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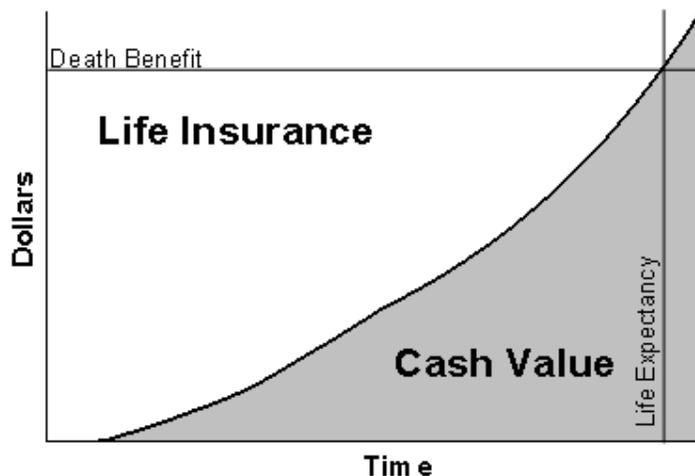
Answers to questions you may not even know you have.

The Fundamentals of Life Insurance

This essay was originally published in Muhlenkamp Memorandum Issue 37, January 1996. It is the third in a three-part series on estate planning. It shows why Ron disagrees with conventional wisdom with respect to life insurance and irrevocable trusts.

As professional investors our perspective and conclusions differ from the conventional wisdom in several areas. One important area of difference is life insurance, which plays an important part in many financial plans. The following is a discussion of life insurance from an investment perspective. Any whole life policy has two parts. The first part is pure insurance, just like a term policy. The second part is a savings account (the insurance company calls it cash value). The savings account is designed to equal the death benefit of the policy at the end of the insured's life expectancy. As the savings account grows, the amount of pure insurance declines. (See Figure 6.17.)

Figure 6.17 Whole Life Policy



Source: Muhlenkamp & Company, Inc.



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Intelligent Investment Management

5000 Stonewood Drive, Suite 300 • Wexford, PA 15090 • (877) 935-5520 • www.muhlenkamp.com

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The insurance company estimates the interest rate it will earn during the life of the policy to determine the amount of the premium required to fund the savings account. They then add on the insurance premium that is required to offset the risk that the insured dies early. The sum of the two is the annual premium. Thus, the policy illustration is based on the premium and the assumed interest rate. If future interest rates match the estimated rate, the cash value of the policy will match the illustration.

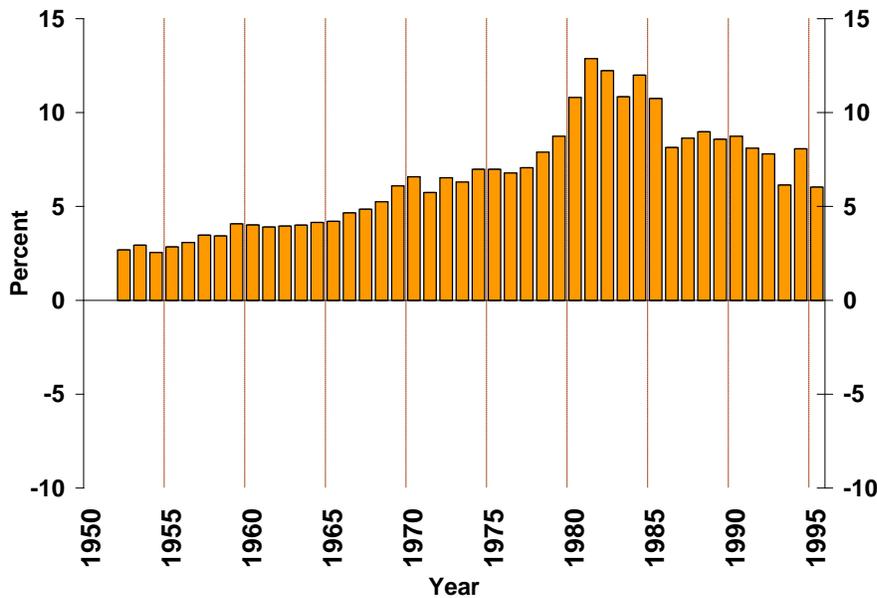
But if future interest rates do not match the estimated rate, the insurance company will “adjust” premiums or the value of the policy to reflect the actual rates. When estimating future interest rates, most insurance companies use a rate similar to what they are currently earning. This rate reflects securities that they have bought and still hold. Since companies don’t replace their entire holdings each year, their response to changing interest rates tends to be gradual and to reflect market changes with a lag. As rates moved up in the 1970s, this lag was reinforced by the reluctance of companies to sell bonds at a loss. As rates have moved down since 1981, the lag has been determined largely by “call protection.”

