



## INSURANCE AS AN ADDITIONAL ASSET CLASS

Life insurance as an asset class requires a second look, as recent tax changes continue to shape the strategy. **Wayne Miller** and **Mark Arruda** explain.

Insurance as an asset class remains a key part of an advisor’s business strategy toolkit. A desire for greater returns seems to come with greater uncertainty, and investors are looking for alternatives. When compared against fixed-income investments, permanent life insurance, specifically participating whole life, provides an appealing solution for those who have a permanent insurance need. New products and tax legislation, however, have led advisors to seek further insights into the merits surrounding insurance as an asset class.

Most life insurance products in Canada come with premiums and a face amount that are guaranteed for life. As a result, one can calculate an internal rate of return (IRR) on the premiums. And because proceeds upon death are tax-free to the estate or named beneficiary, the IRR is a tax-free rate. The only variable is the age of death.

In the case of a minimum-funded universal life (UL) policy, the death benefit is level for life. The sooner one dies, the greater the implicit IRR and vice versa. A non-smoking, healthy male aged 50\*, for example, will find the annual cost of \$1 million of UL to be \$13,654. Guaranteed after-tax IRRs for such a policy are shown in the table below:

AGE AT DEATH	AFTER-TAX IRR
70	11.26%
75	7.56%
80	5.32%
85	3.84%
90	2.81%

\* Values are from SunUniversalLife II, March 2017.

If the man in our example dies at his life expectancy of age 85, the \$1 million death benefit will have been equivalent to the premiums earning an after-tax compounded return of 3.84 percent. This is an attractive rate of return given today’s low interest rates. But is this a good investment? In addition to the unfortunate criteria that death is required, this policy lacks at least one necessary trait to be considered a good investment – there’s no liquidity.

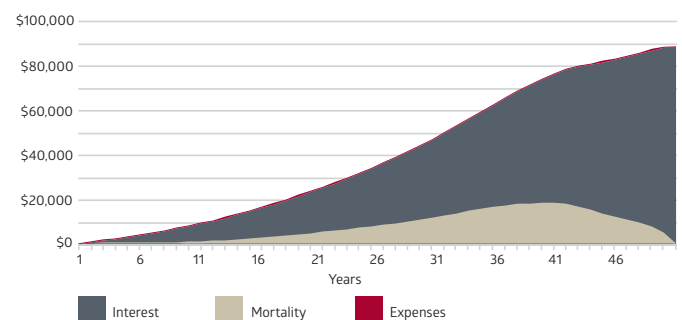
If premium payments stop or the policy is cancelled, the policy owner receives no cash value.

### AN OVERVIEW OF PARTICIPATING WHOLE LIFE INSURANCE

Numerous assumptions, predictions, and factors go into the pricing of permanent life insurance. Three of these are significant in determining the premium: expenses, mortality rates, and investment returns. If the life insurance company assumes low investment returns, poor mortality, and high expenses, the premiums it charges will be higher than if it had made more favourable assumptions.

Par is priced using conservative assumptions. For example, long-term investment returns may be set at 2.5 percent and mortality claims experience may be based on that of 40 years ago. The resulting premium is generally high but the insurance company has equally high expectations that future pricing conservatism will not be required. This usually leads to annual mortality, expense, and investment gains that are returned to the policy owner in the form of annual policy owner dividends.

While life insurance policy dividends come primarily from three sources, they tend to be dominated by investment returns. See the graph at the top of the next column that depicts sample dividends by source for an individual aged 50 at policy issue\*.



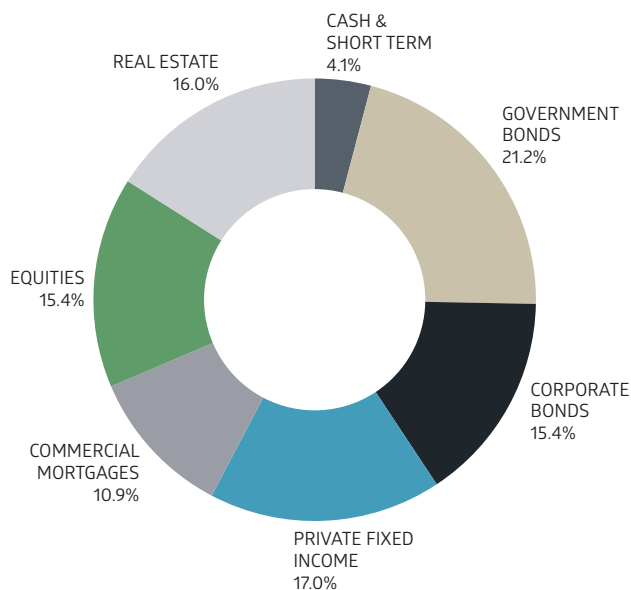
\* Values are for a Sun Par Protector II policy, life pay paid up additions MNS 50 at current dividend scale with premiums payable for life.

