Chapter 9

Variable Universal Life - A Closer Look

> "Stocks have averaged a 10.2% return over the last 90 years" (16).
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> "Over the long term, the stock market news will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a fly epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497" (17).

The introduction of current assumption universal life insurance in 1979 was a revolution for the industry. The universal life chassis, with its flexibility and transparency, provided a potentially less expensive product for the masses, with upside cash value potential. In the early 1980s, the high fixed investment returns resulted in crediting rates of up to 12% in sales illustrations for current assumption universal life policies. However, these returns were an aberration as fixed returns are historically much lower. But equity investments have surpassed fixed vehicles. One hundred dollars invested in 10-year Treasury Bonds in 1928 would have grown to just over $7,000 in 2016, but that same amount invested in the S&P 500® would have grown to over $328,000 (18). This equity advantage was well known to investors in the market in the mid-1980s when variable universal life (VUL) was introduced.

Although VUL policies were not available until the 1980s, the concept of variable life had been introduced by Equitable Life Assurance Society in 1976 (19). However, this policy was strapped to a whole life chassis, and though it had the potential to outperform a traditional fixed whole life product, it was not until the equity investment concept was combined with the flexibility of a universal life chassis that the concept gained favor. The variable life chassis was a fixed premium product, and the universal chassis design allowed policyholders to minimally fund the policy for potentially low cost permanent insurance coverage, or over fund the policy to maximize the investment potential of the policy. Additionally, the policyholder could adjust the death benefit (an increase required underwriting approval) and take withdrawals from the policy, creating a tax efficient investment vehicle.

When Pruco, a subsidiary of the Prudential Life Insurance Company of America, introduced the first VUL policy in 1985, the equity market was booming with double digit S&P 500®returns in 3 out of the 4 prior years, strong returns the year of introduction and no losing year until 1990 when the S&P was down just over 3%, followed by a decade of positive returns. No wonder VUL was a marketing home run.

S&P 500 Annual Returns							
1982	21.55%	**1987**	5.25%	**1992**	7.62%	**1997**	33.26%
1983	22.56%	**1988**	16.61%	**1993**	10.08%	**1998**	28.58%
1984	6.27%	**1989**	31.69%	**1994**	1.32%	**1999**	21.04%
1985	31.73%	**1990**	-3.11%	**1995**	37.58%		
1986	18.67%	**1991**	30.47%	**1996**	22.96%		

VULs greatest departure from prior policies was not just policy flexibility and the ability to invest in the equity markets, but the opportunity for the policyholder, rather than the carrier, to direct the cash value investments. Along with this opportunity came responsibility, and trustees that mismanage a VUL policy's asset allocation open themselves up to potential liability. For example, we have provided initial reviews for VUL policies with cash value allocated 100% in the Money Market account paying less than 1%. How does that happen? At policy issue the Money Market account is noted as the investment option with the understanding that the asset allocation will be reviewed in the future once the policy is issued–and it simply is not done. Luckily, this is rare, but it does happen.

The cash value in a VUL policy is invested in separate accounts, which are essentially mutual fund clones, often from well-known mutual fund families like American Funds, Fidelity or T. Rowe Price. The separate account selection often numbers 30 or more funds and typically includes a diversified group of asset classes. Fund selection from a well-known carrier, which is typical of the separate account variety available, is listed below. The generic fund names are provided to show the variety of fund types. No fund company names are provided, but all funds are linked to well-known fund families.

Large Cap

- Large Cap Value
- Domestic Equity
- Equity Income
- Large Cap Blend
- Index 500
- Large Cap Core Stock
- Socially Responsive
- Multi Style Equity
- Growth Stock
- Focused Appreciation

Mid Cap

- Mid Cap Value
- Index 400 Stock
- Mid Cap Growth

Small Cap

- Small Cap Value
- Index 600 Stock
- Aggressive Equity
- Small Cap Growth Stock

Asset Allocation Funds

- Fund allocations based on investment temperament

International

- International Equity
- Emerging Markets Equity
- Non-United State Equity
- International Growth

Fixed Income

- Money Market Account
- Short Term Bond
- Core Bond
- Inflation Protection Fund
- Lon-Term US Government Bond
- Multi-Sector Bond
- High Yield Bond

Fixed Account

- A fixed return account paying a current return, and providing a minimal guaranteed return.

Real Estate

- Global Real Estate Securities

Commodities

- Commodities Total Return

Like a current assumption universal life policy, the charges within a VUL policy are easily determined in the annual statement or the cost report page of a hypothetical illustration. These include a premium sales charge or loan deducted from the premium before it is applied to the policy, which compensates the carrier for sales expenses, including any taxes that might be applied to the policy. Also included is an administrative charge, which reimburses the carrier for

maintaining the policy, including accounting and record keeping, along with the cost of insurance (COI), the actual mortality charges based on the insured's age, gender, and health, and death benefit amount. The COI charges will be the largest expense over the life of the policy. A VUL policy will also include a charge for mortality and expenses (M&E), which compensates the carrier should the insured not live to the assumed age at underwriting. There are also fees taken at the fund level - fund management fees for the investment expenses of the separate accounts themselves. Each fund will have its own management expense structure fee stated as a percentage of assets. The M&E and fund expense fees will reduce the gross returns in the separate account.

