

# \$3 Trillion in Neglected Wealth: Proactive Management of Insurance Assets



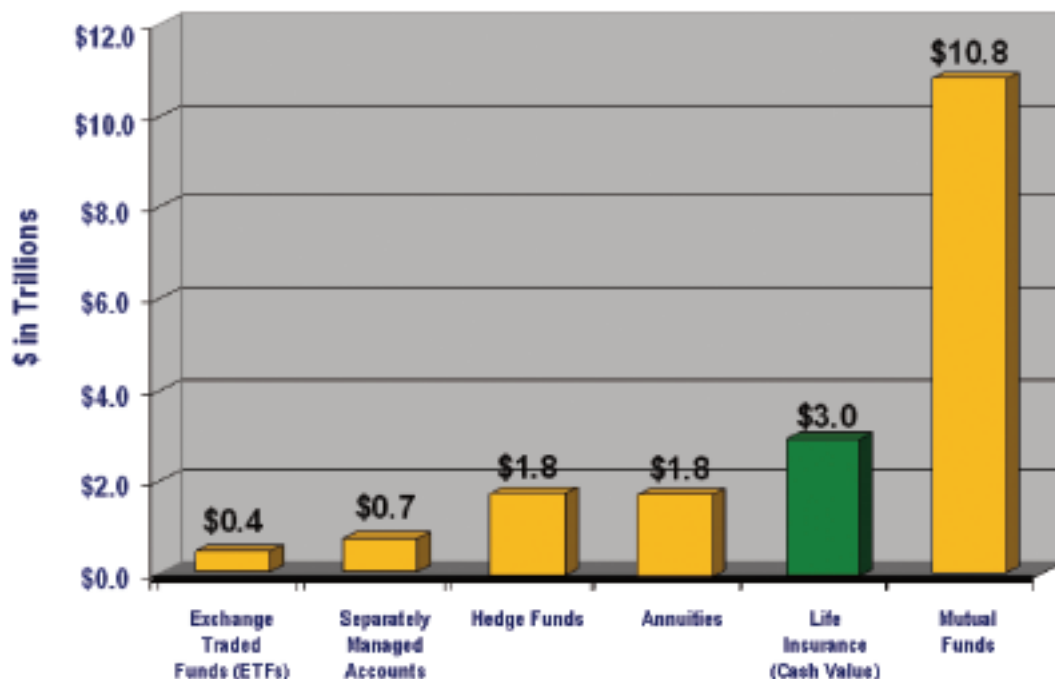
By Barry Flagg

## The Case for Life Insurance Portfolio Management

The wealth management business is poised to add another component of wealth to the management process – the \$3 Trillion in life insurance policy cash values. To put the magnitude of this component into perspective, the amount of money in life insurance policy accounts is more than that in Hedge Funds, Separately-Managed Accounts and Exchange-Traded Funds combined, and equates to almost one-third of the massive \$11 trillion mutual fund industry<sup>1</sup>.

However, as big as the investment *management* business is today, before ERISA was enacted in 1974, it was but a fraction of its current size and investments were generally *not* managed. Instead, investment

### Assets Under Management by Type





products were generally sold by “manufacturer’s reps” serving the needs of the product manufacturers and investment advice was generally “bundled” with and incidental to the sale of the product, after which there was little ongoing advice for the management of that investment.

For instance, while it now seems difficult to imagine the securities business *without investment management*, one of the industry’s largest asset managers – Merrill Lynch Asset Management (MLAM) – was not even formed until 1976<sup>2</sup>. Investment sales were also often based on *hypothetical* projections of some future performance instead of empirical research as to costs and performance (*e.g.*, tax shelters) and “Investment Contracts” paid commissions on deposits (in some cases as much as 50% and more) rather than assets-under-management (AUM) fees.

Before ERISA, investments were generally sold and not able to be purchased, mutual fund sales were generally flat and *half* that of life insurance sales, and the investment business operated much like the life insurance industry of today. Then ERISA provided a “rules-set” that a substantial portion of the investment industry (*i.e.*, Qualified Retirement Plans) had to follow. These rules include 1) the duty to monitor holdings; 2) the duty to investigate the suitability of holdings; and 3) the duty to manage holdings as a “prudent man” would to minimize costs and maximize benefits relative to risk.

In the years following ERISA, third-party administrations (TPAs) developed record-keeping systems to support this duty to monitor. Research providers began publishing pricing and performance data to support the duty to investigate. As information about both current and alternative holdings became increasingly available, the ability to use this information to manage investment holdings became possible, and more and more practitioners got into the investment *management* business, including those financial services businesses not previously in the investment business.

