Could There Be A "Good" VUL Policy?

Long-time readers will probably notice I've become less dogmatic in some of my writing over the last two years and softened my tone considerably on several subjects. For example, although I still think the vast majority of self-styled "financial advisors" are thinly-veiled salesmen, I've gotten to know a few that offer good advice at a fair price. Although I think few people should ever use a whole life insurance policy, I've run into a few people who actually understand the product AND are still happy they purchased it for various reasons. I can even seen a place for reverse mortgages, despite widespread abuse among those selling them. However, one product I thought I would NEVER see a use for is variable universal life (VUL) insurance. Over the last couple of months, however, I've had a number of readers contact me with questions about a VUL being sold by Larson Financial Advisors. It seems this particular product addresses many of the concerns with VUL that I've outlined before. It is enough to make me wonder if VUL really might have a place in a retirement "quiver" for at least some physicians.

Any Financial Product Can Be Bad

The truth is that just about any financial product can be made terrible through design features that benefit the product designer and salesman rather than the consumer. Consider the investment that makes up most of my retirement portfolio- mutual funds. If the only mutual funds available had an 8% load, a 2% ER, 12B-1 fees, surrender charges, horrible active management, and a high turnover rate, then it would be easy to argue that investors should avoid mutual funds altogether. However, thanks to Jack Bogle and others, an investor can now buy every stock in the world in seconds with essentially zero turnover, no fees, and an expense ratio less than 10 basis points.

What is Variable Universal Life Insurance?

VULs came out in the 1980s and 1990s when whole life insurance buyers and sellers realized that the relatively low returns available in whole life were getting creamed by stock market investors. Like with whole life insurance, it has a permanent death benefit along with a cash value component. The money grows inside the cash value account tax-free, and then in retirement the money is borrowed from the policy so it can be spent. Upon death, the death benefit pays off all the loans taken (and still provides a bit of money tax-free to the heirs.) Depending on your state, there may also be significant asset protection benefits for this money, and depending on estate tax laws in place at your death (and the liquidity of your estate) there may be estate tax benefits as well. Unlike whole life insurance where the cash value never goes down and is credited yearly with a dividend by the insurance company, with a VUL the investment component is invested in mutual fund-like subaccounts, and the value rises and falls with the market. The theory is that the long-term returns will be higher but you'll still get the tax-free growth, asset protection, and death benefit. Stock market returns with life insurance benefits, what's not to like?

So Why Doesn't Everyone Have One?

The problems with investing in a VUL are basically three-fold- the investments suck, the insurance is too expensive, and insurance policies aren't designed to be retirement savings accounts. Imagine the worst possible mutual fund, and that's typically what you'll find in a VUL sub-account- poor performance, high fees, and maybe even loads. The worst part is you have nowhere else to go. Instead of having thousands of funds to choose from, you may be stuck with only 5-10, although most newer policies over 50 or even 100+.

The insurance is also too expensive, mostly due to fees. These suckers are typically loaded up with so many fees it's almost impossible to have a positive return. Aside from the ongoing fees, there is usually a surrender charge for the first few years (sometimes for as long as a decade.) The insurance company doesn't want to lose money even if you surrender the policy, and since it's already paid the commission to the salesman, it has to get that money back somewhere. To make matters worse, since every policy is different, it isn't a particularly efficient market, and the insurance itself simply isn't sold at a competitive price.

In order for a VUL to qualify for the tax-free growth and tax-free loans, it has to at least masquerade as life insurance. That means you can't cash it out without paying taxes on the gains. There has to be a death benefit. There are limits as to how much you can contribute for any given death benefit. You must pay interest on any loans you take out etc. Insurance isn't free, and money used for the insurance portion can't be invested on your behalf.

When you consider all of these issues with a VUL policy, the tax, insurance, asset protection, and estate planning benefits just can't make up for all the costs and you end up with a severely under-performing investment that becomes even worse if you want to get rid of it.

What If There Were A "Vanguard" of VULs?

Just because the typical VUL sucks, doesn't mean it isn't possible to have one that might be worth buying for some people. What would that VUL look like? Is it possible for the costs to be kept low enough that the tax benefits would outweigh them? I don't know but I'd love to see the equivalent of the constant lowering of total market ETF expense ratios we've seen over the last 5 years from the mutual fund industry.

12 Requirements To Buy A VUL

Here are twelve requirements I'd have before considering a VUL:

1) Excellent investment options – Remember you're stuck with these options for decades. If something better comes along in the investment world, you're just out of luck. So you'd better hope that the investment options are at least the best available options at the time of purchase. That means low-cost passive investments such as those offered by Vanguard, DFA, and similar companies. It would be even better if there were a brokerage option where I could purchase investments in the future that aren't even available today.

2) Low cost investments – No loads, no additional fees, low turnover, and a low expense ratio.

3) Competitively-priced insurance – Permanent insurance is naturally going to cost a lot more than term insurance, but is it too much to ask that the insurance be as cheap as actuarially possible? This is probably easiest for a mutual insurance company to offer, since like Vanguard, their owners are their policy holders.

4) No surrender charges – Something like 80% of people cash out of their permanent life insurance policies in the first decade, guaranteeing a loss. There is certainly no point in investing in a cash value life insurance policy if you're not planning on holding the policy until death. If you cash out early, you'll lose money. If you cash out late, your gains will be taxable and you'll lose the death benefit. But if you're truly offering an excellent product to well-informed, appropriate consumers, very few people ought to be surrendering their policies in that first decade. You shouldn't have to stick them with a surrender charge in order to guarantee your ability to pay commissions.