It is important to note that this is a general outline of fees. Each carrier may calculate fees differently. Variable life insurance policies are securities under federal law, subject to the regulation of the Securities and Exchange Commission (SEC). They are sold with a prospectus, a mind-numbing document that spells out all policy fees in detail. An agent or broker selling a VUL policy must be licensed both as securities broker and insurance agent. Since it is a security, the policy must be considered suitable for the situation, but suitability is typically a low bar. Nevertheless, when purchasing a VUL policy in a TOLI trust, the trustee should make sure that the grantor is aware of the risks that accompany a VUL policy.

The major risk in a VUL policy is that unlike a fixed life insurance policy, a VUL policy can lose money as the underlying cash value in the policy can experience a negative return. Each month separate account shares are sold to pay the underlying costs associated with the policy which creates a double-edged sword in a down market since a greater number of shares will have to be sold to pay expenses as the market drops.

The asset allocation on a VUL policy is a responsibility of the trustee. While this book is not an investment manual, and we are not giving investment advice, we would be remiss if we did not provide some tips for managing this asset.

First, view life insurance illustrations as little more than a guide. In general, illustrations can be very deceiving unless you truly understand the underlying assumptions and all available pages, including cost breakouts. The illustration is not the contract and illustration manipulation can make policy performance appear better than it will be. Also, the illustration assumes a straight-line return–an illustration showing an 8% return assumes a level 8% return each year, which simply does not occur.

Second, you should match your illustration return to your expected allocation return. If your separate account asset allocation is intended to provide an 8% return, then your illustration should reflect that. It is also important to obtain an illustration for a lesser return. If you project an 8% return, get an illustration that shows both 8% and 6% so you become aware of the downside should your returns be less than expected.

Third, asset allocation is an important part of investing. A Charles Schwab White Paper pointed out that:

- $100 invested in US large-company stocks (as represented by the S&P 500® Index) at the beginning of 1971 would have grown to $8,642 by the end of 2015.
- $100 invested in gold (as measured by the London Gold PM Fixing) would have grown to $2,836 over the same period.

But if that $100 had been invested in a 50-50 split of both investments, the portfolio would have grown to $8,692 over the same span. This return is more than either the stock or gold portfolio alone, and demonstrates lower average risk (20). The paper points out that this will not occur in all time periods, but in most it "dramatically reduced risk in the combined portfolio relative to the two asset classes individually. While stocks and gold are both deemed relatively risky investments,

combining them helps mitigate the risk of the portfolio. This is due to their relatively low correlation to one another." The report goes on to acknowledge that since the 2008 financial crisis, some have pointed out there are "higher correlations between asset classes during periods of market stress," negating the advantage of diversification when it is needed most, but even in times of market pressure, "diversification makes sense as long as assets don't move in perfect lockstep."

Fourth, temper the expectations of the grantor. There are many experts that feel that going forward, we will not achieve the 10% equity returns we have seen in the past, and a more realistic estimate for stock returns would be 7%. Warren Buffet believes that returns of 6% to 7% in the stock market should be expected going forward (21). As trustee, you (and your investment counsel) will have to determine the asset allocation and return expectations for the policy.

Fifth, keep a steady hand. According to a Dalbar Inc. study, for the twenty years ending December 31, 2015, the S&P 500® Index averaged 8.19% a year, but the average equity fund investor earned a market return of only 4.67% (22). Why is this? According to Dalbar, "investor behavior is the number one cause." Overreaction causes bad financial decisions, whether you are responding to good or bad news. When the market drops investors tend to take their money out of the market, when the news is good and the market goes up, money returns. One tip–see if the policy allows you to take the monthly fees from the Fixed Account and each year place into the Fixed Account an amount sufficient to cover those costs. That way, if the market drops you will not be selling separate account shares low to pay monthly expenses (by taking the money out of the market you will also miss any gains, but it is still a prudent step).

The number two cause according to Dalbar? Fees. VUL policies, though they can provide efficient life insurance coverage if managed well, have those annual M&E expenses in addition to fund charges, which push down the net returns on a policy.

As with any other investment approach, a VUL asset allocation may need to change over time. For example, though the Fixed Account may not be a prudent allocation for younger insureds, it can be a viable option for well-funded policies on older individuals. We have come across VUL policies paying a guaranteed 4% net return in the Fixed Account which allowed the policy to run to maturity at current costs. In that case, a prudent decision might be for the trustee to "take the money off the table" for a policy on an older insured, since the recovery time for a market correction is shortened.

Typically, once an allocation is decided upon, we do not see trustees changing the allocations often, though they may be reviewed and re-affirmed annually. More often, a VUL policy allocation is determined when the policy is accepted with an investment professional or trustee committee overseeing the allocation. Historic returns for the separate accounts are available so your investment team can monitor their performance. Carriers actively review fund managers, replacing poorly performing funds periodically. The asset allocation process should be an active part of your TOLI administration process overseen by staff well-versed in investment strategies. Like any other aspect of policy management, asset allocation is a trustee decision, and though grantors and beneficiaries can be made aware of investment decisions, they should not unduly influence them.

The management of a VUL policy is not much different than any other universal chassis policy, the key difference being the additional investment responsibilities. Like all universal life policies, the higher the investment return, the lower the premium. The VUL policy has the greatest upside investment potential of all universal chassis products.

For VUL policies in your portfolio, the following are some practices that should be employed:

- Review your fee structure for ILITs containing VUL policies. Some trustees add a surcharge for the additional