

Will Indexed Universal Life benefit you?

Presented by: Edmond Consulting Group LLC



Erica T. Edmond, MBA
Founder/President

P1: (803) 394-0824/ P2: (404) 803-0443

Fax: 803-234-5004

Email: eedmond@consultwithedmond.com

Career Profile: www.askmsedmond.com

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What is IUL?

Indexed universal life (IUL) provides lifetime coverage. Premiums, cash value, and level of protection can be adjusted up or down during the term of the policy to adapt to evolving needs. Indexed universal life insurance generally provides for indirect participation of an equity index and performance is limited to a cap that is set by the insurance company. Indexed universal life also provides for protection against any negative performance of the index. This is commonly referred to as a downside "floor" of 0%.

How IUL is different from other types of life insurance

Indexed universal life insurance is a type of permanent life insurance. Both permanent life insurance and term life insurance offer death benefit protection. However, permanent life insurance provides these benefits that term life insurance does not:

- Cash value accumulation
- Additional options including long-term care coverage (at additional cost)
- Flexibility based on individual/family/business needs
- Lifetime death benefit protection

Let's take a closer look at each type of insurance and how it compares to an IUL:

Term life insurance

Term life insurance is the simplest form of insurance that can provide you with the ability to purchase coverage for a specific price for a specified period. If you die during that time, their beneficiary receives the value of the policy. These policies are designed as income replacement in the event of the insured's death. However, term life does not have an interest accumulation component to offer the opportunity for cash value accumulation that an IUL does.

Permanent life insurance

Permanent life insurance remains active until the policy matures, unless the owner fails to pay the premium when due. A permanent insurance policy accumulates a cash value which may be accessed through withdrawals and loans or by surrendering the policy to receive the surrender value.

Universal life insurance (UL) is one kind of permanent life insurance that provides more premium payment flexibility and potential for cash value growth. There are a few different types of ULs including:

Guaranteed universal life (GUL)

A GUL guarantees that the death benefit will always remain intact, even if there is not enough cash value to pay for monthly charges, as long as premium payments are paid adequately and promptly. Traditional universal life uses the policy's cash value to pay for monthly deductions; if the cash value is insufficient to cover these charges, the policy will lapse. While a GUL provides assurance of coverage, they typically accumulate little cash value and oftentimes have greater restrictions than an IUL.

Upside potential

With traditional universal life policies, the issuing insurance company declares a fixed rate of interest that is credited to the policy cash value. With index universal life, interest is credited based in part on the potential upward movement of a specific stock market index over a specific period of time. Over the long-term, this could mean more cash value which you can access through loans or withdrawals.

Downside protection

Index universal life policies can benefit from the upward movement of an external stock market index. However, the market index can also go down. For those situations, you will have a minimum guaranteed interest rate that protects against index losses.

Index Universal Life vs. Guaranteed Universal Life

Healthcare costs for an average 65-year old couple retiring now equal \$220,000 for out-of-pocket medical expenses throughout retirement.

US Labor Bureau Statistics via the Stanford Center of Longevity, 2013

Why Index Universal Life Insurance? It's all about upside potential with downside protection. Kevin, age 45, is a computer engineer and has two young sons with his wife, Christine. He needs death benefit protection for his family while he is working, but is also interested in flexible features and potential cash value that he can use during his lifetime. Kevin plans to retire at age 67 and also wants to be sure he has the resources available to build the future he has in mind – sending both of his sons to college, buying

a vacation home and protecting for additional healthcare costs in the event of a chronic illness. He understands that this type of universal life insurance does come with some risk but he is interested in exploring this option when considering long-term potential of cash value growth. The conversation: Kevin speaks to his financial professional and asks to see the benefits of a similar premium payment in an Index Universal Life policy (IUL) vs. Guaranteed Universal Life policy (GUL) in different scenarios. He asks about what his upside growth potential would be in both policies – and with IUL, at two different rates of growth – 6%, and if the market performs well, 7.5%. While the death benefit and cash accumulation are guaranteed on GUL, the IUL can also offer a guarantee for a number of years as well as strong cash accumulation potential. Additionally, death benefit is guaranteed on GUL, while IUL only provides for a limited period of guarantees. He also is interested in the Accelerated Access Solution®, which would allow him to use a portion of his death benefit while he is living should he develop a chronic illness (when criteria is met)