Such ready access to information about current holdings and their suitability relative to peer-group products also lead to regulators and litigators enforcing this standard-of-care. For instance, where as there was comparatively little litigation in the investment business before ERISA, Qualified Plan Trustees were the popular target of litigation involving breach of the duties prescribed by ERISA in the late 1980s and early 1990s. As such, ERISA set into motion three market forces:

- 1) Third-Party Administrators (TPAs) providing information about current holdings;
- 2) Research firms publishing suitability information relative to peer-group products; and
- 3) Regulators and litigators using #1 and #2 to enforce the rules prescribed by ERISA.

The combined effect of these three forces transformed the investment industry from a product-centered, “manufacturers’ rep” business into a client-focused, assets-under-management business in which more and different types of advisors entered the investment business. At this same time, the Baby Boom Generation was moving into its peak earnings and savings years, substantially increasing the demand for investment products, management and advice.

Between the increased supply of investment information, the increased number of investment advisors and investment products, and the increasing demand for such products and services, sales of investment products exploded. Where mutual fund sales were flat before ERISA, they have since increased 800-fold and now total almost \$11 trillion and continue to grow<sup>3</sup>.

## **We Have Been Here Before and Are Going “Back to the Future”**

In that the life insurance industry of today so closely resembles the pre-ERISA investment business, study of parallels between the life insurance business of today and the evolution of the investment business since ERISA offers insights as to the future of the life insurance business. For instance, just as ERISA provided a “rules-set” that a substantial portion of the investment industry had to follow, the Uniform Prudent Investor Act (UPIA) similarly provides a “rules-set” that a substantial portion of the life insurance industry (*i.e.*, Irrevocable Life Insurance Trusts) also must follow.



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These rules under UPIA have now been adopted by 46 states/territories and similarly include 1) the duty to monitor holdings; 2) the duty to investigate the suitability of holdings; and 3) the duty to manage holdings as a “prudent investor” would to minimize costs and maximize benefits relative to risk. And in a repeat of events following ERISA, third-party administrators (TPAs) arrived on the scene roughly coincident following the adoption of UPIA in 1994 (*e.g.*, TrustBuilder in 1992, Resource Insurance Consultants in 2000 and Investment Scorecard originally founded as Advicon in 2003).

Then, again in parallel fashion, life insurance product research became available some years after TPAs were well established (*e.g.*, TheInsuranceAdvisor.COM was granted a patent on its life insurance pricing algorithms and research database in 2002) and TPAs who initially targeted institutional trustees began expanding to serve other advisors (*e.g.*, Investment Scorecard launched Insurance Trust Monitor to serve the needs of individual advisors and private trustees).

As such, at least these two of the above same three market forces that shaped the investment *management* business are now in play in the life insurance business. Recent lawsuits against irrevocable life insurance trust (ILIT) trustees (*e.g.*, *Micale v. Bank One N.A.* and *Cochran v. Key Bank*) and involving breach of fiduciary duty in the management of life insurance assets (*e.g.*, *Vagelos v. Merrill Lynch* and *Larry King v. Meltzer Financial*) also suggest that litigators expect adherence to the rules under UPIA.

In other words, we have been here before and certainly appear to be headed back to the future where UPIA has set into motion these same three market forces in the life insurance business as to:

- 1) Third-Party Administrators (TPAs) providing information about current holdings;
- 2) Research firms publishing suitability information relative to peer-group products; and
- 3) Regulators and litigators using #1 and #2 to enforce the rules prescribed by ERISA.

In another parallel, the Baby Boom Generation is now also on the verge of impacting the life insurance business the way it previously and profoundly influenced the investment business. As Boomers move out through the retirement years and into wealth-transfer years, the population over age 65 will likely double between 2010 and 2030 as a percentage of total population<sup>4</sup>, and they are expected to transfer more wealth than ever before<sup>5</sup>.

Given the unique utility of life insurance for financing estate taxes, or for setting up an endowment for preservation and maintenance of family assets, or as a hedge against risks inherent in certain investments, or to balance an estate between family members, all signs point toward substantial growth in both the demand for and the supply of life insurance portfolio management services. While life insurance agents/brokers have been heard to say “life insurance cannot be purchased, it must be sold”, this too seems to be changing.

According to Life Insurance Marketing and Research Association (LIMRA) and the latest IRS Statistics of Income Bulletin, 56% of married couples with children under 18 believe they need additional insurance and 43% say they are likely to buy life insurance in the next year” *without having to be sold on the idea*. In addition, these same statistics indicate that 80% of married parents are *not* getting, but desire to “periodically to review the terms, provisions, and options of current life insurance policies.”

