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INSIDE INFORMATION

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*** All additional 'Inside Information' content has been removed for this website posting ***

Investing

Sleight of Hand

If you follow this article to somewhere near the middle, you'll arrive at some of the most fascinating illustrations you've seen in the financial services world.

Despite all the violent rollercoaster bouncing around in the equity markets today, the most volatile and temperamental investment vehicle in the financial services world is still the variable life insurance policy. Not only are these contracts linked to the stock market according to the wishes of the client or advisor (the subaccounts are basically mutual funds inside the policy wrapper), but all market volatility is greatly magnified by the fact that every up and down also determines the cost of insurance within the policy. If the market turns bearish, the amount at risk--the difference between the face amount and the value of the accounts; in other words, the amount the insurance company would have to pay out of pocket if the policyholder died--goes up, meaning the cost of covering that extra amount goes up too. Imagine that you have a term policy whose face amount goes up whenever the market goes down, and you have to liquidate your stock positions at a loss to pay the increased premium.

Add to that the question of pricing. Insurance companies sometimes project an optimistic cost of insurance coverage in order to get the business, but actually charge a higher rate once your client has bought the policy The result: you find yourself lost in a world of uncertain costs, uncertain returns, and uncertain performance.

"Insurance company pricing comes from their current mortality experience," explains Joe Maczuga, the founder of Fee Planners Network, an organization that works with fee-compensated planners to apply fiduciary standards to the purchase of insurance contracts. "What we want to evaluate with any new policy is the sustainability of the policy under those assumptions." Maczuga frequently finds himself trying to define the sustainability OF those assumptions as well, since distribution and marketing costs are typically bundled into the cost of insurance, and may or may not be illustrated as forthrightly as an advisor with fiduciary responsibilities would like.

Until recently, consumers and non-agent advisors would be shown policy illustrations without much of a compass to guide them. In fact, despite the high volatility of cash value life insurance, agents are actually prohibited by stern FINRA regulations from using Monte Carlo analysis tools to evaluate the safety and soundness of the policies they sell.

Fortunately, fee-compensated advisors are under no such restriction. Recently, Maczuga let me test-drive the newest version of his organization's Life Analyzer software, and the trip was eye-opening.

Maczuga starts from the premise that every policy illustration is really nothing more than a point-of-sale marketing tool, deliberately developed with more or less misleading assumptions. In addition to possible under-estimated future costs of insurance, the policy illustration always projects a constant annual rate of return into the future--which, of course, masques the hyper-volatility issue altogether. One way to dampen the volatility, of course, is to dump excess amounts of cash into the policy and reduce the amount at risk (and, therefore, the cost of the internal insurance policy). But even if you use this method to mitigate risk, Maczuga believes that planning clients ought to be able to determine, with some precision, how much they might have to sock away in the policy BEFORE they buy it. More often, a tour of the policy's hidden assumptions serves as an educational tool for consumers who are (dysfunctionally) looking for the lowest premium among competing illustrations.

How does Analyzer work? You start by plugging in everything that is disclosed by the policy contract itself. In the case of a universal life policy I was working with, there is a 3.5% disclosed

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sales load, and I was favorably impressed until Maczuga told me that this amount was allocated to state premium and DAC taxes, and no sales commission was disclosed anywhere in the policy paperwork. Hmmmm. Maybe the agent is working for free…

The contract also disclosed fixed policy expenses of $690 a year through 2012, dropping to $66 a year thereafter. The policy guarantees a 4% return on the bond subaccounts, and assumes there will be a 40 basis point enhancement after ten years. I thought that was something to be pleased with, until Maczuga told me that, interestingly, his other analyses have shown that these enhancements were covering up increased cost of insurance assumptions--and that in any case, these enhancements are not guaranteed.

Finally, you in put the yearly cash value assumptions directly from the policy illustration, and the annual premiums that will be paid each year, and the death benefit, which in this case is a constant $1.5 million. The death benefit is important because in order to back out the cost of insurance that is being assumed each year, you need to know the amount that is being insured--the difference between the death benefit and the value of the subaccounts at any point in time. Of course, you also put in the age of the insured, whether it's a male or female and so forth.

