High Net Worth Families

"Why purchase life insurance?"

I have been working with HNW families for much of my 30 year career. Many ask me the question above due to the nature of their estate which, more often than not, is quite liquid. They also believe, if I do all the planning that is necessary I can eliminate any estate tax, therefore, with as liquid as my estate is why should I consider purchasing any life insurance? It is a very good and legitimate question which I will offer many thoughts to consider. Some may resonate more than others and some may hit an emotional string that you may want to explore deeper for more clarity and a better understanding.

The psychology of the HNW is quite different. They want to be wise in their decision making. The traditional life insurance need, providing needed resources to your family and spouse in case of an untimely death, quite frankly, is not an issue. Building wealth vs. maintaining and preserving wealth are not the same. Typically wealth is created by concentrating risk and wealth is preserved by managing and diversifying risk. The drivers for success of a wealthy family usually is centered around; high risk tolerance, self-reliance, self-confidence, and control. These tend not to be the best characteristics when dealing with the management and understanding of risk.

With that said, why would someone of tremendous means consider life insurance as a wise investment with not only their money but with the necessary time to become clear about how it may or may not make sense for their situation.

In my opinion, estate planning is all about putting in place a hedge around your balance sheet. Allow yourself to critically think about the following "hedges" for life insurance use:

Preservation

As one comes into wealth whether by the sale of their company, a high and prestigious position in the corporate world, or by whatever means, the planning for such people can be quite complex. It generally moves the HNW individual out of their comfort zone. They do not necessarily feel they are in control due to the nature of the complexity of estate planning and decision making. There is what I call a "ceiling of complexity" reached in planning that can cause one to "freeze" in their tracks and the planning stalls. When this "ceiling of complexity" is reached significant gaps may exist and cause undue shrinkage to an estate due to an untimely death. Many have had complicated lives, stress builds up over time and when the event finally happens, i.e. monetizing one's estate, human nature many times wants to simplify life, yet as I have mentioned, planning at this level is complex and requires time.

If you happen to be young (age 40-60) and you are in a position of wealth, estate planning involves the transfer of wealth to the next generation in order to preserve all your hard work. It is very difficult to start to transfer wealth as goals have not become clear, the family may be too young, or you do not want to transfer too much too early. I have talked to many estate planning lawyers and people can get in trouble because they give away too much too early. But as the law operates, the estate planning techniques to transfer wealth provide the family with the most leverage when you are young. As you get older and your thoughts, goals and family mature these techniques lose their leverage and effectiveness. Control is the main culprit.

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Most estate planning revolves around the balance sheet of the family but the real issues involve not how to transfer wealth in terms of money but, until you become clear of the principles, values, traditions, heritage, wisdom and what your wealth means to you it is difficult to plan thoroughly enough.

The role that life insurance may play:

- Gives you the ability to "plug the leaks" or gaps that may exist due to untimely death
- Reaching a ceiling of complexity is an unsettling feeling and life insurance can decrease the need for more complexity
- It will offer you a way to preserve planning opportunities and provide the family some flexibility

Charity

The wealthy family typically has many aspirational goals and sometimes the goals are larger than their ability to fund them. Settling for less is not acceptable to these families yet many cannot get their minds around how to accomplish many of these aspirational goals and by default settle for far less. All of their charitable interests need money and lots of it but at the same time as the family explores their thoughts and goals the "family" matures and needs and desires expand tremendously.

There are many techniques to be able to transfer wealth to charitable interests or foundations (public or private). The role of life insurance in these situations is that it can provide additional capital outside the estate to fund aspirational goals over generations. I would say that to add $10-$50mm to your Foundation or for your charitable interests has a huge impact. As your life unfolds and the older you get the desire to put more money at risk and build more wealth lessens and since life expectancy becomes more known as we age into our 80's and beyond the return of life insurance death benefits are quite attractive and competitive along with providing large lump sums to be used to benefit many.