The combined impact of these above three market forces and the Baby Boom Generation certainly suggests the life insurance business is evolving from its product-centered, “manufacturers’ rep” roots towards a client-focused, assets-under-management business in which more and different types of advisors will enter. And while competition is fierce in the investment management business and there is constant pressure on margins, few advisors actually *manage* life insurance portfolio holdings to minimize costs, maximize benefits, and ensure they remain consistent with the intended planning objective.

Herein lies the opportunity.



## A \$3 Trillion Asset Market in Desperate Need of Management

There is *no* segment of the financial services industry where so many owners and their advisors know so little about A) what they are being charged or B) what they are earning. In fact, findings from three data sets: 1) a Tillinghast Towers Perrin study<sup>6</sup>; 2) a third-party administrator (TPA) survey of trust-owned life insurance (TOLI) policy holdings<sup>7</sup>; and 3) research from TheInsuranceAdvisor.COM database, all indicate the disparity between best-available rates and terms and poorly-priced products is as much as 40%. In other words, because so few know what they/their clients are actually being charged, some clients are being over-charged by as much as 40%.

In addition, because there is no requirement that the policy interest/earnings assumption in life insurance sales illustrations in any way relate to actual historical performance for invested assets underlying policy cash values, these sales illustrations of *hypothetical* projected policy values often reflect unrealistic and unsustainable interest/earnings assumptions. For instance, universal life (UL) policies were often sold in the 1980s using *hypothetical* sales illustrations based on unrealistic interest rate assumptions. Variable life (VL) policies were again sold in the 1990s using *hypothetical* sales illustrations again based on unrealistic earnings rate assumptions.

For these reasons, TPAs are reporting that as many as one-quarter to one-third of all life insurance policies in their record-keeping systems are in danger of lapsing without value and without paying a claim even though all scheduled premiums have been paid. In other words, whether because a client is being over-charged or has a policy in danger of lapsing, as many as one out of ever three or four of clients have policy holdings in their life insurance portfolio that are in desperate in need of management.

## The Prudent Investor Act and Life Insurance Portfolio Management

With \$3 trillion in assets sorely in the need of management, tell-tale signs pointing towards growth, and little if any competition (at the moment), the market for life insurance portfolio management services is already emerging. Fortunately, managing a portfolio of life insurance policy holdings under UPIA is little different than the way portfolios of investment holdings have been managed for years. Both are comprised of certain expenses and some expectation as to investment performance.

As such, the objectives in managing a portfolio of life insurance policy holdings under UPIA are the same as that for managing a portfolios of investment holdings, namely; A) to justify expenses and B) to set reasonable expectations as to the rate of return on invested assets underlying policy cash values. These life insurance portfolio management objectives are achieved by following the three basic steps prescribed by UPIA, namely:

- 1) Understand and monitor the pricing and performance of existing policy holdings;
- 2) Investigate the suitability of policy holdings relative to both industry benchmarks and peer-group product alternatives; and
- 3) Use the information from #1 and #2 to manage the portfolio as a “prudent man” would to demonstrably minimize costs and maximize benefits relative to risk.

Expenses in a life insurance policy are comprised of the cost of insurance charges (COIs), fixed administration expenses (FAEs), cash-value-based “wrap fees” (*e.g.*, M&Es) and premium loads. The premium is *not* the “expense” of a life insurance policy (unless a term life policy or otherwise fully-guaranteed product) any more than the \$2,000 contribution to an Individual Retirement Account is the cost of the IRA. In both cases, the costs are those charges deducted from the IRA contribution and/or the life insurance premium.

Determining the reasonableness of expected rates of return on life insurance policy holdings can be accomplished the same way as for other investments. First, examine actual historical performance for invested assets underlying policy cash values. Then calculate the range of returns expected from the asset allocation of invested assets underlying policy cash values. Finally, compute a range of possible outcomes using Monte Carlo simulations.



While there may be other means of setting reasonable expectations as to future performance, the use of insurance company illustrations of *hypothetical* future policy values is *not* one of them. Because there is no requirement that policy interest/earnings assumptions reflected in these sales illustrations relate in any way to actual historical performance for invested assets underlying policy cash values, these sales illustrations simply do not in and of themselves provide reasonable expectations of future performance.

In addition, because insurers can change and increase policy expenses in their sole discretion and without notice to the policy owner (unless guaranteed as in term life or universal life with secondary death benefit guarantees), these sales illustrations do not help establish reasonable expectations of future performance in and of themselves. For these reasons and others, these illustrations were proven unreliable in various successful lawsuits against insurance companies in the late 1980s and early 1990s.

