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White paper

# The position of life insurance in financial diversification

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## The importance of a diversified portfolio

Two-thousand-five-hundred years ago the ancient Greek philosopher Heraclitus noted that the only permanence in the world is change itself. The same holds true today and this same philosophy drives modern portfolio theory. The proponents of modern portfolio theory hold that a diversified portfolio is an important feature of a client's financial strategy if they are to succeed in growing and protecting their financial well being over the long term. While modern portfolio theory usually is used in discussing diversification between different kinds of investments such as stocks and bonds, it is also important to consider other alternative investment types, including both guaranteed investments which provide safety of principal, and non-guaranteed investments that may provide the opportunity for gain (or loss). In any case, building diversity into a portfolio may help:

- Accommodate a variety of the client's needs both currently and in the future
- Provide a hedge against volatility
- Supply a guaranteed lifetime income through living benefits
- Create a hedge against inflation
- Safeguard and provide an inheritance

## The value of life insurance in a portfolio

Life insurance represents a future value in a portfolio to the extent that it is comprised of money that will be collected down the road. The especially good news is that it is a self-completing plan in that as long as the policy owner meets their premium obligations the insurance company will pay the death benefit. Some of the uses of life insurance include:

- Family financial protection to replace lost income if a bread winner dies
- Mortgage protection to pay off a mortgage if a homeowner dies
- Estate planning needs including estate liquidity and estate equalization
- Business succession planning needs such as key person coverage, golden handcuffs and the funding of business buy and sell agreements

## Calculating the rate of return

One advantage to using life insurance as part of a portfolio is the income tax free death benefit it provides to the insured's loved ones. Once an insured dies and the death benefit is collected the rate of return can be determined on the premium dollars that had been paid to the insurer. (It is important to note that without a death, no rate of return can materialize on life insurance but can occur on alternative investments without a death.) That rate of return or "IRR" is what the cumulative premiums paid thus far would have to earn to equal the amount represented by the death benefit in a given year of death.

When looking at rates of return it is important to understand the difference between a tax-free rate of return and a taxable equivalent rate of return. A taxable equivalent is the rate of return a person would have to earn in order to have in pocket, after taxes, the same amount of money a tax-free investment would return. The formula for making this calculation is, tax-free

**Tax-free Rate of Return**
**÷**
**(100 - income tax rate)**
**=**
**Taxable Equivalent Rate of Return**

rate of return divided by 100 minus the income tax rate equals the taxable equivalent rate of return (*see graphic on left*).

Life expectancy also plays into the calculation in that the internal rate of return on the death benefit will be higher in the early years of the policy, but will decrease with time due to the additional premium being paid while the death benefit generally remains the same. The client may want to consider what the rate of return and tax-equivalent rate of return would be at their life expectancy as a good measuring point for the suitability of any life insurance proposal.

Take for instance the hypothetical example of Joe. He is 45-years-old and in good health. He has maxed out his qualified plans and is looking for a place to invest an additional $12,000 per year until his planned retirement at age 65. Joe wants to make sure his family is protected if he were to die prematurely, but he also wants an investment he could potentially access for supplemental retirement. He could purchase a life insurance policy as part of his overall portfolio in order to meet both goals.

| Policy Year | Age | Total Premiums Paid | Cash Surrender Value | IRR on Surrender Value | Death Benefit | IRR on Death Benefit | Pre-tax Equivalent on DB |
|---|---|---|---|---|---|---|---|
| 1 | 46 | $12,000 | $2,478 | -79.35% | $312,484 | 2,504.03% | 3,577.19% |
| 5 | 50 | $60,000 | $47,764 | -7.51% | $356,015 | 66.69% | 95.27% |
| 10 | 55 | $120,000 | $122,829 | 0.42% | $426,693 | 22.29% | 31.85% |
| 15 | 60 | $180,000 | $222,854 | 2.63% | $525,840 | 12.54% | 17.91% |
| 20 | 65 | $240,000 | $355,004 | 3.59% | $657,990 | 8.86% | 12.66% |
| 34 | 79 | $240,000 | $784,338 | 4.80% | $823,554 | 4.99% | 9.00% |
| 40 | 85 | $240,000 | $1,105,068 | 5.00% | $1,160,321 | 5.16% | 7.02% |

Life expectancy age 79

*Nationwide YourLife Indexed Accumulator, Male age 45 Preferred Non-Tobacco, $12,000 annual premium for 20 years, Option 2 increasing death benefit years 1-20, Option 1 level death benefit years 21-120, minimum non-MEC death benefit, 1 Year High-Cap S&P 500, 6% crediting rate, Assumes 30% tax bracket for taxable equivalent*

# Additional tax advantages of life insurance

In addition to the death benefits offered by life insurance, there are also unique tax advantages for insurance products designed to allow for cash accumulation in conjunction with death benefit protection. In cases where the policy accumulates cash, these values grow tax deferred inside the policy. Further, those values can be accessed tax free through withdrawals and loans.[1]

This added benefit of cash accumulation and income tax free withdrawals can make life insurance not only an important tool for protection from premature death, but it can further diversify a portfolio and, most importantly, disbursements from a portfolio when income is needed most.

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[1] This information assumes that the life insurance is not a modified endowment contract, or MEC. As long as the contract meets the non-MEC definitions of IRC Section 7702A, most distributions are taxed on a first in/first-out basis. Surrender charges may apply to partial surrenders. Loans and partial surrenders from a MEC will generally be taxable, and if taken prior to age 59 ½, may be subject to a 10% tax penalty. Loans and partial surrenders will reduce the cash value and the death benefits payable to your beneficiaries, and withdrawals above the available free amount will incur surrender charges. If your contract were to lapse with a loan outstanding, the loan amount in excess of basis will be treated as a distribution and all or a portion will be subject to income tax.