Why Indexed Life is a Great Alternative to More Popular Retirement Savings Plans

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The life insurance industry has the best IRS-approved retirement savings plan today -- and most advisors know nothing about it.

This retirement savings vehicle is not a qualified plan or an investment that goes inside one. It's also not a Roth. It's not an annuity or whole life. Despite sales of around $1 billion in 2009, it is the financial industry's No. 1 secret -- indexed universal life (IUL).

Why IUL?
To explain why IUL is better, we need to start with the fact that after a generation of use, qualified plans combined with variable investments are generally acknowledged as failures. A March 10, 2010 Employee Benefit Research Institute report states that "27 percent say they have less than $1,000 in savings. Fifty-four percent report that the total value of their savings and investments, excluding (home equity) and defined benefit plans, is less than $25,000."

One reason people fail to save is fear -- fear of losing the money anyway, so why bother? With the recent stock market plunges, various reports say many consumers, including those in their 20s and 30s, are too afraid to save in the market, despite the fact that that has been historically proven to be the best long-term place to save. But qualified plans are a different story.

In fact, TIME magazine devoted its Oct. 9, 2009 issue to "Why It's Time to Retire the 401(k)."

"The ugly truth is that the 401(k) is a lousy idea, a financial flop, a rotten repository for our retirement reserves," writes Stephen Gandel, a senior editor of Money magazine, in that issue of Time. "The solution: a new type of insurance. Retirement savings, it turns out, are exactly the type of asset we need insurance for ... to protect against the risks we can't predict and can't afford to recover from on our own. ... Recent opinion polls show people would be willing to give up [qualified plans] for a guaranteed return."

But workers -- and most financial advisors -- have absolutely no idea that a tax-free, market risk-free, gains-locked-in, congressionally-approved solution has been sitting right under their noses for 12 years. Indexed life's primary benefit is the fact that, like an indexed annuity (and unlike a mutual fund Roth), you keep all the gains and suffer none of the market losses. But there are many more benefits included that no other investment can lawfully offer, except maybe a Roth.

	Qualified plan	**Roth**	**IUL**
No market risk if savings are based on stocks			X
Life insurance			X
Accelerated terminal benefit (up to $1 million from day one)			X
Unlimited loan benefit with no repayment required			X
Loans can be used for any purpose			X
Use for "own-banker" concept			X
No contribution limit			X
Earnings can be accessed before age 59 1/2 with no IRS penalty			X
Required minimum distributions not required at age 70 1/2		X	X
Earnings can be accessed tax-free		X	X
Income not included in formula to tax Social Security		X	X
Remainder left to heirs income tax-free		X	X

Many of these benefits also make IULs among the best college savings plans available today.

But how much value does it provide?
What about returns? First, not all IUL plans are made alike. For one, the policy performance depends upon its design. Ideally, it's maximum funded (minimum insurance) with the increasing insurance option, switching back to level at the end of the savings period. Comparing on an apples-apples basis for an M50 NSP saving $1,000 per month for 20 years (using the S&P 500 Index), then "borrowing" $25,000 per year tax-free for 20 years, the 40-year net internal rate of return based on current point-to-point caps (16 percent to 8.25 percent) minus actual policy costs ranges from 7.33 percent down to 1.83 percent.

Because IULs are not all made alike, I'm going to pick just one to use for our examples. Evaluating and comparing plans is beyond the scope of this article, but you cannot compare IULs based on their current illustration rates; doing so is the No. 1 mistake agents make when dealing with these products.

The 7.33 percent new illustrated rate of return on this product translates into a gross historical illustration rate (HIR) of 9.20 percent -- well within its historical range based on an average cap of 16 percent over the past 20 years.

Gross average:	**20-year gains**	**30-year gains**		
	S&P	**IUL**	**S&P**	**IUL**
Past 20 periods	10.47%	10.23% HIR	8.26%	9.57% HIR
Past 25 periods	9.54%	9.86%	7.87%	9.33%
Past 30 periods (60 years)	8.63%	9.52%	7.62%	9.15%

Even though it can outgain the actual index as shown above, one of the knocks against IUL is that it does not include all the gains. But that's actually the desirable tradeoff and basis of the benefit guarantee for having none of the losses -- your client keeps all the gains, after policy costs. This is part of why an IUL can actually outperform and outlast a qualified plan.

What about the net illustrated rate of return?
First, according to S&P, that particular index outperforms most mutual funds in the long term, so it represents the "market" in these examples. Second, according to Morningstar, the average annual fund expense for management and transaction costs is, at a minimum, 3.03 percent. (ERISA-qualified plan costs are estimated to be an additional 1 percent, for total fees of 4 percent per year.) But because of investor behavior, Dalbar states that the net illustrated rate of return for the typical fund investor from 1989 through 2008 was only 1.87 percent. However, for the following example, let's assume the market growth is 8 percent and the net is 5 percent, versus 9.2 percent growth for the IUL.

For a M40/20 percent or 35 percent MTR and income starting in year 26:

	Qualified plan -- net	**IUL -- tax-free**
Annual savings	$12,000 net	$12,000 net
	Net income/CV	**Net income/CV**
Year 26 (age 66)	$90,000/$488,000	$90,000/$958,000
Year 33 (age 73)	$0/Broke	$90,000/$947,000
IRR	4.54%	8.59%
Year 60 (age 100)	$0/Broke	$90,000/$5.26 million
IRR		9.54%

Additionally, because of the IUL's locked in gains and principal guarantee, your clients can also overcome two problems after retirement by achieving the following:

- Remaining substantially, if not fully, invested in the market
- Not abiding by the general withdrawal rule of 4 percent for savings to last a lifetime

If the IUL offers a global index option, the gain over the past decade could have been 1 to 2 percent more. Two companies also offer an option that credits 140% percent of S&P gains (one to a 14 percent cap), so if gains are below normal the actual credit can still be at or above -- something no fund can guarantee. Also, with IUL income not being included in the formula to tax Social Security income, with a 35 percent MTR it can create an additional income of 28 percent of current benefit -- on $1,250, that's $350.

Other benefits of the IUL
Another reason why IULs can perform better is substantially lower lifetime fees. Life insurance deservedly gets a bad rap for costs, but for this top IUL plan, the average expense ratio for all expenses in years one through 20 is 0.847 percent; to year 30, 0.422 percent; and to year 40, 0.233 percent. This is less than one-tenth the average (minimum) mutual fund fee of 3 percent.

The other complaint is that gains don't include the S&P dividends. Well, over the past 20 years, the net illustrated rate of return of the actual S&P with dividends -- less 0 percent in fees -- was 5.55 percent. For this IUL, the net illustrated rate of return was 6.48 percent, or 17 percent more.

With its performance and guarantees. IUL does exactly what many say is needed for retirement savings: providing great return without market risk and giving people retirement security with principal guarantees. For those who complain that gains are still tied to the market, history has shown that in the long term, the greatest risk is not being in the market. All-in-all, there are few better or safer retirement plans. For many boomers, IUL may very well be their last chance for retirement.

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