While prevailing sales practices involve the use of these illustrations, and while agents/brokers often use them to compare some limited number of products to supposedly determine suitability, the prevalence of their use as a sales tool does not make them a useful tool for determining suitability. In fact, the Financial Industry Regulatory Authority (FINRA – formally known as the National Association of Securities Dealers or NASD) prohibits comparison of these illustrations because such comparisons are misleading (see FINRA Rule 2210 Communications with the Public, Section (d)(1)(A), IM-2210-1 Guidelines to Ensure That Communications With the Public Are Not Misleading, and IM-2210-2 Communications with the Public About Variable Life Insurance).

Instead, the suitability of any life insurance policy holding is best determined the same way wealth managers have determined suitability investment products for years, and in the manner prescribed by UPIA, namely;

- A) Examine and justify the insurers' representations about policy expenses, and then separately ...
- B) Determine the rate of return that is reasonable to expect for the given asset allocation and then examine actual historical performance relative to that expectation.

## That Which Is To Be Managed Must First Be Measured

Anything that is to be managed must first be measured. To manage an investment portfolio, the performance of that portfolio must first be measured to identify portfolio strengths and opportunities for improvement. Similarly, to manage a portfolio of life insurance policy holdings (even if just one), the characteristics of that portfolio/policy must first be measured so as to identify portfolio strengths and opportunities for improvement.

Measuring differs from comparing in that measuring involves “ascertaining the dimensions, quantity, or capacity *as ascertained by comparison with a standard*”<sup>8</sup> whereas comparing is “to examine (two or more objects, ideas, people, etc.) in order to note similarities and differences”<sup>9</sup>. In other words, comparing some limited number of options tells us the similarities and differences between only those limited number of choices, and in no way reveals how good or how bad those choices may be relative to the entire universe of options.

On the other hand, measuring reveals both specific strengths and weaknesses as well as the magnitude of those strengths and weaknesses on the continuum for the entire universe of options relative to a generally-accepted standard. Of course, the generally-accepted standard for ILITs is UPIA, and while agents, brokers and consultants may have their own proprietary methods for comparing products and determining suitability, UPIA principles require that we justify policy expenses (*i.e.*, UPIA Section 7) and set reasonable expectations as to the rate of return on invested assets underlying TOLI cash values (*i.e.*, UPIA Section 2(c)(5)).

While we discussed above why illustrations of hypothetical policy values are useless in and of themselves for determining suitability and how such comparisons are “outlawed” by FINRA, these illustrations do include the insurer's representation as to expected future policy expenses. As such, these illustrations do provide useful information essential to measuring and justifying policy expenses as prescribed under Section 7



of UPIA (although detailed accounting of expected future policy expenses may need to be specifically requested from the insurer).

Measuring such policy expenses against industry benchmarks for cost of insurance charges (COIs), fixed administration expenses (FAEs), cash-value-based “wrap fees” (e.g., M&Es) and premium loads can reveal just how well or poorly a particular product is priced for a given client situation. Products offering lower expenses are more suitable than products charging higher expenses, unless there are other reasons that justify higher expenses, such as degree of financial strength and claims-paying ratings, more stable pricing and/or greater access to policy account values.

Similarly, measuring historical performance of invested assets underlying policy cash values against industry benchmarks reveals how well or poorly a product is likely to perform relative to both corresponding asset class indexes and peer-group alternatives. While past performance is no guarantee of future results, it is certainly a reasonable and even essential consideration in determining suitability of a life insurance policy holding to a given client situation (just as historical performance is considered when determining suitability of investments in an investment portfolio).

UPIA also provides that no single factor is the sole determinate of suitability. Instead, suitability involves consideration and measurement of the various characteristics of the given policy holdings relative to the objectives of the portfolio including (but perhaps not limited to):

- 1) Financial Strength and Claims-Paying Ability of the Insurer (i.e., default risk)
- 2) Cost-Competitiveness
- 3) Pricing Stability
- 4) Cash Value Liquidity
- 5) Historical Performance of invested assets underlying policy cash values.

## **If You Don't Know Where You are Going, You'll Probably End Up Somewhere Else**

As discussed earlier, the life insurance business has been traveling down the same road that took the investment business from its product-centered, “manufacturers’ rep” roots to the more client-focused, assets-under-management business of today. However, the investment business is two or three decades ahead of the life insurance business in this journey.

As such, prevailing sales practices in the life insurance business are simply not yet consistent with the more evolved fiduciary principals employed in managing most every other type of asset. For this reason, wealth managers sometimes conclude that “life insurance is different” and thus delegate matters involving life insurance to some “life insurance expert”, often without oversight.

