GUIDING LIGHT

Insurance doesn't provide the best return on investment. But if a client's worst fears become reality, it can help lead the way through life's twists and turns.

By Moshe A. Milevsky

Consumers without formal finance training often ask if life insurance is a good investment, and whether it provides a high rate of return, compared with mutual funds or stocks.

The question reveals innocent ignorance of the purpose behind life insurance, which is to protect a client's dependents and to provide financial security in a catastrophic event. I've developed a habit of telling people that life insurance can be a great investment, with the caveat that it usually does not provide a high rate of return on

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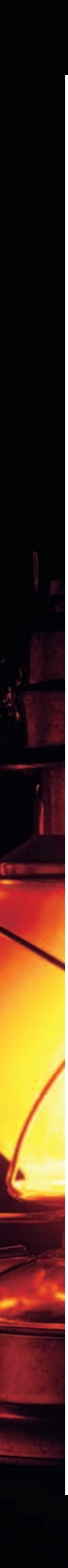

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premiums. In most cases, people can expect the financial gain from buying term life insurance to be negative, especially once they factor in commissions, profits and expenses.

Confused? So are most of your clients. The key to understanding the seemingly paradoxical role of insurance within a personal financial portfolio is to get back to basics. Many of the insurance decisions your clients face during their lives need to be examined in terms of the correlations among risk, return and, most importantly, the hedging motive.

According to modern portfolio theory, upon which most of today's mutual fund industry is based, the benefit from holding a large portfolio of individual companies derives from the statistical fact that not all stocks gain or lose value at the same time. People buy investments not only because they want to make money in the long-run, but also to diversify a portfolio in the short-term. An astute fund manager will add instruments to client portfolios simply to smooth out the bumps created by other holdings, even if they don't provide the highest return on investment.

Think of commodity futures, hedge funds and other alternative asset classes that are presently being promoted. They might not provide great investment returns, but they definitely smooth out the rough edges in equity-laden portfolios. In fact, the goal among institutional fund managers is to discover investments with negative correlations to the rest of a portfolio—statistical parlance for investments that buck the trend and go up when others go down, and vice versa.

But let's get back to insurance as an investment. The primary role of life insurance is to protect the human capital of a family's breadwinner. What happens to the financial value of a client's life insurance when the contract expires at the end of the policy term? If the client is still alive, then her human capital has earned above-average returns but her life insurance has earned below-average returns. But if the person dies, her human capital earns well-below average returns (-100% in fact) while her insurance contract earned well-above-average returns.

Life insurance diversifies the portfolio and hedges the client's human capital. Even if the expected investment return is negative, it is still a wise financial decision. Ensuring a client has sufficient life insurance coverage to protect her family should be one of the guiding lights an advisor uses to develop a complete financial plan.

The chart (see page 15) illustrates how asset allocation, life insurance and human capital interact over the course of a person's life. Early on, there's uncertainty about how employment fortunes will evolve. A person's human capital—which forms the great bulk of her assets—is risky.

As she advances along a career path and converts her earnings potential into financial capital, she can tolerate more financial risk. In the same vein, the face value of life insurance should be less than the present value of human capital, which is in line with the traditional expense approach to life insurance needs. Likewise, once a person reaches her pre-retirement years and has accumulated financial capital, there might be little if any need for life insurance.

This picture is, of course, idealized. Advisors often have some clients with families that must be protected with insurance well past age 60, and others that can dispense with the coverage earlier in life. Income taxes and estate planning motives also add a wrinkle to the argument for not carrying insurance once the human capital is spent.

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WHAT ABOUT INCOME TAXES?

Once you throw income taxes into the equation, life insurance gains another favourable dimension within an asset allocation framework. The investment gains inside certain types of life insurance policies build up without attracting or generating an income tax liability until the policy is surrendered. Although all gains will be taxed at the client's highest marginal tax rate once surrender takes place, the compounded gains can offset the higher tax liability. Further, if the client can borrow against the policy, instead of cashing it in, the after-tax returns can be even greater. Here is a simple example of how life insurance can produce mediocre pre-tax, but excellent after-tax, returns.

Assume a client invests $10,000 (non-RRSP) in a bank's five-year GIC that pays 5% every year. If she is in the