Once the numbers are entered into the spreadsheet, it becomes possible to estimate, with a reasonable degree of precision, the costs of insurance inside the policy. Because those costs go up each year as the policyholder gets older (as he or she becomes more likely, from an actuarial standpoint, to die), this manifests as an upward-sweeping curve, which the software illustrates. At first, the software assumes that the curve follows the 2001 CSO table, which most insurance experts will tell you is a very generous (think: profitable) rate, dramatically overpriced based on actual mortality experience. In my policy, the curve seems to run at about 32% of this benchmark, meaning the contract assumes that insurance prices will run about a third of the CSO table figures. "We normally find that current pricing runs at between 30% and 42%," says Maczuga. The operative word there is "current." "When the policy starts off with a 32% factor," he adds, "you want to know, is it still running congruent with that 32% in the future, or is it deviating from that? It's something we want to find out."

When the illustration is run, there are some discontinuities in the smooth curve which suggest that the company is suddenly introducing lower insurance costs in the out years. When those numbers are brought back to the curve, and the cash value of the account is mapped out on a graph, you see that the projected trajectory differs from the policy illustration. There is an initial surge and then a disturbing downward trend which ends in policy failure around age 79 or 80.

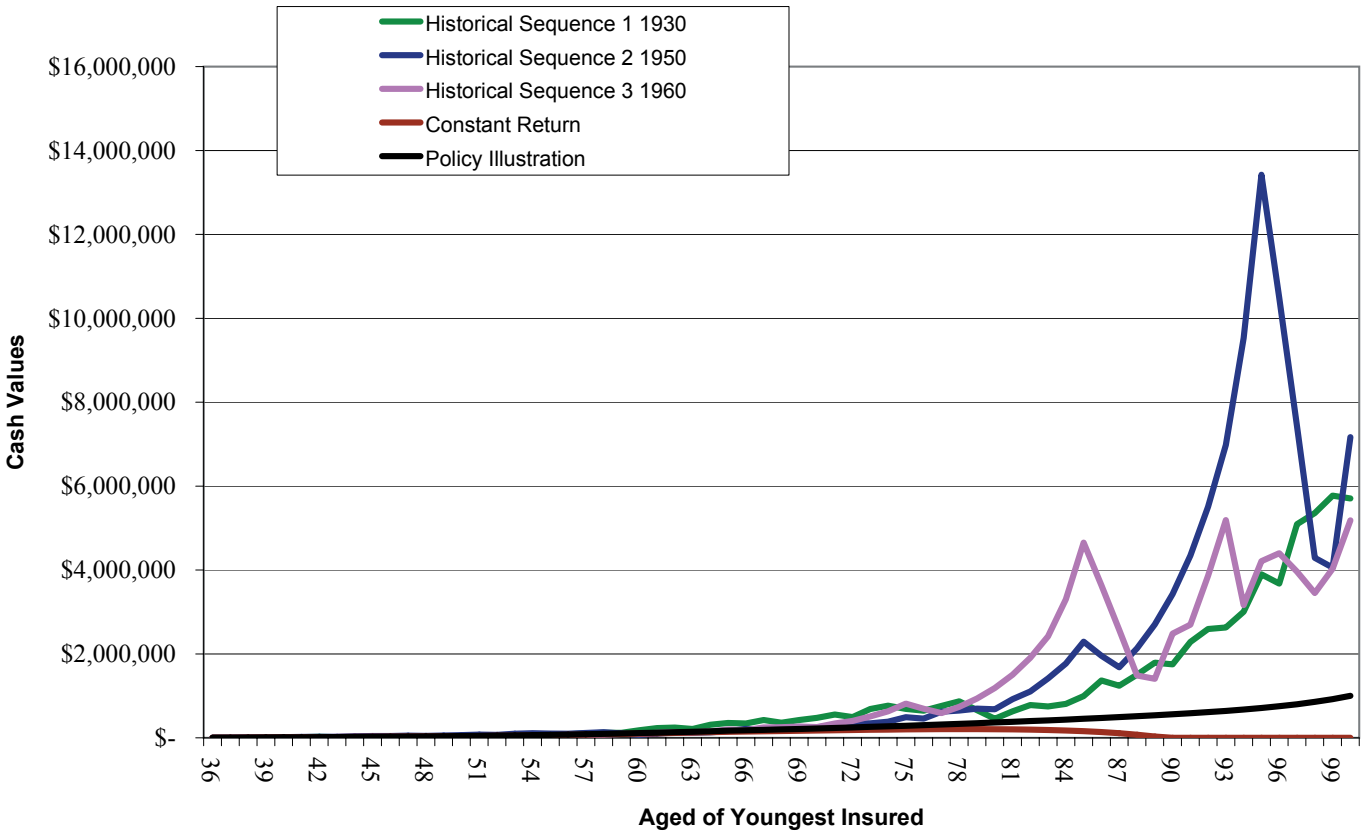
Why? "Initially, a lot of cash is dumped into the policy," Maczuga explains. "But then as they get older, the interest rate doesn't keep up with the cost of insurance, and as the client gets older, the whole downward process starts to accelerate. The less cash value, the more amount at risk, the higher the cost of insurance."