## THE PAR ACCOUNT AND ITS UNIQUE INVESTMENT QUALITIES

The par account is a separate pool of assets specific to the insurance company's participating life insurance line of business. All premiums for participating life insurance are deposited into this account; all claims, expenses, taxes, and policy owner dividends are paid from it. Some Canadian par accounts exceed \$20 billion and have existed for well over 140 years.

A typical distribution of assets for a par account is a mix of longer-term asset types. Because the liabilities associated with these accounts are long-term in nature, the investments are managed in similar fashion. Also, because one goal is to minimize volatility, the accounts tend to have a large percentage invested in fixed-income assets.

Participating accounts in Canada are diversified and each has its own characteristics. The following pie chart demonstrates the distribution of assets in the Sun Life Participating Account. This is a little less typical due to the larger percentage of assets in private fixed income and real estate.



The proportion of the par account invested in each of these separate asset classes can vary. It is a function of available investment opportunities, the overall market environment, and the company's investment guidelines. As an example, during times of market stress, the proportion of the portfolio invested in liquid instruments (most notably government bonds) may increase. However, any fluctuation in asset mix will be marginal — plus or minus three to five percent per asset class — and the overall portfolio composition remains stable through time. The asset mix is designed to fulfill the par account investment objectives to provide death benefits to the insured and annual policy owner dividends. The par account is itself a

product of the Modern Portfolio Theory — working to find the optimal balance of risk and return given the natural constraints imposed by the investment objectives.

This stable asset mix also has the added benefit of lower investment expenses. This means investment expenses tend to be more predictable. Expenses associated with the administration of the par account can vary, and insurers that invest in more complex asset types like real estate and private fixed income may have higher expenses. Overall, these expenses are in the range of five to 15 basis points.

## A HIGH-NET-WORTH CASE STUDY

Let's now explore insurance as an asset class and how it works in a real-life scenario. Dr. Wise is a 50-year-old oncologist earning \$450,000 annually. We'll assume his children are no longer financial dependants.

Dr. Wise's non-registered investment portfolio has a current value of \$1 million — 60 percent in equities and 40 percent in real estate. Given his long-term goals and current financial situation, the time has come to re-evaluate his investment portfolio.

Dr. Wise is particularly concerned about the lack of investment diversity as he has exposure to only two asset classes. Also, since he is beyond the middle of his career and heading toward his retirement years, he believes he should reduce his risk.

Dr. Wise has committed to adding \$50,000 annually to his nonregistered portfolio, and plans to continue this until at least age 65. Rather than liquidate and reallocate some of his current portfolio into fixed lower-risk investments, he will direct all future contributions toward them. He will choose between bonds and permanent life insurance, keeping in mind his goals are to:

- Maximize the value of his estate when he dies
- Minimize the tax burden associated with his non-registered investments
- Maintain significant liquidity within his investment portfolio
- Improve his portfolio risk/return profile

Which asset class best allows Dr. Wise to reach his investment goals?

Let's compare and contrast a fixed-income portfolio with that of the two permanent life insurance options. The starting point will be the fixed-income portfolio. Long-term interest rates are currently at historical lows. We'll assume that long-term Government of Canada bond yield rates forever remain at the level they were on March 1, 2017 (2.4 percent). Also, we'll assume incremental yields on corporate bonds are in line with their historical average.

Dr. Wise is considering a 65/35 percent split between corporate and federal bonds; he is in the top marginal tax bracket of 54 percent. This portfolio, therefore, will yield an after-tax rate of return of 1.5 percent.