INDEX UNIVERSAL LIFE	GUARANTEED UNIVERSAL LIFE
\$1M death benefit, with the option to accelerate 50% of his death benefit for chronic illness (capped at 4% month) Guaranteed to age 66	\$1M death benefit, with the option to accelerate 50% of his death benefit for chronic illness (capped at 4% month) Guaranteed death benefit to age 100
Pay into the policy until age 67	Pay into the policy until age 67
Premium: 6% = \$9,400 ¹ /year* 7.5% = \$7,600 ² /year*	Premium: \$9,800 ³ /year
Cash value at age 67: 6 % = \$240,000 ⁴ 7.5 % = \$200,000 ⁵	Guaranteed Cash value at age 67 = \$21,500 ⁶

The Pros of Indexed Universal Life

Death Benefit – also known as Family Protection

This is an insurance product and ultimately the thing you are insuring (your life) is of utmost importance. Money will never be able to replace the loss of a loved one, but

avoiding the double-whammy of a family death and massive financial hardship is significant.

All life insurance products have a death benefit, so it may seem odd to discuss this as a pro, but ultimately it is the key product that is being purchased, so it shouldn't be dismissed.

I think many people wander around ignorant of the necessity of owning a life insurance policy, but once they are educated and see the need, there is usually a tremendous sense of urgency that is only relieved by their own policy going in force.

Cash Value

An IUL is a **cash value life insurance policy**, meaning that it has a cash value and allows for cash accumulation inside the policy.

This is a distinct advantage of **permanent life vs term life policy** and is part of the reason that an IUL is more expensive than term.

The cash value grows over time as the individual pays into the policy. The cash value can always be accessed and used as you see fit. In addition the withdrawals are tax-free, up to the amount of premiums paid, because the premiums were paid in after-tax dollars. And don't forget that you can also access the growth of your account tax-free, by taking a **life insurance policy loan** (sometimes called a swap loan) against your cash value.

For those with a lot of extra cash to invest each year there is a limit to the amount you can pay into the policy (typically a percentage of the total policy value), this limit is known as the **MEC (modified endowment contract)** limit. So keep that in mind if you're thinking this could be a tax shelter for your tremendous horde of cash in the basement.

Flexible Premiums

Convertible term insurance policies require that you pay your premium each and every month, if you stop paying, your policy lapses.

Whole Life policies require that you pay your premium each and every month, if you stop paying, your policy lapses.

There are some exceptions, but it is fairly rigid.

With an Indexed Universal Life policy you have the ability to pay more or less each month (there is a minimum to cover fees, and a maximum based on the MEC limit) but the policy has much more premium flexibility than the other main life insurance products in the market.

The flexibility of an **IUL** is great for those that have income that fluctuates throughout the year. If you work on commission and certain times of the year are much better than others, you may want to consider the flexible premium options available with an **IUL**.

Locked-in Gains & Annual Reset

Another great aspect of the **IUL** is that each year the gains are locked in or captured. In other words, every year your gain will be secured along with your previous cash value total.

Within an **IUL** your insurance company does not invest your cash value in the stock market. Instead they purchase options on the market index. This provides the option to make money when the stock market is up, but to avoid losing when it goes down.

In reality, the company still loses the “option price” but that is part of the cost of insurance each year and is a fixed cost. In other words, the cost is known ahead of time and therefore the insurance company can estimate accordingly.

The Annual Reset may not seem like much at first, but in reality it's a fairly big deal. What it means is that you are always starting from zero each year. You never have to struggle to “catch up” due to previous losses. Over a 79 year period (1937-2015), the S&P 500 had two periods where it lost three years in a row, 1939-1941 and 2000-2002.

It only had one period where it lost two years in a row, 1973-1974. And after those distinct losses, the market bounced back with double digit returns every time.

For Example

If you have \$100k invested and lose 10% in year one, 20% in year two, and 10% in year three, you'll be at around \$65k at the end of the three years. In order to get back to even, you'll need to get around 50% in the coming year.

However, if you had \$100k in cash value in your IUL over the same period of time, after those three years your cash value would still be really close to \$100k – which means that the double digit returns don't get you back to even, but springboard your policy's cash value to new heights.

