Thinking Differently about Whole Life Insurance - The Asset Class Conversation

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As this white paper is being written towards the end of 2018, the stock market is near its all-time highs, yields on bonds are still close to historical lows and banks are paying around one to two percent on savings accounts and CD's (depending on how long you lock up your money). In this environment, what is an individual, family or entrepreneur with good savings habits supposed to do?

The idea of using Specially Designed Life Insurance Contracts (SDLIC) as an alternative asset class to bonds and cash is a concept taking shape in the financial services industry. SDLIC's are implemented along with the Infinite Banking Concept (IBC) in order for people to design their own Privatized Banking System. You can learn more about this concept at www.inifinitebanking.org or read our book titled "Building Your Own Privatized Banking System" but the purpose of this white paper is to help you understand why certain types of life insurance have significant benefits associated with these areas of your financial picture:

- Where you store your savings
- How you manage your cash flow
- What capital you access to expand your personal or business economy

Here are some reasons why we believe that a SDLIC can replace the role that cash and traditional fixed income assets performed in your portfolio over the last 30+ years.

REASON #1 – The Benefits of a Risk Averse Financial Intermediary

Life insurance companies, specifically mutual insurance companies (MIC) who offer dividend paying whole life contracts, are financial institutions with unique characteristics that can offer a different way to allocate your monies versus bonds and cash. According to Carlos Lara,[1] the co-author of *How Privatized Banking Really Works*, a life insurance company plays the role of a **financial intermediary** in our economy. Their activities are similar to banks, finance companies, mutual funds, and hedge funds because they create their own financial products and act as a custodian with funds received by the account holders. Each of these companies invest those monies received into **primary securities** such as stocks, bonds, mortgages, or real estate.

Mr. Lara explains that these financial intermediaries can allow individuals, families and business owners the ability to diversify their portfolios without the need to do a substantial amount of research and due diligence. Facilitating the flow of information helps the intermediary reduce transaction costs for the customer. Life insurance companies have been acting as a financial intermediary for hundreds of years. They take in large sums of money from the public every year and as of year-end 2012, life insurance companies held $5.6 Trillion in financial assets compared to $15 Trillion in assets held by banks. What makes a life insurance company unique is that their operation is more of a **liability driven business** with actuarial certainties already factored into their financial models. The main financial product offered to the public, a life insurance contract, provides protection through the death benefit as well as the accumulation of savings.

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[1] Lara, "The Policy Loan Debate Explained"

Because both the death benefit and cash value of the policy are a liability on the insurance company's financials, it is very important that the assets held on their books represent a conservative portfolio. Looking at data provided by ACLI's 2016 Fact Book[2], the life insurance industry had these aggregate assets in their 2015 General Accounts:

Bonds -	70.1%	(mainly corporate bonds and mortgage backed securities)
Stocks/Equities -	2.2%	
Mortgages -	10.3%	
Policy Loans -	3.2%	
Cash and Short Term Investments -	2.6%	
Other Investments -	11.6%	
TOTAL ASSETS -	**100%**	

Since almost three-fourths of life insurance companies' assets are held in bonds, it is important to address a concern most people mention:

Wait, I thought you said investing in bonds was a bad idea in today's economy? Why would I want to put money in a financial institution that has most of their assets in bonds?

BUYING POWER

First thing to understand when allocating capital is that **size matters.** The larger your portfolio or the more money you have to put to work, finding better opportunities with more attractive terms is a possibility. Who do you think will get access to better yielding bonds: an individual with $500,000 to invest OR an insurance company with $50 million to invest? If a corporation can sell a bigger chunk of its debt offering to an investor willing to buy $10 million worth of bonds, the corporation may be willing to pay an extra 0.5% to 1% on the offering versus rounding up 1,000 investors at $10,000 each.