The first insurance alternative is a participating whole life policy\*. The face amount that is supported by \$50,000 annual premiums for Dr. Wise is \$1,112,082. Because the case scenario calls for only 15 annual deposits/premiums, the premiums due after year 15 are assumed to be funded by the annual policy owner dividends.

All other dividends will be reinvested to buy additional insurance. To make the comparison as fair as possible, a dividend interest rate of 4.75 percent is used. The 4.75 percent represents what a dividend scale interest rate could ultimately be if the interest rate environment was the same as that described for the fixed income portfolio, and if real estate performs at historical levels while equities return an average of eight percent.

The second insurance alternative is a universal life insurance policy\*\*, specifically one with the same initial face amount as the first alternative and funded with 15 annual premium deposits of \$50,000 each. The investment-side account will be invested in a portfolio with similar characteristics to the participating account, earning 2.5 percent.

The chart below illustrates the tax-free death benefits (in thousands) to the estate, and corresponding internal rate of return (IRR) for the two insurance alternatives.

AGE	PARTICIPATING WHOLELIFE		UNIVERSAL LIFE	
	ESTATE BENEFIT	IRR	ESTATE BENEFIT	IRR
65	\$1,896	10.92%	\$1,733	9.91%
75	\$1,713	4.59%	\$1,738	4.67%
85	\$1,714	2.97%	\$1,744	3.03%

\* Specifically a Sun Par Accumulator II Life Pay policy. The annual premium includes a \$15,000 annual plus premium benefit. \*\* Specifically a SunUniversalLife II Level COI policy with insurance amount plus fund death benefit option.

The two alternatives show similar results at life expectancy. In comparison, the IRR for the fixed-income portfolio will always be the after-tax rate of return, i.e., 1.5 percent.

The next step is to look at the relative cash surrender values (in thousands) of the two permanent insurance alternatives. These are shown in the next chart. The par policy offers greater cash surrender values at all durations, particularly the later ones.

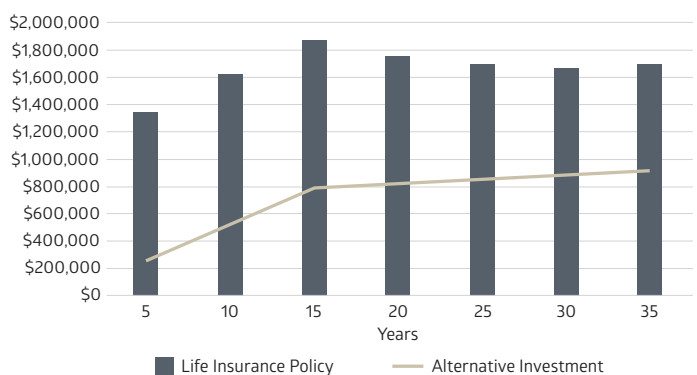
AGE	PARTICIPATING WHOLELIFE	UNIVERSAL LIFE
55	\$221	\$182
65	\$843	\$621
75	\$1,072	\$626
85	\$1,335	\$632

A desire for liquidity may not be limited to later ages. Many people, especially low-risk investors, will have an interest in shorter-term liquidity. The liquidity in the first five years is illustrated in the next chart. The percentages in the chart are the ratio of the cash value at that duration to the premiums paid to that point in time. Once again, the par policy is superior to the UL. Both, however, are less than the fixed-income portfolio, which can be cashed in for 100 percent of its value under this interest rate scenario.

Based on this objective analysis for Dr. Wise, the par alternative is the better permanent life insurance solution. Now let's consider how the par policy compares to the fixed-income investment. As noted, Dr. Wise will assess his alternatives by looking at three factors: benefits to his estate, interim benefits to him, for example, liquidity, and relative level of risk.

### ESTATE BENEFIT

One would expect that permanent insurance would provide a greater benefit to the estate than the alternate fixed-income investment. At each horizon, the benefit to the estate upon death is greater for par than for the non-registered taxable investment. And given there is a 100 percent chance that Dr. Wise will one day die, this is an important consideration.



### LIQUIDITY

Dr. Wise is fairly affluent and not likely to rely much on his nonregistered portfolio for living expenses in his retirement years. He is, however, interested in liquidity for two reasons. He could use the asset as a last resort should his fortunes change, and he can leverage it should he wish to invest in another asset or business.

