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# Articles

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***"Variable universal life policies are a bit like diabetes. Real problems are likely to occur if left unattended, but with wise management, both can be nicely handled."***

## **VUL Policies Work with Astute Management**

*by Peter Katt, CFP, LIC*

Variable universal life (VUL) allows policyholders to control how their policies' premiums are invested by selecting from various mutual funds available. Most VUL buyers select equity funds. In contrast to VUL, whole life and universal life policy premiums are mostly invested by the insurance company in investment-grade bonds held for yield. Therefore, investment results for whole life and universal life will change relatively slowly and are backed by a minimum guarantee, which means the cash values can never take a loss. VUL policies invested in equities will have investment results that are volatile and unpredictable, with occasional cash value losses that can be dramatic. This plays havoc with trying to select a premium schedule to follow.

I have written about my client experiences with VUL policies that have fallen apart due to equity sub-account losses that caused the current cash values and target premiums to be illustrated as incapable of properly supporting the policy. Expected large premiums are shown that seem like the equivalent of a margin call; this often triggers a solicitation of my services. But this doesn't mean that VUL can't be used for clients' life insurance needs. With astute management, VUL policies can be part of the life insurance portfolio.

The problem is that VUL has often been treated as just a better-performing version of whole life and universal life without realizing that VUL's inherent investment volatility makes it a very different kind of life insurance. The major reason for the failure to recognize this is VUL illustrations. Agents and buyers get their primary understanding about life insurance by viewing illustrations provided by the insurance company. Illustrations show how a policy is illustrated to perform based on the premiums, insurance costs, and constant investment yields. Investment volatility of equities funding VUL policies can produce losses of 20 percent or 50 percent in a very short period of time, with no guarantee that subsequent gains will offset the losses anytime soon, or that the investor policyowner won't get out of the equity funds, thereby removing their participation in a recovery. This VUL fact simply cannot be seen by viewing their illustrations.

### **Beware Level Death Benefits**

By far the largest problems with VUL involve policies with level death benefits. It is impossible to know how much and the timing of premiums with such investment volatility. The extent of this target premium malfeasance can be seen by doing probability studies such as Monte Carlo testing. Measuring outcome probabilities has been around since the 1940s and is very useful in decision-making. If it were

routinely used when considering the purchase of level death benefit VUL policies, few would be bought because it would become obvious that there is no way to manage premiums with such investment volatility.

I have a client age 53 with a VUL that represented the entire insurance program. After looking at alternatives, the client decided not to pay any additional premiums and to retain only a portion of the VUL, diversifying into three other types of non-VUL policies by withdrawing three-fourths of the cash values and reducing the death benefits by at least the same amount. I did a Monte Carlo test on the remaining cash values and death benefits, and determined a 35–50 percent probability of failure, measured around life expectancy and beyond, without the payment of large premiums at some unknown time.

In lieu of this I dropped the death benefits to one-third (\$2,300,000 to \$773,000), with the remaining cash values of some \$400,000. The death benefits were changed to the specified amount plus the cash values, or \$1,173,000. This amount of initial death benefits and cash values allows for the policy to become paid up at age 100 at a constant 5 percent, making it a conservative ratio of cash values to death benefits, and making it quite likely that the death benefits will experience a significant increase over time.

I calculated the ratio of cash values to death benefits for every year to 100. The safe management of this VUL design calls for a downward adjustment of the death benefits anytime the cash value ratio falls behind and stays there for several years. As a demonstration of this, I used a slice of historical total stock returns minus VUL expenses. I intentionally ended the period with two years of significant losses to provide a better demonstration of how this management system handles them. Table 1 is not intended to be a prediction or estimate, but merely a demonstration of how this management system works.

Age	Yield	CV	DB	Age	Yield	CV	DB
53	-0.7%	\$379,800	\$1,149,000	70	-8.3%	822,400	1,595,400
54	25.7%	477,600	1,250,600	71	5.4%	855,500	1,628,500
55	-9.9%	431,100	1,204,100	72	17.3%	996,600	1,769,600
56	21.7%	520,500	1,293,500	73	31.3%	1,285,700	2,058,700
57	15.3%	596,100	1,369,100	74	-6.1%	1,191,800	1,964,800
58	14.3%	676,600	1,449,600	75	20.3%	1,416,400	2,189,400
59	-11.2%	595,500	1,368,500	76	21.4%	1,700,000	2,473,000
60	22.8%	725,500	1,498,500	77	5.1%	1,765,300	2,538,300
61	9.9%	790,800	1,563,800	78	31.1%	2,287,000	3,060,000
62	-9.7%	707,200	1,480,200	79	17.3%	2,654,200	3,427,200
63	2.3%	720,400	1,493,400	80	4.1%	2,727,900	3,500,900
64	13.2%	807,300	1,580,300	81	15.7%	3,118,700	3,891,700
65	17.8%	942,300	1,525,300	82	30.3%	4,024,400	4,797,400
66	-15.8%	783,300	1,556,300	83	-4.3%	3,806,500	4,579,500
67	-27.6%	561,300	1,334,300	84	-19.9%	3,018,000	3,791,000
68	36.0%	755,500	1,548,500	85	-22.1%	2,316,000	3,089,000
69	22.7%	918,000	1,691,000	Blank	Blank	Blank	Blank

As an insured gets older, the cash value-to-death benefit ratios get higher. In the demonstration, the ratios have been good until age 85, when they drop below my benchmark due to the large losses. The ratio at 85 should be around 80 percent, but is down to 75 percent. If the insured were in declining health, I would probably reset the ratios downward and 75 percent would be fine because of compromised mortality.

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