The lesson here, which Maczuga wants me to see on a very simple universal life policy, is that very subtle differences make a huge difference in the terminal effect. Maczuga estimates that a client who buys this particular policy would need to dump in an additional $87,000 today in order to stabilize a situation that looks so safe and sound on the policy illustration. By way of comparison, Maczuga runs an illustration of a no-load policy offered by Ameritas, graphs the two side-by-side, and we see a smooth cost of insurance curve and projections of a healthy product.

"In fairness," Maczuga adds, "there have been some commission policies that we have compared with no-loads where the commission policy was well-priced. There are still the problems with lack of liquidity due to surrender charges, but the pricing indicated that there was a high probability of maintaining the policy."

The real fireworks comes next, as we turn to a more volatile variable universal contract and start looking at various sequences of investment returns. (I can almost

Figure 1: Projections of Cash Values



feel my computer start quaking.) Here we input a 3.5% premium load, a $90 fixed yearly expense and 70 basis point M&E expenses for the first 15 years, dropping to 10 basis points after that--all from the contract disclosures. The policy illustration projects an optimistic 10% fixed annual rate of return from a somewhat aggressive underlying portfolio of subaccount funds, and discloses portfolio fund expenses of 83 basis points.

Net it out, and you're projecting 9.17% a year in actual returns on the subaccounts. From there, if you graph the future cash values, the policy illustration offers a nice, smooth ride off toward the heavens at roughly a 30 degree angle. What's not to like?

If you accept all the assumptions in the policy, the future could look even brighter. Maczuga has entered into the Analyzer a variety of sequences of market returns, one starting in 1930, another in 1950, yet another starting in 1960. Assuming a moderately-aggressive client, he graphs out the projected cash value rollercoaster that the policy would have followed for each historical sequence of returns, and we produce Figure 1. Notice that the policy illustration is actually rather moderate compared with the outcomes when you introduce variable returns into the equation. Quick, find me a pen! Where do I sign?

But Maczuga suggests that I try a bit of additional analysis before committing to this particular policy. First, he is curious about the cost of insurance curve, which, you will notice in Figure 2, doesn't actually resemble a curve. In the first year, the projected cost of insurance is actually higher than a comparative benchmark that Maczuga establishes (based on experience with other policies). So far, it looks pretty conservative. But notice in Figure 2 (next page) how, somewhere around the 14th or 15 year, the illustrated cost of insurance, teased out of the assumptions in the policy illustration, seems to veer south like a plane that just

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lost one of its engines. Maczuga redraws the assumption according to the orange curve, assuming--I think plausibly--that the cost of insurance probably won't go down or stay flat as the client ages. Then he turns back to the sequences of returns, to see if this seemingly minor adjustment in the policy's cost of insurance would change anything.

It does, as the reader can see from Figure 3. In fact, there's something kind of alarming about the differences between Figure 1 and Figure 3, not least of which is the fact that the policy crashes and burns, depending on your historical sequence of returns, anywhere from age 72 to 93. The policy illustration curve, which looked so conservative a few minutes ago, now soars into what might better be described as fantasyland.

"The policy lapses in each scenario," says Maczuga. "If you ever get a downturn in cash value, and you will, then those higher COIs will eat away at the policy, and it never recovers even in the good subsequent years."

When Maczuga shows these illustrations to the insurance companies, he always gets the same answer: the actuaries believe they can maintain the pricing that is reflected in the policy illustration. "We can't get companies to explain their pricing," he says. "If you put your trust in the insurance company, the way the regulations are written, they can use the illustration software to do anything they wanted. All the risk is on the client, and all the fiduciary responsibility of premium design is on the advisor."

In this particular case, he says, if you revise the assumptions so that the cost of insurance follows a plausible curve, there is no plausible way the policy can succeed, no matter what historical return sequence you choose. The

Illustrated costs per $1,000 are derived by reverse engineering the carriers' policy illustrations. Projected costs per $1,000 are those which are used to recast projected cash values.