However, by delegating life insurance matters to a “life insurance expert” who understands life insurance sales practices, but who does not adhere to basic financial management principals for justifying expenses and setting reasonable rate of return expectations, wealth managers place themselves at a disadvantage by risking the disappointment of their clients and disappointment in investment results; losing the opportunity to actually manage policy holdings to ensure desired results are achieved; and losing the opportunity to charge fees for such management services.

Whether a wealth manager delegates certain life insurance functions to a life insurance specialist or not, the wealth manager should have an overall process for selecting, trading/exchanging and/or managing life insurance policy holdings which embodies the principals of financial management to which all other components of wealth are subjected. For example, let's walk through the steps that wealth managers should, at a minimum, take using an actual portfolio comprised of two joint-survivor universal life (JSUL) holdings with \$300,000 in account values and \$5.0M in death benefits insuring the lives of a 69 year old male in average

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health and a 60 year old female in excellent health (*i.e.*, a 20+ year life expectancy) neither of whom use tobacco in any form, as follows:

**Determine the Life Insurance Portfolio Objective** – Because all life insurance products are *not* created equal, and in today's market are in fact designed very differently for different portfolio objectives, it is important to first determine the objective of the life insurance portfolio. For instance, products with low COIs and FAEs are most suitable for defined-death-benefit, minimum-premium portfolios intended to finance a defined estate tax liability, which is the case for our M69/F60 couple. On the other hand, products with low premium loads and/or low cash-value-based “wrap fees” are most suitable for defined-contribution, maximum-accumulation objectives like “wrapping” life insurance around a defined amount of otherwise taxable investments to shelter gains from income taxes. Portfolio objectives can also change, in which case changes to portfolio holdings may be appropriate through either an exchange of one policy type for another, or the sale of certain holdings on the life settlement secondary market, or termination of certain policy holdings altogether.

**Investment Plan** – This Investment Plan should be drafted in a manner similar to that for any other investment, including identifying the portfolio objective, the time horizon, the funding plan/budget, and the investor temperament. For instance, our M69/F60 couple considers themselves (and were tested by a Risk Profile Questionnaire) to be moderate-risk investors (particularly given the 20+ year time horizon) and planned to pay premiums for 5 - 10 years after which cash values and interest/earnings thereon were to be sufficient to pay all future policy expenses and permanently maintain the \$4.5M death benefits to pay anticipated estate taxes. While prevailing life insurance sales practices typically start with a given product and work backwards to justify suitability (like in the case of these JSUL products placed when interest rates were high and illustrations of hypothetical policy values looked appealing), it is the Investment Plan that determines the appropriate asset allocation. The Plan then assists in determining a reasonable rate of return to expect, which in turn determines product selection. By drafting an appropriate investment plan and maintaining it, a wealth manager greatly reduces the risk that his/her performance will be viewed in hindsight and creates the opportunity to charge fees for the value created by this proactive management process.

**Measure Strengths, Weaknesses & Opportunities for Improvement** – Once the portfolio objective is defined and the investment plan is established, the suitability of existing or proposed life insurance products can and should be measured against those objectives and against that plan. For instance, the characteristics of existing policy holdings for our M69/F60 couple were as follows:

- 1) **Financial Strength and Claims-Paying Ability** – Both insurers of existing holdings are ranked in the top-decile of all insurers and this is thus considered a strength of these holdings.
- 2) **Cost-Competitiveness** – Policy expenses in existing holdings are roughly equal to industry benchmarks (as shown in the next section below) and thus present an opportunity for improvement.
- 3) **Pricing Stability** – Because the premium payment plan was originally calculated using interest rates that proved unsustainable, current policies are under-funded and in jeopardy of lapsing (also shown in the next section below).
- 4) **Cash Value Liquidity** – Current portfolio holdings were placed almost 10 years ago and as such there are few restrictions on access to cash values which is a strength.
- 5) **Historical Performance** – Invested assets underlying the cash values of existing holdings underperformed both their peer-group and the asset-class benchmarks for the asset allocation appropriate to the client's investor temperament.