The bonds and the mortgages that insurance companies own are callable. “Callable” means that the companies issuing these securities can “call” or refinance them when interest rates drop. As interest rates fell over the past 15 years, many of us benefited by refinancing our mortgages. But this benefit was at the expense of the holders of these mortgages, including insurance companies. Much of the mortgage refinancing has been completed, but the bond refinancing is still going on. This is because most bonds have five or 10 years of “call protection”; therefore, the call response lags the market by five to 10 years.

How do these changes in interest rates get reflected in individual policies? In the 1970s, interest rates rose, exceeding rates that had been estimated in the 1960s. (See Figure 6.18.) As a result, the death benefits on two policies that I bought in 1964 and 1970 were upped by 40% in the early 1980s. This sounds impressive until you recall that the Consumer Price Index (CPI) doubled during that period.



Figure 6.18 Nominal Long-Term Government Bond Rate, 1952-95



But since 1984, interest rates have fallen well below the levels that insurance companies estimated in the early 1980s. If you bought a whole life policy 10–15 years ago, you have probably received a statement in the past two to three years saying that the insurance company needs more money, or they will decrease your death benefit. But this statement only reflects the decline in interest rates that occurred from the early 1980s to the late 1980s. The decline in rates that has occurred since the late '80s means that three to five years hence (due to the call lag), you will get another statement saying that the insurance company needs more money *again*.

The people who have bought policies since 1985 will also receive statements asking for more money. And we believe there is a 50% probability of a third “adjustment” five to 10 years down the road. We estimate that the decline in the value of the policy will approximate 20% each time, for a *cumulative* 40%–60% decline.

The problem is that old and obsolete interest rates are still being used in policy illustrations. We recently reviewed a policy proposal in which the cash value illustration was based on interest rates credited to the policyholder of 8%. Yet a footnote stated that the actual rate credited will be 2% less than the company earns on its investment portfolio. The illustrated numbers were obsolete the day they were printed. In any other business, such illustrations would be considered fraud.



Policies are sold on the basis of “illustrated” growth in the cash value. In recent years, disclosure has improved and these tables usually include a footnote which states that in fact the interest earned will be 2%–3% less than what the company earns on its investment portfolio. So the company is telling you up front that your assets with them will earn 2%–3% less than the company earns *with your money*.

Since the bonds and mortgages they invest in normally earn about 1% more than Treasury bonds, you can expect to earn about 1%–2% per year less than if you had simply bought long-term Treasury bonds.

The conclusion is that any money set aside to accumulate in an insurance policy or a fixed annuity will earn returns of 2%–3% a year less than corporate bonds, which means it will earn 1%–2% a year less than Treasury bonds. It also means it is likely to earn about 1% more than passbook savings and 4%–5% a year less than common stocks. It *cannot* do better. When insurance commissions are figured in, the results become significantly worse.

If you are 35 years old, have few or no assets, and have people dependent on you, buy life insurance to cover the risk of early demise. We strongly recommend term insurance. But if you are 55 years old and have assets sufficient to care for your dependents, you don’t need life insurance. Under these circumstances, buying “cash value” life insurance merely prevents earning a decent return on your money. We call that a poor investment.

A second area where we disagree with the conventional wisdom is in the use of irrevocable trusts. (The following comments do not apply to revocable trusts.) The use of irrevocable trusts is driven by three factors:

1. IRS regulations that gifts to charities or heirs be irrevocable to qualify for charitable deductions or for exclusion from the donor’s estate.
2. The donor’s belief that they can only spend “income” during their life-time; therefore, they believe they must keep their assets in their name.
3. A desire to control assets from the grave, either to protect irresponsible heirs from themselves or to benefit from the donor’s superior investment acumen.



Our objection to irrevocable trusts is that they are irrevocable. The trust may not be able to adapt to changes in the world or in people. We've seen trusts that irrevocably stipulated:

- Trustees who became senile or died.
- Bank administrations whose trust departments became incompetent or were so careful to protect principal that inflation destroyed the assets. (See our essay "Estate Planning for Generations," Figure 6.15, Line B.)
- Charities whose later administrators adopted policies counter to the donor's intent. (Henry Ford II resigned as trustee of the Ford Foundation—which his grandfather's will created—in disgust.)
- Investments that became obsolete. (I had a college classmate whose wealthy grandfather, observing the need for good public transportation, stipulated that his assets should always be invested in streetcar companies. His grandson was as broke as I was.)

Meanwhile the IRS discounts the value of any charitable gift to its "present value" in calculating any tax deduction. We've seen present values as low as 5% of the intended gift. The donor and the charity would have been better served with a present gift of 5% of the expected future gift. This would allow the remaining 95% to be invested (or gifted or spent) in concert with a changing world.

