astounding. If you invested \$100K at 7.98% for 25 years, you'd end up with \$682K. At 11.05%, you'd have \$1.37M, or over twice as much money. That's the price of investing with an insurance company, I suppose.

What Is Your Crediting Rate Likely To Be?

So, as you can see, it really all comes down to what the crediting rate ends up being and how the insurance costs change. Some of this is under the control of the insurance company, since they can reduce the cap and increase the insurance costs at their own discretion. It really requires a great deal of trust in that single company to put any significant portion of your portfolio into one of its

portfolios. Some of your return, of course, relies on market returns. Let's just hypothetically say they leave the cap where it is (a big assumption) and don't change the costs of insurance (another big assumption) and look at what the crediting rate would have been over the last 25 years using their "annual point to point" method (they do offer other methods with various changes in the other terms of the policy) assuming a January 1 anniversary date when all the resetting occurs. Keep in mind that many wise people believe future market returns will not be similar to what we have experienced over the last 25 years.

We'll start in 1989 and go through the end of 2013.

Year	Total Return	Index Return	Crediting Rate
1989	31.69%	27.25%	14.50%
1990	-3.10%	-6.56%	3%
1991	30.47%	26.31%	14.50%
1992	7.62%	4.46%	4.46%
1993	10.08%	7.06%	7.06%
1994	1.32%	-1.54%	3%
1995	37.58%	34.11%	14.50%
1996	22.96%	20.26%	14.50%
1997	33.36%	31.01%	14.50%
1998	28.58%	26.67%	14.50%
1999	21.04%	19.53%	14.50%
2000	-9.10%	-10.14%	3%
2001	-11.89%	-13.04%	3%
2002	-22.10%	-23.37%	3%
2003	28.68%	26.38%	14.50%
2004	10.88%	8.99%	9%
2005	4.91%	3.00%	3%

2006	15.79%	13.62%	13.62%
2007	5.49%	3.55%	3.55%
2008	-37.00%	-38.47%	3%
2009	26.46%	23.49%	14.50%
2010	15.06%	12.64%	12.64%
2011	2.11%	0.00%	3%
2012	16.00%	13.29%	13.29%
2013	29.60%	32.39%	14.50%

So, you can see that even with the relatively high cap rate of 14.5%, you would be capped out in 10 years, or 40% of the time. If that cap were decreased to say, 9%, that would increase to 13 years, or over half the time and if it decreased to the guaranteed minimum of 4%, that would occur in 16 of 25 years. The minimum 3% floor kicked in 8 times, or nearly 1/3 of the time. Over this time period, the annualized (geometric, not arithmetic) return of the S&P 500 Index fund would be about 9.04%. The average crediting rate over this time period for this policy (which didn't exist in 1989, by the way) would have been 9.17%, slightly HIGHER than the return of the S&P 500 Index Fund. But remember the crediting rate IS NOT your return, especially in the first decade or two, because of the costs of the insurance and fees.

So what would your return be if your average crediting rate were 9.17% for 25 years? If the insurance costs stayed the same, it would be slightly higher than the 8.6% scale illustrated above. You'd break even around 5-6 years, be approaching 5% returns at 10 years, and have returns of over 8% at 25 years. Any objective observer has got to admit that while that doesn't look particularly attractive in the short term, it is pretty good in the long run (although still significantly less than you could have made just buying an index fund instead.) But always remember the assumptions. We're assuming you're healthy and easily insured, that the

insurance company doesn't raise the cost of the insurance and that the insurance company doesn't lower the cap rate. Also bear in mind that this is a pretty good policy, and far better than many I've seen out there. When you buy a policy like this, you're making a bet that requires a lifetime of trust in the insurance company NOT to change the deal, because the guaranteed returns are terrible.

Of course, there is also the issue of the fact that even without ever giving you a negative crediting rate, the insurance policy still underperformed an index fund by 1% a year. At \$5500 per year, an additional 1% of return each year adds up to having a 17% larger portfolio (\$508K vs \$434K) after 25 years. (Yes, it would be a little less after tax, but a broad market index fund is awfully tax-efficient and taxes shouldn't add up to 1% of return.) So even one of the best IULs out there, with some rather generous assumptions and covering a period of time including some of the greatest bull markets in history and some terrible bears, still lags behind an index fund.

As you can see, your short term money doesn't belong in an insurance contract since you will have a negative return. Your long-term money is also likely to do worse in an insurance contract than in riskier assets. So the reader is left with the question, "What money DOES belong in an insurance contract?" None of mine, that's for sure (and that's ignoring the fact that my insurance cost would be far higher than this policy illustrates.)

What do you think? Were you surprised that the potential returns could be as high as this illustration and my example show? Do you own an IUL? Are you happy with it? Why or why not? Comment below!