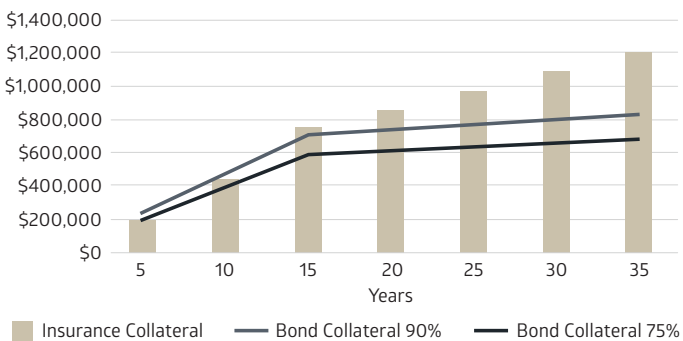
In terms of liquidity, the par policy has three options:

1. Dr. Wise could surrender (cancel) the policy and collect the cash surrender value. At some point, however, particularly after the first 10 years, there will be an associated policy gain. This gain is fully taxable as income, so the after-tax cash surrender value would need to be compared to the fixed-income portfolio. In practise, however, such policies are seldom surrendered.
2. Insurers offer policy loans against the cash value, but there may be tax consequences.
3. The most likely solution to meet a need for access to the cash value is to use the cash value as collateral for a third-party loan.

For the same reasons, Dr. Wise is unlikely to ever cash in the full value of the fixed-income portfolio. And also for the same reasons, he may wish to leverage its value. Lenders may be willing to lend up to 90 percent of the value of the fixed-income portfolio.

Liquidity defined in this way is comparable between the two alternatives, with the alternate fixed-income investment performing better in the later years. The interest on third-party loans can be capitalized, and the outstanding loan would be repaid at death from the tax-free death benefit. Because policy owner dividends can never be negative, banks may lend up to 90 percent of the policy's cash value.

But because the value of the fixed-income portfolio will drop when interest rates go up, it would be prudent to borrow less than the full 90 percent of the fixed-income portfolio. Otherwise, in the event the market value of the portfolio drops below that of the loan, the lender will make a margin call and require some of the loan to be repaid or additional collateral be secured. For this reason, a more conservative approach would be to cap the investment loan at 75 percent. This revised definition of liquidity shows a marked advantage to the life insurance policy.



## CORPORATE CONSIDERATIONS

Dr. Wise runs an incorporated business. Within his private corporation, he can set up a holding company for income over and above what he needs for business purposes. The holding company receives the income as tax-free dividends from his operating company. This has its advantages, but also comes with its share of challenges:

- Investment growth on these assets is taxed each year.
- Any dividend distribution to Dr. Wise is also taxable.
- Upon his death, Dr. Wise's assets will be taxed in the hands of his corporate beneficiaries.

For this particular case study, Dr. Wise can address each of these challenges if the life insurance policy is owned by his corporation, and funded by the assets within it.

For corporate beneficiaries of a life insurance policy death benefit, the capital dividend account (CDA) provides a tax-efficient method of moving money out of the corporation to the estate or new shareholders. The tax-free death benefit is first paid to the corporate beneficiary. The death benefit, less the policy's adjusted cost basis, can be credited to the corporation's CDA. This credit can then be used to pay a tax-free capital dividend out of the corporation. Any portion of the death benefit that exceeds the CDA credit can be paid out of the corporation as a taxable dividend.

These factors will often allow strategies using corporate-owned life insurance to outperform an alternate taxable investment, in particular when the policy is held until the death of the life insured.

The analysis in this study leads us to the conclusion that permanent life insurance, specifically participating whole life, is in fact an attractive alternative asset class when compared against fixed-income investments. The benefits to the estate were greatly enhanced, investment liquidity was comparable, and the efficient frontier, due to the low standard deviation of returns, was expanded by incorporating insurance.

These results will vary somewhat based upon both the actual permanent life insurance product used and the age at which the strategy is being considered. But based on this analysis, there has been no impact on the strategy of life insurance as an asset class resulting from the recent tax changes.

This approach isn't for every client. The analysis is geared toward not only high-net-worth investors who are in a unique position to capitalize on the benefits provided through permanent life insurance, but also investors who are already using this strategy.

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