No Required Distributions or Penalties for early access

When you get ready to retire, there is no mandatory distribution in an IUL. If you have an IRA or **the pesky 401(k)** you'll have to start taking distributions (withdrawals) when you turn 70 1/2. I'm sure you know already, but the reason for this mandatory withdrawal is because the IRS can't tax that money until you start to take **401k withdrawals**.

This may not seem like a big deal to you when you read it, but if you're trying to build your retirement account while you or your spouse is still working, these mandatory distributions can seriously slow your progress. The IUL has no such mandatory distribution requirement.

If your spouse is working and you are retired, you can live off the employment income and let your cash value grow and grow without taking out any money. (If you have a 401(k) and you are still working after reaching the age limit, you can delay the distributions, but only until you stop working, then it becomes mandatory).

Is it Tax-Deferred or Tax-Free?

The IUL is a **tax-deferred policy**. Similar to that of a 401(k) or an IRA, but different in many significant ways (some of which I've already mentioned above). If you choose to build up your cash value in an IUL and use the protection during your working years, the policy will act much like any other tax-deferred product. The cash value will grow and you will not pay tax on the growth in the cash value. If you happen to close the account (not recommended) or take withdrawals instead of policy loans, you will pay taxes on the growth.

However, unlike the IRA and 401(k) accounts, there is a way to access the cash value tax-free without incurring any penalties. In addition, you can always withdraw from your cash value up to the amount of the premiums paid (your basis) without being taxed because those premiums were paid in after-tax dollars.

With an IUL you can access your cash value at any age, without penalty or compulsion. You do not have to wait for some required age to have access to your cash value. Many tax-deferred retirement accounts have an age restriction of 59 1/2 before you can access the money. If you withdraw ahead of time there are penalties and restrictions.

I don't know about you, but I prefer to have zero limits on accessing my own cash. With an IRA you do have some stipulations for emergencies, and age distributions, but even so they can be limiting.

Excellent Growth Potential

The **Indexed Universal Life** insurance policy has serious upside growth potential. This is probably one of the biggest reasons why individuals looking for permanent life insurance will choose an IUL over a Whole Life policy.

Whole Life insurance has rather conservative guaranteed growth rates. The IUL can double those rates in a year in which the cap is hit.

If the market index that your policy is tracking increases 10% in a given year your account will be credited around 10%. If the market index increases 20%, your account will be credited with the max or cap, which is currently around 13% for most policies.

When the index returns a rate that is higher than the cap, the company keeps the difference.

You don't keep "excess" Returns

The additional % that the market index returns above the cap is used to make up for the years in which the company has to cover the losses of a negative year and give the minimum guarantee. Not all companies offer a minimum guarantee that is above 0%, but some do offer a guarantee around 1%. This can be a big deal in covering the cost of insurance in down years. Paying the max allowed in the first few years of a policy will really tilt the policy in your favor for the life of the product.

Doesn't Impact Social Security

You don't have to worry about the Indexed Universal Life policy impacting your Social Security tax situation. Many people don't know this, but the money you make from Social Security in retirement may be taxed as income if you make more than a certain limit. The income from an IRA might just put you over the limit (currently \$32,000 if filing jointly, or \$25,000 if filing as an individual) and therefore cause your social security to be taxable.

Let's say for **example** you get \$24,000 a year from Social Security, and you take another \$40,000 from your IRA each year. If your house is paid off and you don't have any other write-offs, you may find yourself in a situation in which the Social Security benefits are taxable, and you'll end up in a higher tax bracket.

If instead of an IRA you had an IUL policy loan for \$40,000 per year, your taxable income would be zero because you would be under the base limit. For an individual or family that is living on less than \$80,000 per year, you may find that your annual tax savings are in excess of \$10,000. That's a big deal. For those making more, your savings would be even greater. That's a bigger deal.

The Cons of Indexed Universal Life

0% Returns WILL Reduce your Cash Value

One of the big selling points of the **Indexed Universal Life** policy is the fact that you never lose cash value, because there is a floor of 0% (sometimes 1%). The reality is that the cost of insurance in the early years can be significant, and therefore you may see your cash value decrease if you have been paying near the minimum premium each month.

It is recommended in the early years that you do what you can to pay the maximum premium. Doing this in the early years when your cash value is low and just starting to grow, will help get the ball rolling and the momentum accelerating.

