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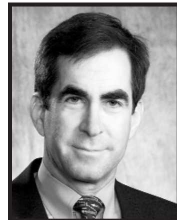
Building wealth with insurance

As a financial planner, I'm always looking for better tools to build wealth.

One area I've explored extensively is investing through insurance products. They come in various flavors such as variable annuities, variable universal life, equity indexed annuities, whole life and many more.



ALLAN ROTH

I've found these products all have one thing in common – they generally do a great job of transferring your wealth to others. While they can make sense in certain circumstances, insurance products are often sold to clients who don't have a thorough understanding of what they have bought.

What do many people think they have bought? The value proposition of a product that gives them the upside of the market, without any of the downside risk. You can't get more emotionally compelling or seductive than that!

Who would want "temporary" insurance that is likely to expire worthless when you can get "permanent" insurance, not to mention loaded with all sorts of guarantees and lock-ins. Unfortunately, they generally just don't work.

I don't have space in this article to review all the illusions I've shattered in my practice on this subject, so the best I can do is explain the logic of why they systematically don't work.

Insurance companies invest their assets in stocks, bonds, real estate and cash. You can either invest directly in those same assets or indirectly through insurance products. If you go the indirect route, your expected return will be reduced by large commissions, administrative costs, premium taxes and profits.

The costs you are paying make even expensive mutual funds look cheap!

What about all of those guarantees such as a death benefit or guaranteed income benefit? Well, the truth is that they are mostly illusions that have less value than you think.

First of all, the U.S. stock market has rarely declined in value over a 10-year period and has always bested inflation over a 30-year period.

Second, the income benefits are generally paid out as annuities over which you do not control the assumptions. That means they can pay out at rates that would make a low interest paying bank look appealing.

Finally, these guarantees are coming at a cost that you are paying for.

Another selling point on these products is that they are more tax efficient – both income taxes and estate taxes.

As far as income taxes go – forget it! True that you get to defer taxes until you withdraw the funds, but when you do so, you generally get zapped at high ordinary income tax rates rather than the lower dividends and long-term capital gains rates.

The real tax efficiency comes from the fact that insurance product returns are so much lower, and that's one of the few tax efficiencies I don't want.

It's true that you can create trusts that will let assets escape expensive estate taxes, but you can also gift the same amount of funds with the same estate tax benefits. Anyway, who knows what Congress is going to do in the future with estate tax laws?

Insurance products feel really good when they are sold…and yes, the key word here is SOLD.

The NASD has put out two alerts regarding variable annuities as complaints about

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Example of insurance investment

DESCRIPTION (True but not accurate)	REALITY
Gives you 100 percent participation of the S&P 500 index.	Stripped of the dividend yield—there goes half of your REAL return.
Return capped at 9 percent each year - about what the market earns over time.	The market may average 9 percent but it comes in years of negative 20 percent and positive 30 percent. You capture all of the negative but little of the positive.
You get a guaranteed return of principal.	You are guaranteed you won't lose more than inflation—a guarantee that provides little value.
You think you are getting all the upside of the market without the downside risk.	You will probably earn little REAL return.

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insurance investments rise. NASD Vice President of Investor Education John Gannon says, “never invest in something you don’t totally understand.”

Believe me, these products are complex and quite hard to understand – just look at the size of the prospectus. Gannon says the NASD has a proposed rule to disclose the essential information to investors in plain English.

I often sit down with a client and call his insurance company to confirm the product he has purchased. In every case, the client has been unpleasantly surprised by what he has bought and how it has performed.

While Colorado has some suitability requirements, they vary by line of coverage. Selling a high cost annuity in an already tax deferred IRA is completely legal and done all the time.

Personally, I can’t think of any reason to sell these other than to create commissions.

Kirk Yeager, deputy commissioner of the Colorado Division of Insurance, says the Division is monitoring these concerns to determine if this is something that the commissioner should recommend for a change of law.

Regarding the role insurance should play in your finances, local advisor James A. Shambo CPA, PFS says, “Insurance preserves wealth, investments create wealth and confusing the two is a sure way to financial disappointments or outright disaster.”

Always insure yourself for something you can’t afford to lose. When it comes to building wealth through insurance, the bottom line is that it rarely makes sense as a tool for the investor.

My advice is to invest directly rather than through expensive insurance products.

Allan Roth is a CPA and certified financial planner. He is the founder of Wealth Logic LLC, an hourly based financial planning and licensed investment advisory firm, and is an adjunct finance faculty member at the University of Colorado at Colorado Springs. He can be reached at 955-1001 or at ar@DareToBeDull.com.

Build your own principal protected investment

If you have $10,000 in an IRA but want some market upside without risking principal, try:

- Buying a 20-Year $10,000 Treasury Strip for $4,000.
- Buying a total stock market index fund for $6,000.

You end up with a guarantee of getting your full $10,000 backed by the full faith and credit of the U.S. government plus all the upside of the $6,000 invested in the market. Your fees are less than 0.15 percent versus the insurance version, which has fees 20 times that amount.

Buying an insurance investment

If you feel this product may still be right for you, here are some rules that may help.

1. Stick to low cost no-load products from institutions such as Vanguard or TIAA-CREF.

2. Make sure you understand the surrender charges and time periods for those charges.

3 Ask your agent if there are products with lower surrender charges that have shorter time periods. Some insurance companies offer higher commissions to sell the same product with higher charges.

4. Ask your agent to put down in writing why this product is suitable for you.

5. Never put IRA money in an insurance product—you get no tax deferral, just higher costs.

6. Try to get low cost term insurance first. If you can’t, then investigate these products.

7. These polices may make sense if:

   - You don’t have the discipline to otherwise save.
   - Without these “guarantees,” you will otherwise move in and out of the market.

8. Before you buy, visit www.NASD.com and click on Investor Alerts and then on Annuities and Insurance.