<b>Asset Allocation &amp; Expected Rate of Return</b>	<b>Inforce Holdings Conservative @ 5.55%</b>	<b>Benchmark<sup>10</sup> Averages @ 5.55%</b>	<b>"Best of Breed"<sup>11</sup> Moderate @ 8.00%</b>
<b>Financial Strength/Claims-Paying Ability Ranking</b>	Top 7%	N/A	Top 3%
<b>Total Weighted-Average Annualized Costs<sup>12</sup></b>	<b>\$70,370</b>	<b>\$69,981</b>	<b>\$39,770</b>
• Cost of Insurance (COI) Charges	\$60,068	\$5,320	\$893
• Fixed Administration Expenses (FAEs)	\$5,160	\$5,320	\$893
• Cash-Value-Based "Wrap Fees" (e.g., M&Es)	0bps	0bps	87bps
• Premium Loads	10.00%	8.50%	7.05%
<b>Coverage Duration without Add'l Premium<sup>13</sup></b>			
• Guaranteed Minimum Duration of Coverage	10 years		16 years
• <u>Expected</u> Duration of Coverage	18 years		28 years
• Earliest Expected Lapse/Premium Call	13 years		19 years
• Probability of Death Benefit Maturity	0%		17%
<b>Cash-Value Liquidity Ratio</b>	<b>100%</b>		<b>92%</b>
<b>Historical Performance</b> .....Average	<b>5.21%</b>		<b>9.55%</b>
Minimum	<b>4.00%</b>		<b>-15.59%</b>
Maximum			<b>34.69%</b>

**Investigate Best-Available Rates and Terms** – Below is an example Rates & Terms Sheet for our M69/F60 couple showing A) the characteristics of current portfolio holdings, B) representative benchmark averages<sup>10</sup> for peer-group products, and C) a database search for best-available rates and terms which are most consistent with portfolio objectives and the investment plan:

By investigating rates and terms as they relate to the specific strengths and weaknesses of current portfolio holdings, we can begin to see the management possibilities for maintaining portfolio strengths as to financial strength and claims-paying ability and cash value liquidity while also addressing portfolio weaknesses by reducing portfolio expenses, improving pricing stability, and increasing the rate of return that is reasonable to expect on invested assets underlying policy cash values.

**Manage Portfolio Holdings to Minimize Costs & Maximize Benefits Relative to Risk** – Managing any portfolio of assets involves justifying portfolio expenses, maximizing performance/benefits relative to acceptable risk, and ensuring that portfolio objectives are achieved. In portfolios of life insurance, this generally means ensuring that planned premiums and corresponding cash values are adequate to pay future and generally increasing policy expenses (*e.g.*, in much the same way as the manager of a target-benefit retirement plan measures current plan status against the present value of future benefit costs). This is accomplished by periodically measuring actual portfolio cash values against cash value targets from the original illustration of hypothetical policy values and considering five activities or portfolio management options (PMOs), as follows:

1. **Change Premiums** – When planned premiums and cash values are more than necessary to cover expected future policy expenses, a policy is considered over-funded and premiums can be reduced or refunded to the extent of such over-funding. Conversely, when a policy is under-funded, the wealth manager should consider increasing planned premiums to thereby increase cash values to cover expected future policy expenses, which in the case of our M69/F60 couple would require additional annual premiums of roughly \$55,000.
2. **Change Death Benefits** – Should a client need more life insurance, death benefits can generally be increased in over-funded policies without additional premiums, and should therefore be considered,



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but will generally require medical and financial qualification to do so. On the other hand, wealth managers should consider reducing policy benefits in under-funded policies in order to reduce policy expenses to amounts supportable by currently planned annual premium and existing cash values, which in the case of our M69/F60 couple would require a death benefit reduction of approximately \$2,000,000.

3. **Change Cash Value Investment Allocations** – To the extent that changing the asset allocation for a given policy holding is appropriate, the wealth manager should re-evaluate the allocation of invested assets underlying policy cash values (which may also involve a change of the policy itself and require grantor cooperation to do so). For instance, a more aggressive allocation among asset classes with greater historical rates of return should be considered to make up for under-funding albeit with greater statistical volatility, which in the case of our M69/F60 couple would require a very aggressive asset allocation in an attempt to achieve a near 12% rate of return. On the other hand, a more conservative asset allocation should be considered in an over-funded portfolio to reduce portfolio risk while maintaining adequate funding with a lower historical rate of return.
4. **Sell, Buy or Exchange Policies** – In the same way portfolio managers sell investments that are no longer suitable, wealth managers should consider either a) exchanging less suitable life insurance policy holdings in favor of more suitable products offering rates and terms more consistent with planning objectives; b) borrowing from policy cash values and reinvesting proceeds in a manner that enhances benefits; or c) trading less suitable life insurance policy holdings by selling existing holdings on the secondary market for a profit that is greater than the cost to repurchase a new policy with the same or greater benefits on the open market<sup>14</sup>, all of which generally require grantor cooperation and medical and financial qualification. In the case of our M69/F60 couple, an exchange of current policy holdings could reduce policy expenses by approximately 40% and potentially increase the rate of return that is reasonable to expect on invested assets underlying policy cash values. Together these steps reduce the degree to which the portfolio is under-funded, improves pricing stability to extend the duration of coverage without additional premium, and reduces to \$17,500 (down from \$55,000) the amount of additional premiums needed to mature policy death benefits as permanent.
5. **Wait-and-See** – If policy cash values are slightly above or below targets, or if investment performance is within expected ranges and policy expenses are justified, or if cash values and planned premiums are sufficient to support projected expenses for the foreseeable future, then a deliberate “wait and see” approach can be considered. In the case of our M69/F60 couple, current policy holdings were not in immediate danger of lapse as coverage was guaranteed for another 10 years and expected to continue for at least another 13 years (as determined using Monte Carlo Simulations). As such, a wait-and-see approach could be considered over the short-term so long as policy holdings continue to be monitored and the client is kept informed as to these PMOs.