Figure 2:
Comparison of Cost per $1,000 of Amount at Risk
First 20 Years

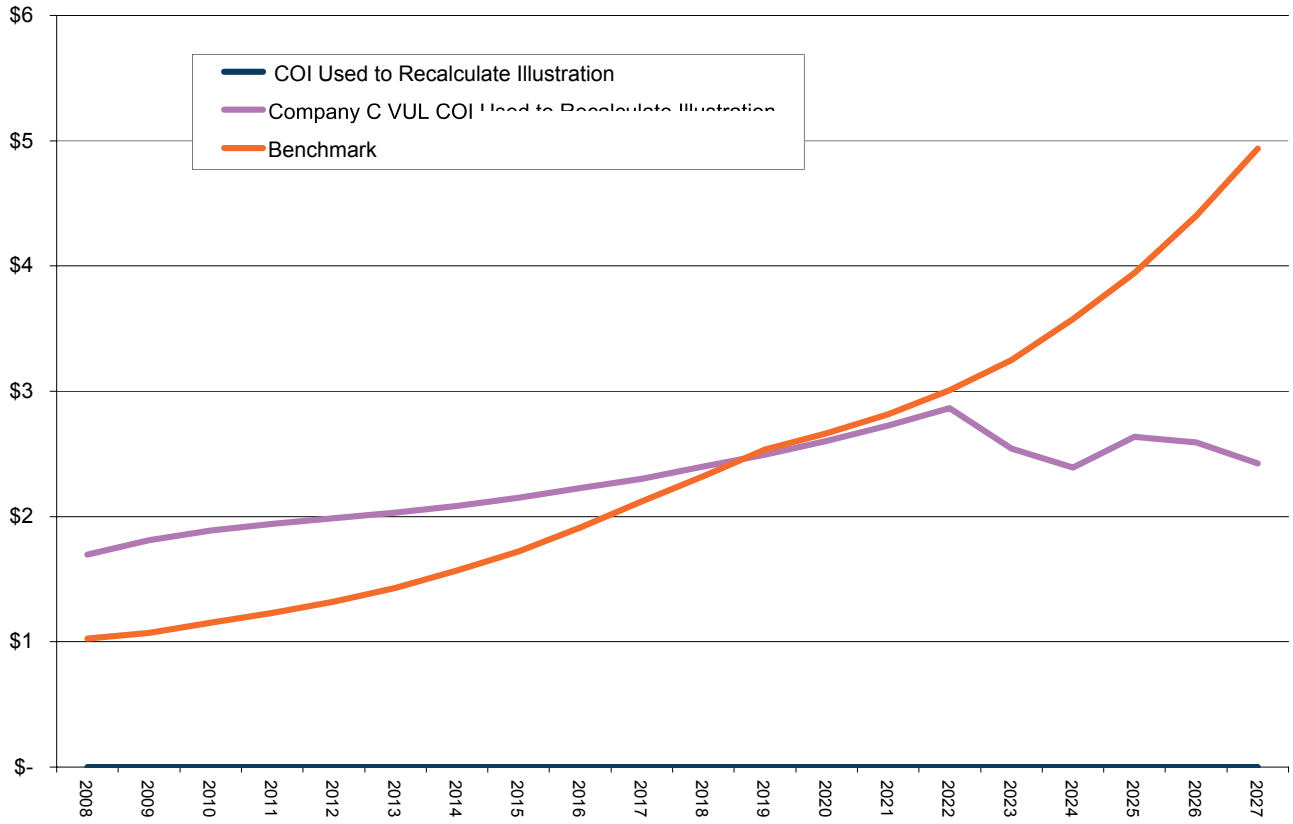
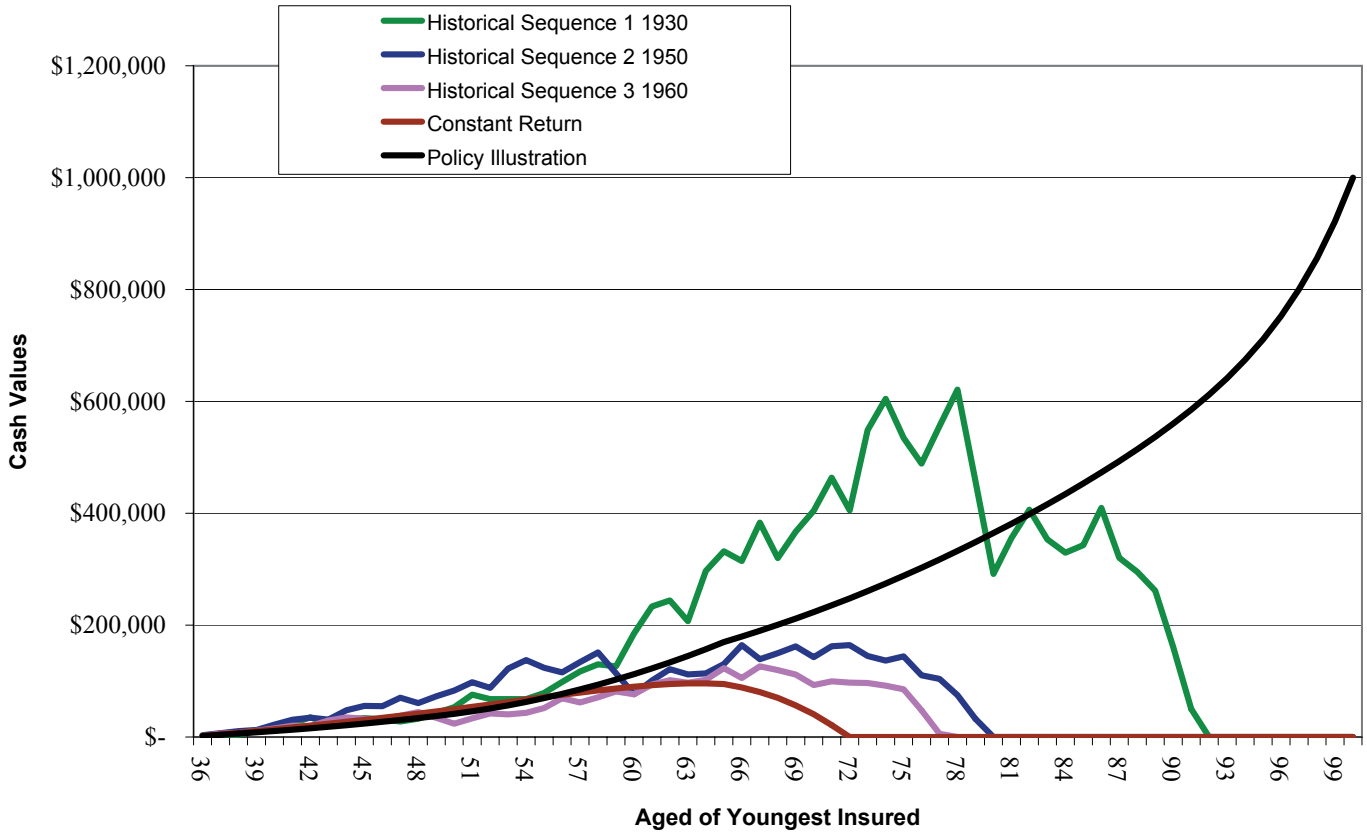