5) Low (no?) commissions – Speaking of commissions, if we can

have no-load mutual funds, why not no-load insurance policies. Agents like to point out that the consumer doesn't pay them, the insurance company does, but who are we really kidding here? All expenses including company profits are paid by the consumer in some way or another.

6) Zero percent interest – Since the point of this policy is to act as an investment, and you know that to access your money eventually you're going to have to take out a loan, why can't that loan be offered at 0%? It would be direct recognition (I don't think this term is even used with VULs) so the money you're borrowing is no longer invested in the policy, but why should you have to pay the company interest to borrow your own money? Even if 0% interest is impossible, let's see how close we can get to it shall we?

7) Overfunded policy, paid annually – Again, the point of the policy is to act as an investment. You want to be able to contribute as much as possible to the investment component while spending as little as possible on the insurance component. That means funding it up to the "MEC line" and paying annually, or at least not penalizing the policyholder with higher premiums for paying it monthly.

These last 5 requirements have more to do with the purchaser than the policy, but they would still be requirements for me to recommend one for someone.

8) Insurable at a reasonable price – I'm probably never going to invest in a life insurance policy because the costs of insuring climbers are just too high. The same issue exists for those with health problems. Mixing investing and insurance usually doesn't make sense for most people, but for some people, it NEVER makes sense.

9) Maxed out retirement plans – Remember that a very low cost VUL MIGHT make sense when compared against a taxable account, but when you're comparing it against a solid 401K or Roth IRA,

it just isn't going to hold up. If you haven't maxed those out, it's frankly pretty stupid to even look at a VUL.

10) High dividend/capital gains tax rate – Dave Ramsey likes to call cash value insurance the "payday lender of the middle class." The tax benefits are just dramatically less if you're not paying much in tax anyway. If you're in the 10% or 15% bracket, your capital gains rate is 0%. If you're under $200K, your rate is only 15%. That goes as high as 23.8% for an individual with a taxable income over $400K. If you're investing in something that is highly tax-inefficient, like corporate bonds or REITs, your marginal tax rate could approach 50%. That's when the tax benefits of a VUL might make up for the costs of the insurance.

11) High value placed on asset protection, estate planning, or the death benefit – Life insurance can offer many benefits, but the fewer of these you care about the less benefit you are likely to get from investing in life insurance. If your state has a low (or no) exemption for life insurance cash value from your creditors, that aspect is useless. If you have no liquidity issues, or are nowhere near the $5M ($10M married) estate tax exemption, the estate planning aspects don't do you any good. Likewise, if you don't really care about the death benefit, why pay for it?

12) The alternative is paying an AUM fee – If you're working with an asset manager to whom you are paying an AUM fee, then a VUL becomes more attractive. The advisor would get paid by the commission you're paying anyway (at least until someone comes out with no-load insurance) and you'd save the AUM fee you'd otherwise pay on those assets.

Not For Me

I'm not going to invest in even a perfect VUL. Between my 401K/profit-sharing plan, defined benefit plan, backdoor Roth IRAs, stealth IRA, individual 401K (for the blog) and other investments I want to make in 529s, UGMAs, and a taxable account (like real estate) I just don't have the money to put in to anything else. The insurance component of any product would be too expensive due to my bad habits. I also don't place much value on the asset protection, estate planning, and death benefit of permanent insurance and dislike the lack of flexibility inherent in an investment that must be held for decades. I also find a taxable account an exceedingly attractive alternative. Thus far in my life, a taxable account has LOWERED my tax bill rather than raised it, thanks to tax-loss-harvesting and donating appreciated shares to charity. I'm in a relatively low tax bracket (actually got down into the 25% bracket last year, last time I'll see that for a while) and I don't pay an asset manager. It just doesn't make sense for me.

But I've met enough doctors in real life and on the internet whose financial lives are sufficiently different from mine that they could possibly benefit from a really good VUL. Check the example below to see how it might benefit some people.

The Math

How does this work? Let's use a hypothetical example. Let's assume you put $30K a year into a perfect VUL policy over 30 years, and $3K of that goes toward insurance costs. It provides the same investments available to you in a taxable account (let's say they gain 8% a year) and you're in the top tax bracket now and in retirement, let's say dividend and long-term capital gains rate of 23.8%. You then borrow the money out at 0% in retirement. After 30 years, the cash value in the policy would be $3.06M. Now, let's compare that to a taxable account. We'll assume the investments are fairly tax efficient, perhaps a yield of 2% taxed at 23.8%, lowering your rate of return to 7.52% per year. After 30 years, you pull all the money out and pay capital gains taxes at 23.8% on it. You end up with 2.37M, $690K less. You also don't get the asset protection and estate planning benefits (if any), and the death benefit.

This whole post has been mostly hypothetical to show that a really good VUL could be a good idea for certain investors. Whether the policy being marketed by Larson Financial is really good or not remains to be seen. I’ve sent a draft of this post to Tom Martin, their main investment guy, and asked him to submit a guest post about it. Then we can see how close it comes to an “ideal” policy and readers can decide if something like that makes sense for a portion of their retirement money. For the rest of us, we’ll continue to [not mix insurance and investing.]