### **Ideas Are a Dime A Dozen - People Who Put Them Into Practice Are Priceless**

A substantial number of UL and VL policies sold in the 1980s and 1990s are under-performing original “as sold” hypothetical projections and are now in need of attention to prevent lapsing without value and without paying a claim. New products are available that are priced based on updated mortality tables and offering lower pricing than older products based on older mortality tables. However, few sales persons embrace the above-described *process* of life insurance portfolio management. Herein lays the opportunity for the wealth manager to put proactive life insurance portfolio management into practice.

With the advent of third-party administrators (TPAs) who provide standardized policy record-keeping, administration and monitoring services, and life insurance product research providers who publish standardized pricing, performance and suitability data, the inner workings of the life insurance products are no longer



the exclusive domain of the life insurance agent/broker. The wealth manager can now apply the same management principals to the client's life insurance policy holdings as they have applied to other components of wealth all along. And because the value to the client is in this process, wealth managers can charge fees for this value in the same way assets-under-management (AUM) fees are charged for the management of investment portfolios.

For instance, in our example M69/F60 couple, revisions made as a result of the proactive management process reduced portfolio expenses by 43% and increased the rate of return that is reasonable to expect on cash values investments. Together these reduced the required premium by over \$37,000 *annually* while increasing the probability that portfolio objectives would be achieved. So while it may have been difficult to see how a AUM fees could be charged for the management of life insurance policy holdings under the old paradigm, most clients would pay a 1.0% (or more) AUM fee (*i.e.*, approximately \$3,000 in recurring and increasing fee income from our M69/F60 couple) for portfolio management services that produce value greater than the fee (*i.e.*, \$37,000+ annually) in the same way and for the same reasons clients readily pay AUM fees for investment management services.

All in all, life insurance portfolio management is likely the largest wealth management opportunity in three decades. With \$3 trillion in assets for which few clients or advisors know what they are being charged or what they are getting in investment performance, and which are generally under-served by traditional life insurance agents/brokers holding on to outdated sales practices, life insurance policy holdings are in desperate need of management. And with at least two of the three market forces that transformed the investment business from product-centered, "manufacturers' rep" roots to a client-focused, assets-under-management business now also in play in the life insurance business, wealth managers should seriously consider applying familiar and proven financial management principals to expand their services and fee opportunities to now include this large component of wealth that has thus far been left behind.

## Footnotes

1 Source: Tiburon CEO Summit XII - Keynote Presentation Highlights 5/11/2007; 3/05 ICI web site; 7/19/04 Barron's; 4/04 Research (MMI); 12/15/06 Investment News (Ceruli); 7/03 Ticker; 5/27/02 Merrill Lynch Presentation (Cerili) (Doe); 10/014 Investment Consulting News; 7/13/01 Ceruli Presentation (Strategic Inshight) (Ceruli); 7/11/01 RunMoney Conversation (Jorgensen); 7/2/01;

2 Merrill Lynch web site About Us > Company Overview > Our History: "1976 - Merrill Lynch Asset Management (MLAM) is created as an integral business unit in the Merrill Lynch family" <[http://www.ml.com/?id=7695\\_8134\\_8296\\_14044\\_14072](http://www.ml.com/?id=7695_8134_8296_14044_14072)> and "1997 - Merrill Lynch becomes the first financial services company to surpass \$1 trillion in client assets under management" <[http://www.ml.com/?id=7695\\_8134\\_8296\\_14044\\_14074](http://www.ml.com/?id=7695_8134_8296_14044_14074)> as at October 1, 2007.

3 Source: 2007 Investment Company Fact Book – 47th Edition by the Investment Company Institute [www.icifactbook.org](http://www.icifactbook.org).