Figure 3:
Projections of Cash Values



subtle change in pricing, mixed in with the incredible volatility of the product, virtually guarantees failure on a policy that looked very (that word again) plausible in the illustration.

Earlier on, I noted that even the worst policy can be fixed if you dump enough money into it, reducing the amount at risk to less policy-killing levels. With the analyzer software, an advisor can run the illustration at higher premiums and see the various outcomes, including (if you raise the premiums high enough) something resembling the optimistic joyrides of Figure 1. Or, more likely, if the client wants to use the VUL policy as a retirement account, the advisor can evaluate the safety of taking withdrawals and monitor it. "We can put $150,000 a year into this and other policies for 15 years, and then see what would happen if we take out $120,000 a year for a period of time," says Maczuga. "We can plug in different return sequences and see if we have a high or low chance of sustainability. We might find that we couldn't support $120,000, but $108,000 is a realistic number."

The alert reader will recognize that in today's suddenly-volatile market scenario, a lot of these policies are likely experiencing the negative effects of reverse compounding and selling at the bottom to pay internal insurance costs. Maczuga says that this comes with the VUL territory, and then makes an important point. "Nobody has been able to convince me differently, that VUL should be an advisor product, not a commission product," he says. "These things have to be monitored closely. It just does not work on a 'sell and walk away' basis."

If you're interested in doing your own spreadsheet evaluations of existing client policies, this might be a good time to add the Analyzer to your toolbox. It costs $2,600 a year for members of Maczuga's network, which you can join from the web site through this link: http://www.feeplannersnetwork.com/. I hope you have as much fun with it as I did. ■