INSTITUTIONAL ASSET MANAGEMENT

The second thing to realize is that a life insurance company has an unique structure to its portfolio that is very different from individual investors. The main risk to a life insurance company is actuarial in nature, not market related. This means that as long as the people insured as a risk pool live to their normal mortality, the life insurance company has already accounted for the major costs in their financial models. The fluctuation of their underlying investments in their portfolios (again, mostly bonds) will not impact the long-term solvency of their balance sheet. This is because a life insurance company has a huge advantage over individual investors when designing their portfolio. The life insurance company is receiving an annual stream of new money to invest from the policy premiums. This fact allows them to

[2] Source: ACLI, 2016 Fact Book, Table 2.1 (pg. 11)

maintain a long-term focus on their portfolios while also being able to adjust to economic changes.

Both individual investors and life insurance companies want to generate growth through income and appreciation but a life insurance company's **time horizon** is much longer than most individuals (especially mutual insurance companies). Individuals will be impacted by an increasing interest rate environment because their bonds are mostly held in mutual funds and not individually issued bonds. Mutual insurance companies are adequately prepared for interest rate changes and their asset management tool relates to the dividend rate they pay to policy holders. As interest rates have fallen since the early 1980's, so have the rate of dividends paid by MIC's. But as interest rates move higher, dividend rates have the potential to move in that same direction. The positive correlation between interest rates and dividends is a huge benefit to individuals, families and business owners thinking about SDLIC. If we see interest rates rise in the future, then dividends could increase regardless of how one is utilizing the cash value in a SDLIC contract.

FINANCIAL STRENGTH

It is often mentioned by people who have money sitting in the bank, that one of the main reasons they want their money in the bank is **safety.** The perceived safety is directly related to FDIC protection on one's bank account up to $250,000. The Federal Deposit Insurance Corporation (FDIC) is a US government corporation operating as an independent agency created by the Banking Act of 1933. As of August 27, 2014 the FDIC insured deposits at 6,638 institutions. FDIC is funded by premiums that banks and thrift institutions pay for deposit insurance coverage and from earnings on investments in US Treasury securities.

FDIC pools its reserves into the Deposit Insurance Fund (DIF). When people deposit or save money in a bank, they are under the impression that their money has *FDIC protection*. It is important to know what assets are actually backing their bank's assets should the bank fail for some reason. At the end of 2007, the DIF had a balance of $52.4 Billion on insured deposits of $4.29 Trillion. That represents a reserve ratio of 1.22%. The fund is mandated by law to keep a balance in the DIF equivalent to 1.15% of insured deposits.[3] That ratio is extremely low compared to reserve requirements for other types of financial institutions and that is why the FDIC also reminds depositors on their website www.fdic.gov that *FDIC deposit insurance is backed by the full faith and credit of the United States government*. What that essentially tells you is the US government will use all of its powers to tax and spend to protect depositors. Of course, it is ironic that the people being affected by higher taxes and loss of purchasing power through currency devaluation are the same people depositing more of their savings into banks! Finding another financial institution that values financial strength as one of its main purposes is paramount for people and companies with good savings habits in today's economy.

Life insurance companies are overseen by each state they do business in. Each state has a state-sponsored Guaranteed Insurance Fund (GIF). A portion of each insurance company's revenue generated in that particular state is paid into the fund as a

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[3] Investopedia, The History of the FDIC, http://www.investopedia.com/articles/economics/09/fdic-history.asp

"premium" similar to how banks pay a premium to the FDIC. This is one method that policy holders receive safety because if an insurance company ever became insolvent, the GIF would look to provide the contractual guarantees in existing policies while other insurance companies consider possible acquisitions of the troubled insurance company's assets. High quality life insurance companies focus on multiple areas of strength when looking at their balance sheet. **Risk Based Capital (RBC)** measures the minimum amount of capital for a company to support their overall business operations. A good company will be in the 7%-10% RBC range and a great company will have a 10%+ RBC. Another method of measuring strength deals with the analysis of ratings agencies. Ratings agencies like Standard & Poors and Moody's will regularly monitor the financial strength of life insurance companies. Dealing with at least an "A" rated company is our recommendation because that means they are well positioned for changes in almost any economic climate. And the last tool to gauge the strength of life insurance companies is the **Comdex Score**. The Comdex is a combination of several industry variables used to "grade" a company on a scale of 0-100. Our recommendation is to deal with companies with a score of 90 or above.

