TENON FINANCIAL
RETIREMENT PLANNING & INVESTMENT MANAGEMENT

Retirement Planning Insights

August 2023

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Tenon Financial Happenings

Dancing in Ocean City, Maryland

Last month my daughters competed in a dance competition in Ocean City, Maryland.

As is typical for these competitions, they take place in vacation destinations. However, there generally isn't much time to actually enjoy the town because of how much dance there is. With that said, us dance parents find ways to entertain ourselves.

That generally involves hanging out in the convention center for hours on end in between waiting to watch our kids' dances. There may or may not be some beers had during that time. And if the weather is nice and someone remembers to bring it, some throwing around of a football outside.

We had enough down time one day for me to take one of my daughters to get a hermit crab, which she's been asking for for a long time. She named him Randall (yes, Randall..)

One of the ways I keep myself engaged with my kids' dancing is by being the lead "prop dad." Not only do I design and build the props used by my kids' dance school, but I'm also responsible for transporting them to and from the competitions and coordinating other parents to help set them up and take them down when it's time.

While this doesn't require as much time as being a "dance mom," where there's lots of running around to fix make up, steam costumes or frantically find missing earrings, it nonetheless gives me a sense of purpose and a way to help contribute.

Here's me and some of the other prop dads killing time before setting up our props (I'm the one sitting on top):

Dance is now done for the season, but starts up again in a few weeks with the start of school. TBD where next year's national competition will be. Regardless where it is, I'll be there with the props!

Have a good August.

-Andy

Retirement Planning Happenings

An introduction to Indexed Universal Life ("IUL") insurance

Over the last few years, I've witnessed an increase in people selling a certain form of life insurance as an investment-like retirement income tool. It goes by names such as a Life Insurance Retirement Plan ("LIRP"), The LASER Fund, Private Reserve Account, Section 7702 Plan and a handful of other creative terms.

All of these marketing names are ultimately in reference to a certain type of permanent life insurance policy known as Indexed Universal Life ("IUL") insurance.

My first introduction to this product was about five years ago when I came across an online pitch for something called a "Tax Free Retirement Account." The illustrated numbers with regards to how much you can get out of it for how much you need to put into were really impressive. AND all of the money taken out is allegedly "guaranteed" to be tax-free for life! It sounded too good to be true, so I started researching and investigating as much as I possibly could.

I eventually figured out the underlying product was an IUL insurance policy. The more I searched up IULs, the more I was exposed to lots of different sales pitches from different people calling it different things. And I soon found that a lot of people selling IULs were making claims that were half-truths, misleading or outright false.

I ultimately realized that while it's possible the product's results could potentially turn out as originally shown at the time of sale, there are lots of ways in which they could fall far short. And the results aren't nearly as "guaranteed" as the pitches makes them sound.

With that said, I decided to do a three-part series in this newsletter explaining 1) the basics of IULs, 2) how they're potentially used as a retirement cash flow tool, and 3) the truth behind common claims in IULs sales pitches.

With this information in hand, if you're ever presented with an IUL as a retirement cash flow tool, you'll better be able to make an informed decision as to whether or not it might make sense for you.

The first part of this series is the basics of life insurance, and how IULs work:

There are two main types of life insurance: Term and Permanent. IUL is a form of permanent life insurance.

Term Life Insurance

Term life insurance is life insurance that only lasts for a specific period of time; typically 10-30 years. The cost or premium payments for term insurance are generally fixed throughout the life of the policy.

For example, assume you buy a 20-year term life insurance policy that has $1,000,000 of death benefit. Further assume the required premium for the policy is $1,000 per year. So long as you continue paying the $1,000 in annual premiums on time every year you're alive, the insurance company will pay your beneficiary(ies) $1,000,000 if you die any time during those 20 years.

Conversely, if you don't die within those 20 years (and don't otherwise extend or convert your policy to other coverage), the policy simply expires after 20 years. You no longer have to continue paying the annual premium payments after the policy ends, but you also have no sort of residual value.

Permanent Life Insurance

Whereas term life insurance only lasts for a specific length of time, Permanent life insurance lasts permanently...for the life of the insured. Though it should be noted that the word "permanent" is a bit of a misnomer as permanent policies generally have a maturity date. If the insured is still alive as of the maturity date, the policy is typically involuntarily surrendered by the insurance company at that point. Older permanent policies commonly mature if/when the insured reaches age 90 or 95. Newer permanent policies generally mature if/when the insured reaches age 120.

In addition to providing life insurance for a longer period of time than term policies, permanent policies also have a cash value accumulation feature whereas term policies do not. More on cash value in a bit...

Within the category of permanent life insurance, there are two main sub-categories or types of policies; Whole Life and Universal Life (there is also Variable Life, but it's less common than Whole Life or Universal Life, so I'm excluding it here).

Permanent Life Insurance - Whole Life Insurance

There are many ways in which whole life insurance policies can be customized, but the basic structure is such that the amount of death benefit you purchase is fixed and guaranteed for the life of the policy, as is the amount of premium payments required to be paid. In other words, so long as you pay $X of premium payments every year, the beneficiary(ies) will receive a death benefit of $Y upon the passing of the insured.

