

## **A Compelling Alternative to Mutual Funds**

*by Glenn S. Daily*

The spending phase of retirement planning usually involves two conflicting objectives. One is to provide income that starts out at an adequate level, keeps pace with changes in living expenses, and cannot be outlived. The other objective is to provide an inheritance for heirs.

The adviser's job is to help the client strike an acceptable balance between these objectives by examining the key variables of rate of return, taxes, inflation, and lifespan. If the investment strategy uses a portfolio of mutual funds, the income objective is fulfilled by withdrawing living expenses each year, and whatever is left at death passes to the client's heirs.

Suppose we take the actuarial approach of computing the expected present value of the income stream and the inheritance, discounted for mortality and interest. Multiply each year's withdrawal by the probability of being alive, multiply each year's remaining fund balance by the probability of death, and take the present values, using a discount rate equal to the after-tax compounding rate. The present value of the benefits (the income stream and inheritance) must be exactly equal to the initial investment, because we've really done nothing more than compound a number and discount back at the same rate.

Now consider two other investment vehicles: variable immediate annuities and variable universal life.

A variable immediate annuity provides monthly payments for life. The initial payment is determined by the state premium tax, the income option selected, the assumed interest rate, and the insurer's assumed mortality rates. Subsequent payments rise or fall based upon the performance of the contract's family of mutual funds in relation to the assumed interest rate.

A portion of each payment is deemed to be a return of principal, and the remainder is taxed as ordinary income. At death, any unrecovered cost basis can be deducted on the decedent's final tax return. For a life income option, this tax deduction is the only benefit received at death; other options may provide for continued payments for some period.

For reasonable assumptions, the expected present value of an immediate annuity's after-tax benefits will be greater than 90% of the premium; in other words, the net cost of distribution, administration, and risk-bearing is less than 10%. This is the effect of favorable tax law, which permits a faster recovery of cost basis than is actuarially correct.<sup>1</sup>

Variable universal life is cash value life insurance with investment flexibility, and it enjoys the same income tax advantages as other cash value policies. In particular, investment earnings grow tax-deferred within the policy and escape tax entirely at death. For reasonable assumptions, the expected present value of a low-load policy's death benefits will be at least 120% of the expected present value of the premiums. This is the effect of using a before-tax rate of return for internal compounding and an after-tax rate of return for discounting.<sup>2</sup>

What happens if we combine an annuity and life insurance to satisfy the income and inheritance objectives? Intuitively, the favorable tax treatment of both products appears to provide enough raw material to exceed the benefits of a mutual fund portfolio. Recall that the actuarially-computed benefit/cost ratio for mutual funds is 1.00, and a 50/50 allocation to a VIA/VUL combination might produce at least 1.05 (the average of .90 and 1.20).

The table on the last page confirms this intuition with a simple example. A 65-year-old woman with \$250,000 to invest can choose between mutual funds or a 55% annuity/45% life insurance combination. To set up a conservative withdrawal plan using mutual funds, she chooses a 3% target return. That produces a base payment of \$7,500 (3% of \$250,000), which will be adjusted up or down each year after the after-tax return is known. With a 9% net return and 25% effective tax rate (assuming a blend of ordinary income and realized and unrealized capital gains), the after-tax return will be 6.75%, and both the annual payment and the remaining fund balance will increase at a 3.64% rate (1.0675/1.03), offsetting inflation. Column 2 shows each year's after-tax year-end withdrawal, and Column 4 shows the year-end fund balance available at death.

Alternatively, she invests \$137,500 (55% of \$250,000) in an annuity with a 3.5% assumed interest rate, 8% net return, and \$9,059 before-tax base payment. Column 3 shows the after-tax payment each year, using a 35% tax rate for ordinary income. Column 6 shows the value of the tax deduction for the unrecovered cost basis at death.

The remaining \$112,500 goes into a \$200,000 low-load VUL policy. (Because of tax law limitations on premiums, a roughly equivalent stream of five \$25,000 premiums is paid, rather than a single premium.) Column 5 shows the death benefit at the end of each year.

In most years, the annuity/life insurance combination provides a higher after-tax income and a higher death benefit than the mutual fund portfolio. The actuarial value of each benefit stream, using a 6.75% discount rate, is shown in the bottom row. As expected, the income and inheritance benefits of the mutual fund portfolio equal \$250,000. The benefits of the annuity/life combination total \$269,000. The favorable tax treatment of both products more than offsets the higher expenses.

The expected present values also demonstrate the annuity's efficiency at turning a nest egg into retirement income: 91% of the amount invested is converted into after-tax income, compared with less than 48% using mutual funds. Even if the mutual fund investor emphasizes income rather than inheritance and chooses to liquidate all principal by age 95 (and incur some risk of outliving her money), the mutual funds' efficiency still would not exceed 80%.

The combination of annuity and life insurance would look even more attractive in an estate planning context. If you can set up the annuity to provide inflation-adjusted income payments with low risk, the life insurance can be held outside of the estate, using an irrevocable trust or other arrangement. The mutual funds cannot be held outside of the estate, however, because the principal is needed to generate the income payments. Under the current estate tax system, gifts are taxed more favorably than inheritances, so the investor's heirs would receive an additional benefit from the annuity/life insurance combination.

Of course, this simple example is just a starting point for a thorough comparison. Other sets of assumptions will produce different results, and some clients may not want to invest their money in insurance products for other reasons. Also, salespeople may try to substitute high-load for low-load products, thereby converting nest eggs into commissions. When implemented carefully, however, the advantages of the annuity/life insurance combination can be compelling. This retirement planning technique is likely to receive more attention in the future as new types of immediate annuities are developed.

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<sup>1</sup> For more information, see Glenn S. Daily, "The Attractions and Pitfalls of Variable Immediate Annuities," *AAIL Journal*, February 1994.

<sup>2</sup> For more information, see Glenn S. Daily, "Does Life Insurance Add Value?", *Journal of Financial Planning*, October 1993.

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<b>VIA/VUL vs. Mutual Funds</b>					
<b>Age</b>	<b>After-tax income</b>		<b>Death benefit</b>		
	<b>Mutual funds</b>	<b>VIA</b>	<b>Mutual funds</b>	<b>VUL</b>	<b>VIA</b>
65	\$7,770	\$8,550	\$266,880	\$317,160	\$48,130
70	9,300	10,010	319,130	360,550	36,090
75	11,120	11,810	381,610	430,090	24,060
80	13,290	14,040	456,320	514,360	12,030
85	15,890	14,390	545,660	606,570	0
90	19,010	17,810	652,490	702,300	0
95	22,730	22,030	780,240	789,240	0
99	26,220	26,120	900,220	840,620	0
Expected present value	\$119,300	\$125,500	\$130,700	\$141,100	\$2,400
Assumptions:	MF	VIA	VUL		
Assumed return	3.00%	3.50%			
Gross return	10.00%	10.00%	10.00%		
Expenses	1.00%	2.00%	1.35%	+ loads	
Tax rate	25%	35%			