Dealing with a financial professional who has done their due diligence on several mutual insurance companies is important. You want to understand the reasons behind choosing a company and how their operations will sustain over the long term through multiple economic cycles.

REASON #2 – Protecting the Purpose of Your Money With Whole Life Insurance

The purpose of most fixed income assets inside of a portfolio is to minimize risks associated with equity securities and fulfill the need of generating income off your portfolio. Ever since the 1980's, holding bonds and cash in your portfolio did an amazing job of reducing risk and generating overall growth. In fact, over the thirty years between 1981 and 2011, long-term US government bonds actually outperformed stocks measured by the S&P 500 Index 11.5 percent to 10.8 percent. This was the first thirty-year period since 1861 in which bonds outperformed stocks. A balanced portfolio of 50 percent stocks, 40 percent bonds, and 10 percent cash performed tremendously for many Americans who accumulated money in the 1980s, 1990s, and 2000s. The steady decline in interest rates over the past thirty years has meant that conservative investors received both steady income *and* appreciation from their fixed-income holdings.[4]

But there is a huge concern that exists today: ***What happens with those same portfolios from today (2018) forward - knowing that most people's time horizon for saving and utilizing money is at least 30-40 years?***

With interest rates still at historical lows and banks having no need or desire to pay savers anything on their bank accounts to attract deposits, it's time to "think differently" about risk minimization strategies. A SDLIC has the characteristics to

[4] "Bonds Outperform Stocks Over Past 30 Years," http://wallstcheatsheet.com/stocks/bonds-outperform-stocks-over-past-30-years.html

accomplish your **Utilization strategies** while minimizing the key risks that threaten your personal economy:

<u>Market Volatility</u>

The uncertainty and volatility of the stock market is a big reason there are so many assets sitting in accounts tied to bonds and cash. Even while stocks produce solid, long term returns, history has shown that stocks don't always perform as expected over certain time periods (1960's, 1970's, and 2000's). The benefit of SDLIC is that it doesn't rely on stock market performance at all to accomplish its intended results. As mentioned before, life insurance companies on average have less than 3% of their balance sheet assets in equities. And dividend payments are more about matching assets to liabilities over the long term while optimizing a growth through income approach. Implementing a SDLIC in your financial picture is one strategy to reduce market volatility in your portfolio.

<u>Inflation</u>

Some people believe that **inflation** means a rise in interest rates. While interest rate movements can be a symptom or result of inflation, the real definition of inflation should be understood as *the loss of purchasing power through the devaluation of one's currency*. In order to stay ahead of inflation, one needs to implement strategies that grow your assets at a rate above the inflation rate on top of your utilization needs. That rate of growth can be created through income and appreciation sources.

With our current economic environment, it can be difficult to get a fixed income asset (like a bond) or a cash account to appreciate in value. Why? Because as interest rates increase, the jump in yields will be offset by the loss in bond principal. Cash accounts just experience income through interest payments, which is set by the banks. A SDLIC is able to provide someone practicing infinite banking a way to hedge inflationary concerns and its impact on your personal/business economy. As interest rates rise, dividend rates can rise to offset the negative impact on your financial picture. Since dividends are positively correlated to interest rate movements, this correlation creates a way to have your money working for you (through dividends and interest) while you also have the ability to utilize your money (through policy loans). This combination is hard to find in other asset classes.

<u>Income Taxes</u>

Most mutual insurance companies who offer policies that fit the SDLIC strategy are more than 100+ years old. Many of the companies that we have researched have been operating longer than our Internal Revenue Code, which was established in 1913 with the creation of the Internal Revenue Service. Here are just a few of them: Penn Mutual (est. 1847), Mass Mutual (est. 1851), Guardian Life (est. 1860), Lafayette Life (est. 1905), and Ohio National (est. 1909).