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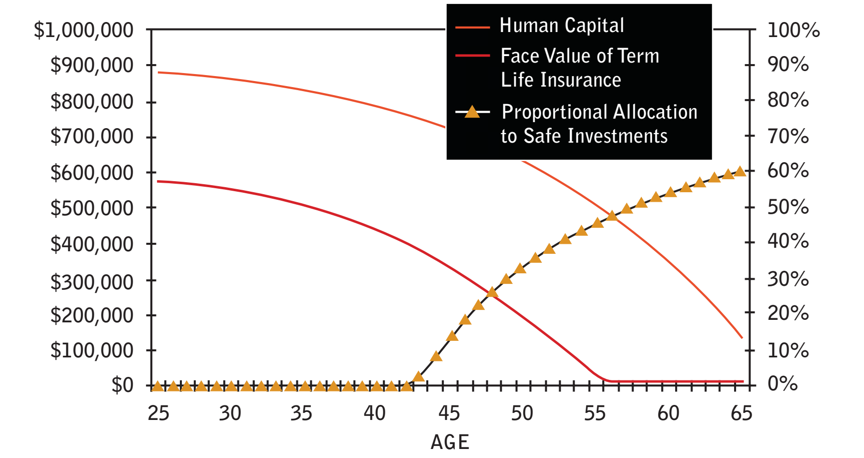
Photography by Geoff George

INSURANCE NEEDS

As a person accumulates financial capital, she may need less life insurance.



Source: *Ibbotson Associates,* 2004

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50% marginal tax bracket, the annual interest of $500 will only leave her with a post-tax gain of $250. That can be reinvested in another GIC and left to grow over time. For the sake of argument, let's say the client can reinvest the gains at 5% pre-tax. Say the same process happens the next year. The client will have to pay half of the interest income in taxes and then the remainder can be reinvested. At the end of the five-year period, the after-tax rate of return will be 2.5% per year. Sure, pre-tax she earned 5%, but after tax it was only 2.5%. Do the math and you'll find that in 30 years the client has $20,975 ($1.025^{30}$ multiplied by the initial $10,000). The 1.025 figure comes from the total after-tax return.

Here's where things get interesting with life insurance. With permanent (non-term) life insurance policies, a portion of the periodic premium that goes toward the savings component grows tax-deferred. Since the inside buildup is tax-free, at the end of 30 years an investor has 1.05^{30}, instead of the lower 1.025^{30}. That's $43,220 before taxes are paid, and a gain of $33,220. The client must then pay tax at 50%, which leaves her with $26,610.

Compare the numbers and you'll get my point. The client has $5,635 ($26,610 minus $20,975) more from the tax-free, inside build-up within the life insurance policy than she would with a GIC. This is about 50% more on an initial $10,000 investment. Now scale that up to a $100,000 or $500,000 investment and you'll understand the magnitude of this after-tax benefit. This type of example applies to people with substantial net worth who require the tax shelter.

Using insurance in this way makes sense for people who have used up other sources of tax-exempt growth. But such clients are, in fact, purchasing a tax shelter that is being combined with a life insurance policy.

For some clients, in addition to providing a solid hedge against the loss of the family breadwinner, an insurance policy can offer an after-tax rate of return that far exceeds the investment return from competing products that don't get such beneficial tax treatment. Life insurance should be part of the family's diversified portfolio.

LONGEVITY INSURANCE

The same line of thought applies to insurance protection toward the end of life. As people age, the value of their human capital dwindles and all they have to support themselves during retirement is the financial capital amassed while working. At that point in life, future needs are unpredictable.

This uncertainty can be diversified away, by being a member of a defined benefit pension plan, or by voluntarily purchasing a life annuity with an RRSP/RRIF that provides a higher rate of return to a person who lives for a long time. So, although a client's liabilities might increase beyond what was expected if she reaches her 90s, so too will the investment return from a life annuity.

The conceptual framework behind total asset allocation is to view all of the financial decisions a client faces during a lifetime in terms of investment returns, risks and hedges. A decision or investment might not make sense from a purely-expected return perspective. But once the correlations, or hedging properties are examined, it quickly redeems itself. AE

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WHAT WOMEN WANT

Having difficulty turning female prospects into clients? Try these strategies.

By Betty-Anne Howard

Illustration by Tracy Walker

ARE you listening? If you're an advisor with women clients, you'd better be, because that's what they expect.

Women often say they find financial issues boring or intimidating. But what they're really saying is that they have a hard time finding an advisor who will take the time to communicate with them, listen to their concerns and answer their questions.

I design and deliver seminars geared toward women. In fact, those seminars lead to half of the attendees, sometimes as many as 80%, becoming my clients. Here are a few of the things I've learned:

Spark some interest. I use some pretty over-the-top seminar headings—Financial Planning with Passion; Smart Women Finish Rich and Happy; or Sex, Religion and Money: The Final Taboos. Headings like these catch a woman's attention and immediately convey the seminar won't be boring. To stimulate dialogue, and to learn something about my prospective clients, I hand out workbooks with blank pages and take hoards of pencil crayons. Then I ask attendees to draw pictures reflecting what their lives would look like if they had a healthy relationship with money. The results are revealing. Their pictures include trees with strong trunks and roots, and lots of green leaves and sunshine. One prospect drew a beach, hammock and sunny weather. But when I ask those same women to draw a picture of their current relationship with money, I rarely see sunshine. One prospect completed the assignment by drawing a picture showing an anchor, which told me she felt weighed down by financial worries.

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