Strategies to Reduce Volatility and Improve Tax Efficiency

Why a cash value life insurance policy may be right for your portfolio.

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Many investors believe that the primary goal of diversification is to hedge against risk and volatility. Another fundamental goal for diversification, however, should be to increase tax efficiency—something that many investors overlook.

One simple way to achieve both of these objectives is to consider the addition of cash value life insurance to your portfolio.

CASH VALUE LIFE INSURANCE AS AN ASSET CLASS

Life insurance may not come to mind immediately when thinking about portfolio asset classes, but it should. Several types of cash value life insurance (CVLI) exist, and some offer advantages over other asset types.

For example, certain types of CVLI offer returns that are not correlated with the stock market. That means a policy can act as a hedge against the losses of traditional investments, such as stocks, bonds, and mutual funds. Further, a properly-designed CVLI policy is given preferred tax treatment, allowing cash value to grow tax-free and, if properly managed, accessed tax-free. In this way, it can also act as a tax hedge against capital gains and income tax liabilities.

TYPES OF CASH VALUE LIFE INSURANCE

When considering a tool like CVLI in a portfolio, investors should understand the different types of policies and how each of them works. We will examine two common types in this article.

Whole Life Insurance

In this type of contract, premiums are paid to the carrier, who then invests them. In return, the carrier credits policyholders with a dividend as long as the policy is in-force. This guaranteed rate gives the policy owner the benefit of a bond-like return. Whole life contract guarantees are generally better than the guarantees offered by other types of life insurance. However, a whole life policy is also less flexible, from a design standpoint, because premiums are fixed. In addition, the costs can be higher throughout the life of the policy.

Whole Life Summary:

- Dividends credited
- Average earning rate can fluctuate from company to company
- Fixed interest rates, similar to highly rated corporate bonds
- Strong guarantees, but no flexibility

Universal Life Insurance

In a pure universal life policy, the carrier declares an interest rate, and they credit that interest rate at guaranteed intervals. Premiums are flexible, and a policy can be designed to have a limited number of premium payments.

Another type of universal policy (and one investors should pay special attention to) is the equity indexed universal life (EIUL) policy. Like standard universal life policies, EIULs offer cash values, but they have a different way of crediting interest. Carriers with EIULs take the policy premiums and utilize them to implement a collar strategy. In a collar strategy, premiums are paid to the carrier. The carrier then sells call options and buys protective put options on positions they own. In return, the policy's performance is tied to an index, such as the S&P 500. Because a collar strategy is a protective strategy, the carrier is able to guarantee the policyholder a floor, or minimum return (i.e., 0 percent) that protects them from losses. With an EIUL, if the index the policy is tied to goes down 20 percent, the cash value will not go down. EIUL policy cash values also have a ceiling, or cap, on the upside (i.e., 10 percent), which means that if the index goes up beyond the cap, the policyholder will get a portion of the total upswing.

EIUL Summary:
- A floor to prevent losses
- Capped upside potential
- Index-tracking cash values

IMPROVING TAX EFFICIENCY

Tax efficiency is often an overlooked portion of retirement planning. Yet, this should be one of an investor's primary concerns, since the only sure thing about the future of taxes is that it's completely unpredictable. When an investor cannot see what is coming, the only way to hedge against the possibilities is to structure one's assets so that some are removed from potential tax burdens. That is the goal when using CVLI.

Potential tax exposure in retirement is often visually represented by buckets. First is the income bucket, which is comprised of taxable income sources—such as a 401(k), traditional IRA and/or pension. When a retirement saver contributes to these accounts, they receive a deduction and the contributions grow tax-deferred. But when they begin to take distributions, they are taxed as ordinary income. While it is advantageous to get the tax deduction on the front end, investors should hedge against future tax rate risks by not having all assets in the first bucket.

The second bucket is the taxable bucket or capital gains tax bucket. This will generally include anything that is in a taxable account or a brokerage account, such as stocks, bonds, and mutual funds. Assets distributed from this bucket are taxed at a capital gains rate, which is advantageous because long-term capital gains rates are lower than income tax rates.

The third bucket is one that is often overlooked, and that is the tax-free bucket. This bucket includes accounts such as the Roth IRA and investments such as municipal bonds. In these accounts and investments, the contributions grow tax-free and distributions are tax-free. CVLI also fits into this bucket because, when the policy is properly designed, dollars that are put in grow tax-free, and the owners can withdraw them tax-free.

CONCLUSION

Investors should consider having a properly licensed advisor review their portfolios to determine if a CVLI policy could provide a hedge against market volatility and future taxes. An important goal should be to ensure the insurance contract is structured in such a way that the premiums do not exceed tax law limits, thus creating what is referred to as a modified endowment contract, or MEC, as that will prompt the loss of all the tax benefits.

Advisors should also confirm that the funds designated for payment of the EIUL premiums can be committed for the long term, so that the policy does not lapse. If the policy lapses after funds have been distributed, the distribution can become taxable. In the same vein, since EIUL contract expenses are generally front-end loaded, a distribution plan should be designed to avoid pulling money out of the EIUL policy for roughly 10 years. Finally, advisors and investors should work with a carrier that historically has not increased charges on their active policies. ■

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