With each whole life policy premium payment that's made, some is used to pay for the cost of the insurance, some is used to pay the other costs and fees of the policy and the remainder is put into a cash accumulation feature. This "cash value" is money that the policy holder owns. Cash value can be taken out of the policy through outright distributions, or it can be borrowed against whereby the insurance company will extend a personal loan to the policyholder using the policy's cash value as collateral.

The policy's cash value earns interest. Specifically, in a whole life policy, the rate of interest is fixed and guaranteed for each interest crediting period. Assume the policy is structured such that the cash value is credited with interest once per year. At the start of each interest crediting period, the rate of interest will be known and fixed. For example, assume there is currently $100,000 of cash value in the policy and a new annual interest crediting period is starting. Further assume the insurance company informs you the interest rate for the new crediting period will be 4%. At the end of the period, the cash value will be credited with $4,000 of interest, bringing the total cash value to $104,000 (plus any portion of additional premium payments that went into the cash value during the year).

Permanent Life Insurance - Universal Life Insurance

Like whole life, Universal Life Insurance policies are similarly permanent policies where coverage lasts for the life of the insured and some of the premium payments go into cash value. However, the main difference between whole life and universal life is that the amount of premium is flexible in universal life policies whereas premium is typically fixed in whole life policies.

For example, in a universal life policy, the policyholder could choose to pay less - or nothing - in premiums for a given year, so long as there is enough cash value in the policy to cover that year's policy costs and fees. Conversely, in a whole life policy, even if the amount of cash value is in excess of the annual costs and fees of the policy, the policyholder would still need to make the agreed upon fixed annual premium payment (where some of the premium would be used to pay that year's costs and fees of the policy, and the rest would go into the policy's cash value).

Within the Universal Life Insurance sub-category of the Permanent Life Insurance category, there are three types of policies: Universal Life (yes, you read that correctly...one of the sub-categories of the broader Universal Life category is also called Universal Life), Variable Universal Life and Indexed Universal Life.

Permanent Life Insurance - Universal Life Insurance - Universal Life

A "Universal Life" or "UL" policy is a type of universal life insurance policy where the interest credited to the cash value is a fixed rate. Like with a whole life policy, the interest rate can change each interest crediting period. And, also similar to a whole life policy, once an interest crediting period begins, the rate is fixed and guaranteed for the duration of that period. The interest rate can generally only reset after the current interest credit period ends and a new one begins.

Permanent Life Insurance - Universal Life Insurance - Variable Universal Life

A "Variable Universal Life" or "VUL" policy is a type of universal life insurance policy where the interest credited to the cash value is variable and is based on the performance of selected investments held within the policy. The policy's cash value gets invested in mutual fund-like investment accounts that invest in portfolios of stocks, bonds, etc. The policyholder is able to select from a menu of available investment options each interest crediting period. The interest credited to the cash value is directly tied to the performance of the investments selected for the interest crediting period. If the investments go up X%, the cash value will be credited with X% of interest. Similarly, if the investments go down Y%, the cash value will get negative interest such that it will go down Y%.

Permanent Life Insurance - Universal Life Insurance - Indexed Universal Life

An "Indexed Universal Life" or "IUL" policy is a type of universal life insurance policy where the interest credited to the cash value is variable and is "indexed,"

or based on, reference to the performance of an index, such as the S&P 500. Similar to VUL, the policyholder generally does not know the ultimate rate of interest that will be credited to the cash value for each interest crediting period. However, different from a VUL is the fact that the interest credited to the cash value can never be less than zero.

This is because, unlike with VUL policies, IUL policies do not directly invest their cash value in securities or traditional investments. Instead, the insurance company promises to credit an amount of interest that's zero or larger based on a pre-agreed formula that references the return of an underlying index selected by the policyholder. The formula uses some combination of Participation Rates, Caps and/or Spreads.

A Participation Rate is how much of the reference index's return is applied as interest for the policy's cash value. For example, a participation rate of 50% means the policy's cash value will be credited interest equal to 50% of whatever the return was of the selected index. Assume the selected index is the S&P 500, and its price increased 10% during the interest crediting period. A participation rate of 50% means the policy's cash value would be credited 5% interest for that period (i.e. the cash value interest is only participating in 50%, or half, of the S&P 500's 10% price return)

A Cap is a ceiling on how much interest will be credited to the cash value during any interest crediting period. For example, a cap of 8% means the cash value will not be credited with more than 8% interest for the period. Assume the selected index is the S&P 500 and its price increased 10% during the interest crediting period. Further assume there is a 100% participation rate. A cap of 8% means the policy's cash value would be credited with 8% interest for that period (i.e. 100% participation of the S&P 500's 10% price return, but subject to the 8% cap)

A Spread is a reduction in interest crediting from the amount of interest that would have otherwise been credited. For example, a spread of 2% means the interest credited will be 2% lower than it otherwise would have been. Assume the selected index is the S&P 500 and its price increased 10% during the interest crediting period. Further assume there is a 100% participation rate and an 8% cap. A spread of 2% means the policy's cash value would be credited with 6% interest for that period (i.e. 100% participation of the S&P 500's 10% price return, but subject to the 8% cap AND reduced by the 2% spread).

That's it for this first of three parts about IUL. As you can see, the product can be quite complicated. That doesn't mean you should necessarily avoid it, but it does mean it's not something that should be purchased without a real thorough understanding of how it works.

In next month's newsletter, I'll talk about how IUL can potentially be used as a retirement income tool.

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