Since the inception of our tax code, permanent life insurance contracts have received tax preferential treatment. For example, dividends from whole life policies are treated as a return of capital for tax purposes making those policies very tax efficient. The internal build-up of cash value in a policy grows tax deferred and is accessible by the policy owner on a tax-free basis through the proper use of policy loans. Finally, beneficiaries receive the death benefit income tax free when the insured dies. If a policy loan exists when the insured passes away, the existing loan balance is simply subtracted from the death benefit and the remaining balance goes to the beneficiary income tax free.

The only other assets that retain similar income tax benefits like a SDLIC are Roth IRA accounts, municipal bonds, and the equity in your personal residence (i.e. your home equity). Unfortunately, in our opinion, these other assets do not possess the same level of flexibility, access, and control that a SDLIC provides the policy owner.

<u>Longevity Risk</u>

The good news is that people are living longer. What's the bad news? That people are living longer…Financial security is more of a myth rather than a reality for millions of Americans. Many people have an irrational perspective of retirement and very few Americans can even define what retirement means for them.

As more people plan to "retire", the concern is genuine that a lot of people may "run out of money before they run out of time." Determining a way to take care of both your month-to-month expenses and big ticket items while someone is in their 20's, 30's, 40's, 50's, and even 60's, will allow for people to build their wealth with flexibility, access, and control. SDLIC's are built to manage one's big ticket items throughout someone's life and all of its other benefits optimize its utilization so the purpose of one's money is protected.

REASON #3 – Life Insurance is an "AND" Asset

If a SDLIC is set up with the appropriate contract offered from a highly rated mutual insurance company, then you will own a very unique financial vehicle. SDLIC's achieve **uninterrupted compound growth** when very few asset classes have the ability to do so. It's tough for people to comprehend this concept because most people are not aware of the **opportunity costs** that relate to every financial decision. When you choose to do something with your money (save it, invest it, or use/spend it), the opportunity cost relates to the fact that your money could always be doing something else. Consider these examples:

<u>Example #1</u>

You are contemplating a big ticket purchase of a car. It will cost you $30,000 to buy the car but you don't have that amount of money saved at this time. You have the option of financing the car and making $525 monthly payments (five year loan at 1.99%). After careful analysis of your cash flow, a decision is made to hold off on buying the vehicle until you have saved up enough money to pay cash for it. The opportunity cost in this example is that by choosing to pay cash for the vehicle, you will not own a new car for the next 3-5 years (depending on the amount you save each month towards a car purchase).

In the same situation, if you choose to purchase the car and finance it with the dealership, you will be making $525 payments each month for the next 60 months.

And while the "cost" in your mind is only the 1.99% in interest you are paying, you also have to consider the opportunity cost of sending $525 for the next 60 months ($31,500+) out of your control to a financial institution that will not give you access to those funds until the loan is paid in full.

Example #2

There is $100,000 sitting in your savings account at the bank. It is earmarked for major expenses that occur throughout your lifetime. You add money to this account every so often when your checking account balance gets too high or when you have a financial windfall (commission check, tax refund, RMD withdrawal from your IRA, etc.). At one time you were earning 5.0% on the balance in this account but now you only receive 0.50% on this account. Two things bother you about the current situation with this account:

#1 – You are earning 90% less interest (5.0% vs. 0.50%) on the account balance but you do not want to risk losing the principal by putting the money in an investment.

Opportunity cost – Choosing a low interest rate over the risk of principal loss.

#2 – Whenever you use the money in this account for big ticket items (pay cash for a car, go on a vacation, pay your taxes, fix up your house, etc.), you worry about the uncertainty of your future. You think to yourself – "What happens if I need that money in 20 years because my health deteriorates or something changes with our financial situation?"

Opportunity cost – Once you use your money sitting in your savings account, it is considered gone forever. Whether you are making 5.0% or 0.50%, all of that interest you *could have* earned in the future will be lost!