One of the benefits of an **IUL** is the flexible premium. But if you consistently pay the minimum premium, the down years will definitely be a big kick in the pants and you'll be disappointed at the cash value of the policy. This can also start a snowball effect as the costs increase as you age.

Cost of Insurance Rises as you Age

The cost of insurance is based on your age, your rating, and the amount insured. For each \$1000 death benefit there is a cost that increases each year as you age. The reason the cost goes up is because you are more likely to die.

Whole Life policies average the total cost of insurance for the entire life and provide a fixed premium.

IUL policies have an increasing rate. This means that it is cheaper in the beginning and more expensive down the road. This can be scary for those that are not prepared financially and as they get older the cost of insurance skyrockets out of control.

Competent Insurance agents are not trying to sell you a product that will lapse in your old age due to crazy expenses. Yes it can happen, but that should not be the intention of the qualified agent. The intent of an **IUL** is to gradually decrease the "net amount of risk" (as seen by the insurance company), as you age.

What does this Mean?

On most IUL policies, the death benefit is equal to the original insured amount minus the cash value. In other words, if you purchased a \$500,000 policy, and you had \$200,000 in cash value at the time of your death, your beneficiaries would receive a check for \$500,000, not \$700,000. This means that the insurance company only had to pay out \$300,000 at the time of your death, because you had accumulated \$200,000 in cash value during the life of the policy.

All this to say, that as you get older the cost per \$1000 of death benefit increases, but so should your cash value. Therefore the risk to the insurance company is relatively the same. You have a higher risk of dying because you are older, but they also have a lower amount at risk, so the two should even out.

This is all fine and good if things go as expected. But if you pay the minimum, and the policy struggles because there are a few bad years in the beginning, you may find yourself down the road with too little cash value to compensate for the increasing cost of insurance associated with your age. You can always call and lower your death benefit, but that is obviously not something that most want to be facing.

The S&P Index Crediting does NOT include Dividends

In order for the insurance company to give you a floor of 0% and to also give you some of the upside of the S&P 500 index, they have to buy options. These options are not the same thing as buying the underlying stock that these options represent. As a result, the company does not get the dividends that a stock owner would rightfully get.

Therefore, when you look at the S&P 500 index you must be aware that the index was created to include the dividends associated with the representative stocks. In other words, you will earn less than the index because you're not getting the dividends.

In some years this can be a 1% difference in the index, and in other years it may be as high as a 4% difference. But it's helpful to know that you will never get the same rate of

return that the index itself returns. To be fair, almost all asset managers fail to earn the same rate of return as the index, but that's another point entirely.

There is a Crediting Cap

As mentioned earlier there is tremendous upside to an **IUL** because they are buying options on a given index. However, they do cap the credit amount so that in years where there is an index return of 22%, you will only be credited the max, or cap rate, associated with your policy. The cap rates are typically between 11-14%.

This can be frustrating if you are watching your mutual fund go through the roof and you want to get in on some of that action. But it is usually outweighed by the converse effect of watching your **IUL** sit stationary while your mutual fund plummets in a bear market.

Credit caps are just a cost of doing business with an **IUL** policy. If you don't like it, you may be better off with a Variable Universal policy or perhaps another product that is fully in the stock market.

It's Complicated

Finally, it's also true that an **IUL** can be complicated. This is especially true when compared with term life insurance. The fact that the cost of insurance rises as you age, and that there are some strategies for increasing death benefits and strategically managing the policy throughout the years to manage the various indexes and crediting options, means that it isn't simple. This isn't a big deal if you have a good agent that you trust, but it can be an issue if you don't have an agent and prefer to just pay the premiums and forget about it.

There are plenty of good reasons to choose an **IUL**, but they need to be understood and weighed against the disadvantages and your own personal situation and needs. It can be complicated, but if you choose to stay educated and discuss your policy once a year with your agent, it's not something that should really be a deal breaker.

The **Indexed Universal Life** policy is a solid and reliable life insurance product that provides a specific set of benefits to the consumer. For those that want a taste of the bull markets without the bite of the bears, this may be the perfect product for you. Do yourself a favor and stay educated. If you need any additional help, or just have some basic questions, please don't hesitate to reach out – we'd love to help.