Strategies to Reduce Volatility and Improve Tax Efficiency

By Jason M. O'Dell, MS, CWM and Michael Lewellen, CFP


Although many investors believe the primary goal of diversification is to hedge against risk and volatility, another fundamental goal for diversification is to increase tax efficiency—something many investors overlook. A simple way to achieve both objectives is to consider adding cash value life insurance (CVLI) to your investment portfolio.

Cash Value Life Insurance as an Asset Class

Life insurance may not come to mind immediately when thinking about portfolio asset classes, but it should. Several types of CVLI exist, and some offer advantages over other asset types. For example, certain types of CVLI offer returns that are not correlated with the stock market. That means a policy can act as a hedge against the losses of traditional investments (eg, stocks, bonds, and mutual funds). A properly designed CVLI policy is given preferred tax treatment, allowing the cash value to grow tax-free and, if properly managed, accessed tax-free. In this way, it can also act as a tax hedge against capital gains and income tax liabilities.

Types of Cash Value Life Insurance

When considering a tool like CVLI in a portfolio, investors should understand the different types of policies and how each of them works. We will examine two common types in this article (Table).

Whole Life Insurance

In a whole life insurance contract, premiums are paid to the carrier, who then invests them. In return, the carrier credits policyholders with a dividend as long as the policy is in force. This guaranteed rate gives the policy owner the benefit of a bond-like return. Whole life contract guarantees are generally better than the guarantees offered by other types of life insurance. However, a whole life policy is also less flexible, from a design standpoint, because premiums are fixed. In addition, the costs can be higher throughout the life of the policy.

TABLE. WHOLE LIFE INSURANCE VS EQUITY INDEXED UNIVERSAL LIFE INSURANCE

Whole life	Dividends credited Average earning rate can fluctuate from company to company Fixed interest rates, similar to highly rated corporate bonds Strong guarantees, but no flexibility
Equity indexed universal life	A floor to prevent losses Capped upside potential Index-tracking cash values

Universal Life Insurance

In a pure universal life policy, the carrier declares an interest rate, and they credit that interest rate at guaranteed intervals. Premiums are flexible, and a policy can be designed to have a limited number of premium payments.

Another type of universal policy that investors should pay special attention to is an *equity indexed universal life* (EIUL) policy. Like standard universal life policies, EIULs offer cash values, but have a different way of crediting interest. Carriers with EIULs take the policy premiums and use them to implement what is called a *collar strategy*. In a collar strategy, premiums are paid to the carrier. The carrier then sells call options and buys protective put options on positions they own. In return, the policy's performance is tied to an index, such as the S&P 500. Because a collar strategy is a *protective* strategy, the carrier is able to guarantee policyholders a *floor*, or minimum return (eg, 0%), that protects policyholders from losses. With an EIUL, if the index the policy is tied to goes down 20%, the cash value will not go down. For EIUL policy cash values, there is also a *ceiling*, or cap, on gains (eg, 10%), which means that if the index goes up beyond the cap, the policyholder receives a portion of the total gain.

Improving Tax Efficiency

Tax efficiency is an often-neglected facet of retirement planning that should be among an investor's primary concerns, because *the only sure thing about the future of taxes is that it's completely unpredictable*. When an investor cannot see what is coming, the only way to hedge against the possibilities is to structure one's assets so that some are removed from potential tax burdens. That is the goal when using CVLI.

Potential tax exposure in retirement is often visually represented by buckets. First is the *income bucket* composed of taxable income sources—such as a 401(k), traditional IRA, and/or pension. When people saving for retirement contribute to these accounts, they receive a tax deduction and the contributions also grow tax-deferred. When they begin to take distributions, those are taxed as ordinary income. Although the tax deduction on the front end is advantageous, investors should hedge against future tax rate increases and risks by not having all assets in that first bucket.

The second bucket is the *taxable bucket* or *capital gains tax bucket*. This will generally include anything that is in a taxable account or a brokerage account, such as stocks, bonds, and mutual funds. Assets distributed from this bucket are taxed at a capital gains rate, advantageous because long-term capital gains rates are lower than income tax rates.

The third bucket is often overlooked, and that is the *tax-free bucket*. This includes accounts such as a Roth IRA and investments such as municipal bonds. In these accounts and investments, contributions grow tax-free and distributions are tax-free. A CVLI policy also fits into this bucket because, when the policy is properly designed, dollars that are put in grow tax-free, and the owners can withdraw them tax-free.

Conclusion

Investors should consider having a licensed advisor review their portfolios to determine if a CVLI policy could provide them with a hedge against market volatility and future taxes. An important goal is to ensure the insurance contract is structured so that premiums do not exceed tax-law limits, which can create what is referred to as a *modified endowment contract* (MEC), because that will prompt the loss of all the tax benefits.

Advisors should also confirm that the funds designated for payment of the EIUL premiums can be committed for the long term, so that the policy does not lapse. If the policy lapses after funds have been distributed, the distribution can become taxable. In the same vein, since EIUL contract expenses are generally front-end loaded, a distribution plan should be designed to avoid pulling money out of the EIUL policy for roughly 10 years. Finally, advisors and investors should work with a carrier that historically has not increased charges on their active policies. ■

Jason M. O'Dell, MS, CWM
Principal
OJM Group (www.ojmgroup.com)
Cincinnati, OH
Author of *For Doctors Only: A Guide to Working Less and Building More.*

Michael Lewellen, CFP
Director of Financial Planning
OJM Group (www.ojmgroup.com)
Cincinnati, OH

Disclosure

OJM Group, LLC. ("OJM") is an SEC registered investment adviser with its principal place of business in the State of Ohio. OJM and its representatives are in compliance with the current notice filing and registration requirements imposed upon registered investment advisers by those states in which OJM maintains clients. OJM may only transact business in those states in which it is registered or qualifies for an exemption or exclusion from registration requirements. For information pertaining to the registration status of OJM, please contact OJM or refer to the Investment Adviser Public Disclosure website www.adviserinfo.sec.gov.

For additional information about OJM, including fees and services, send for our disclosure brochure as set forth on Form ADV using the contact information herein. Please read the disclosure statement carefully before you invest or send money.

This article contains general information that is not suitable for everyone. The information contained herein should not be construed as personalized legal or tax advice. There is no guarantee that the views and opinions expressed in this article will be appropriate for your particular circumstances. Tax law changes frequently, accordingly information presented herein is subject to change without notice. You should seek professional tax and legal advice before implementing any strategy discussed herein.