Example #3

You are an entrepreneur with good money habits. You've done well for yourself by saving and accumulating money in different asset classes, including stock, bonds, cash, real estate and various business ventures. You have built up a pool of money that you do not need for your month-to-month expenses ($500,000) and you have invested those particular dollars into municipal bonds paying a 4% tax free yield.

One of your former business partners approaches you with a business opportunity that requires a sizeable cash investment - $100,000. After reviewing the details of this opportunity, you are confident that your skill set could be beneficial to the success of this opportunity. If the investment pays off, the cash flow generated could equate to 20% of your invested principal with realistic assumptions. The question is: ***Do you liquidate $100,000 of your muni bond portfolio to invest in this business opportunity?***

Opportunity cost – In order to potentially achieve 20% cash flow from your $100,000 investment, you need to give up the 4% yield on your muni bonds and put your investment principal in a situation where the loss of principal is greater. You are faced with giving up a known return and apparent safety of principal for something that is unknown with greater growth potential. You need to choose between the 4% muni yield **"OR"** the potential 20% cash flow yield from the business venture.

In all of these examples, if someone has already implemented the infinite banking system using SDLIC's, then they will own life insurance contracts that act as an **"AND"** asset. To implement the "AND" strategy with an asset, you need to be able to utilize one important financial concept – **leverage**. Utilizing leverage means you are able to borrow against an asset so that your capital is working for you in more than one place! This is not a new concept. Entrepreneurs have been implementing leverage strategies inside of their businesses for hundreds of years. Real Estate investors accomplish this feat all of the time. And you can even use leverage when investing in the stock market (through a margin loan).

The problem in today's economy is that people are having to choose between characteristics with their money that they value on both sides:

- Should I keep my money in the bank (SAFETY) **OR** invest it in the stock market (GROWTH with risk)?

- Should I keep my cash in the bank as a cushion and finance a big ticket purchase **OR** pay cash for the item and lose potential growth on that cash in the future?

- Do I need to pay off my bank loans as quickly as possible with extra cash flow (GIVE UP CONTROL) **OR** should I stretch out my payments as long as possible and constantly have to deal with the bank's loan requirements?

Depending on your mindset with money or finance related decisions, opportunity costs can result in more of **your money flowing out of your control** and into the control of other financial institutions. With the implementation of a SDLIC, your personal/business economy has the ability to optimize the internal, external, and eternal returns of your financial picture.

You can continue to earn an internal return (3-4% Tax Free) with your SDLIC's dividends and interest while you also earn an external return in your personal or business economy. Here are a few examples of external returns on top of what your infinite banking system can produce:

- Recouping Interest costs from banks, credit cards, and mortgage companies
- Accelerate paying down your debt to increase future cash flow
- Create the ability to use your money for more than one purpose (instead of locking up your money in a retirement plan or one company's balance sheet)
- Paying your income taxes with money that continues to generate an internal return
- Always having control to make a decision of whether to save money (build cash) OR investment money (put capital to work in your personal or business economy) because you are aware of all of the variables pertinent to the decision

The purpose for writing this white paper was to help you achieve a better understanding of certain key topics that can substantially improve your personal or business economy. We believe everyone who has positive cash flow and good habits with money deserves to hear about how specially designed life insurance contracts (SDLIC) can be utilized inside of an infinite banking system as both an alternative asset class and a cash flow tool. If you believe in minimizing your risk in your portfolio and want to pay build significant wealth in your personal and/or business economy, then we urge you to reach out to us and learn more.

Thank you for reading.

About The Author…

John E. Moriarty, ChFC is the founder and president of e3 ConsulantsGROUP, e3 Wealth, and e3 Tax. e3 operates a *family office model* that serves individuals, families and entrepreneurs **based on their mindset**, not based on the size of their net worth. If you desire to learn more about the organization's services, please visit their website at www.e3wealth.com or email at info@e3wealth.com so you can receive an electronic copy of their book *Building Your Own Privatized Banking System* can be obtained.