4 Source: U.S. Census, 2000

5 Ken Dychtwald Ph.D., President & CEO, Age Wave in "Financial Wake-Up Call: The Future of Financial Services" Keynote Presentation at National Financial Partners 2007 Fall Sales & Strategy Summit.

6 Tillinghast Towers Perrin study referenced in the May 2003 issue of Trusts and Estates.

7 CASCO survey reported in the April 1999 issue of Trusts & Estates magazine both indicate that trust-owned life insurance (TOLI) death benefits can be increased by 40% or more, or that premiums can be reduced by 40% or more in 65% to 85% of single-life and survivorship trust-owned policies respectively.

8 "measure." *The American Heritage® Dictionary of the English Language, Fourth Edition*. Houghton Mifflin Company, 2004. 20 Sep. 2007. <[Dictionary.com http://dictionary.reference.com/browse/measure](http://dictionary.reference.com/browse/measure)>.



## DISCUSSION TOPIC

9 "compare." *Dictionary.com Unabridged (v 1.1)*. Random House, Inc. 20 Sep. 2007. <Dictionary.com <http://dictionary.reference.com/browse/compare>>.

10 The above shows example premiums, premium loads, policy administration expenses, cost of insurance charges, cash-value-based "wrap-fees", cash values, and death benefits for a hypothetical policy based on TheInsuranceAdvisor.com, Inc. (TIA) benchmarks. TIA benchmarks are derived from industry standard mortality tables (see Society of Actuaries 75-80 Basic Select & Ultimate Gender-Distinct Age-Nearest Mortality Tables at [www.soa.org](http://www.soa.org)), industry aggregate expense ratios (see Society of Actuaries Generally Recognized Expense Table for 2001 also at [www.soa.org](http://www.soa.org)), generally accepted actuarial principals, and an assumed net policy earnings rate as shown. The hypothetical policy values produced do not reflect an actual product for sale, nor do they reflect the mathematical average of all products, but instead illustrate example policy pricing and performance intended as representative of an "average product".

11 "Best-of-Breed" products are defined as such using TheInsuranceAdvisor.com (TIA) Star Ratings based on all five (5) factors of appropriateness as to 1) high ratings for financial strength and claims-paying ability, 2) low premiums due to low cost of insurance (COI) charges, low fixed administration expenses (FAEs), low cash-value-based "wrap fees" (e.g., M&Es), and/or low premium loads, 3) stable pricing, 4) high cash value liquidity, and 5) superior historical performance of invested assets underlying policy cash values.

12 Weighted-Average Annualized Costs reflect the weighted average of total year-by-year policy costs as to cost of insurance charges (COIs), fixed administration expenses (FAEs), cash-value-based "wrap fees" (e.g., M&Es) and premium loads based on each respective insurer's representations and all weighted for the time-value-of-money using a time-value-of-money rate equal to that rate at which cash values would be expected to otherwise grow but for the deduction of these policy charges. If actual COIs, FAEs, "wrap fees" and/or premium loads are higher than such pricing representations, or if actual policy interest/earnings are lower than shown, then additional premiums will be required or benefits will be reduced. Conversely, if actual COIs, FAEs, "wrap fees" and/or premium loads are lower than such pricing representations, or if actual policy interest/earnings are higher than shown, then premiums may be reduced or benefits could be increased.

13 Probabilities for success (i.e., that policy death benefits will mature and become permanent) and for failure (i.e., that the policy will lapse without value and without paying a claim unless addition premiums are paid) are determined through a Monte Carlo Simulation in which the duration of coverage is calculated in 1,000 separate trial runs using 1,000 different and randomly-selected assumptions as to the policy earnings rate, and where the number of trial runs reaching policy maturity divided by 1,000 equals the Probability of Death Benefit Maturity, and where the figure shown for the Earliest Expected Lapse/Premium Call reflects the earliest calculated date of lapse out of the 1,000 separate trial runs.

14 See page 2 of "The Two-Headed Beast" in the April 2003 issue of *Financial Advisor* magazine.

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### About the Author:

*Barry D. Flagg is the inventor/founder of TheInsuranceAdvisor.com, the leading publisher of life insurance pricing and performance research and ratings. Barry's unique background as a practitioner that ranked him in the top 1% of his peers brings an unparalleled perspective to his presentations. His experience in product analysis and sales and marketing makes him an expert in applying prudent investor principles to life insurance product selection and practical portfolio management. As a speaker, author, and educator, Barry has addressed the world's most prestigious corporations and industry groups, been published/featured in the industry's most-read magazines, and been cited in legal and accounting books and journals. Barry is a CLU, ChFC and the youngest CFP® in history.*