Life insurance can also be used to replace wealth that has been transferred to charities to make sure family objectives are met. Another way to think about it; if your children/grandchildren or long term legacy is all in good order and the balance of your estate will go to your choice of charities or foundation then life insurance plays a role of making sure your family "stays whole" as some of the estate may be subject to transfer costs.

Tax Leverage

The HNW tend to like arbitrage opportunities. The more wealth that can be transferred without income, estate or gift tax is very beneficial. There are ways to remove Life insurance from your estate. Life insurance by law is income tax free so if you can by-pass the gift or estate tax the benefits are then leveraged by two significant tax brackets.

The "Unknown"

- When will someone die?
- What are the needs of the extended family?
- What will be the tax environment?
- What will be your thoughts about helping others?

The role life insurance can play is that it will allow you the time to become more clear, build your plans and watch them mature with the ability to change as needs and life change as it inevitably does in most families.

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Opportunity Costs/Hedge

HNW families are intelligent people. They deploy their assets wisely and for a purpose. Rarely do they set aside money for estate costs, shrinkage or any gaps that tax law changes may create later. There is a lost opportunity for their money if it has to be diverted from their goals and aspirations. Depending on the estate asset mix and how far their planning has taken them; tax laws change, the ceiling of complexity gets in the way, gaps exist and therefore, costs emerge and long term opportunities are lost. In some way, you can think of a portion of your estate as a tax-deferred loan from the government or a tax balloon payment.

Life insurance can be used as a hedge on health (it cannot always be purchased) and an allocation of resources (assets) that can create a capital sum to preserve opportunities for assets of the family. You are actually spending the government's money to pay them off in order to maintain focus on your investment opportunities.

There is an 85% chance that most people will die by age 95[1]. The IRR on death in most of the cases we work on is 6% or greater. Therefore, there is an 85% probability that the IRR on death is greater than 6% (income and, in most cases, estate tax free).

[1] Proprietary Actuarial Life Expectancy Data from The Efficient Edge

Liquidity

Some of the wealthy families continue to have a desire to build and push the "envelope". They want to expand their "empire" whether that is through real estate, another enterprise, etc…. Life Insurance would provide the needed liquidity to pay off loans, provide businesses with staying power, and bring/keep the best people to continue the mission.

Flexibility/Equalization/Freedom

- How does one maximize the meaning and impact of their wealth?
- How does one answer to the ever changing and expanding needs of the family?
- How does one think about treating family equally or equitably?
- Many want to spend their wealth differently so life insurance can provide the flexibility and freedom to manage your desires and surprises as life unfolds

Life insurance can give you the flexibility to stretch your mind and your goals and meet the unexpected.

Asset Protection

Life insurance can be "overfunded" to shelter assets from creditors (depending on state laws). The high net worth would have to assess their concern and need for asset protection. There are ways to accomplish the task without life insurance but many practitioners see it as a basic tool to be considered.

Asset Class

Let's first agree that the life insurance market is very sales centric, products are numerous and complex, it lacks objectivity and disclosure, compensation structure requires the producer to sell, has no incentive built-in to service, and the tools used, policy illustrations, are flawed. I believe in life insurance, people need it and it is a very valuable asset. Much like any other asset, if life insurance is managed to optimize return and fits the needs of the family its value and return is quite compelling.

Life insurance can be a value added component of an asset allocation and diversification methodology and investment program.

- The death benefit is paid on the event of death rather than a market event
- The living benefits, cash value, takes on the asset class attributes of the policy itself

Permanent life insurance has unique characteristics that make it uncorrelated with every other asset class: the proceeds are income tax free, estate tax free if certain trusts are used, cash values build up tax-deferred, transfer of wealth via cash values can be shielded from creditors, the owner may draw upon cash values, and the death benefit allows the owner to turn periodic payments into a capital sum with very attractive rates of return.

There are many "flavors" of life insurance and different reasons to own any one type. Is there a need for a level or inflation adjusted death benefit, what is the risk tolerance, are guarantees important, what is the budget or gifting constraints, how much flexibility do you need? These are a few of the questions that need to be asked. There is a cost to each feature that is desired. Many don't know and agents tend to sell the "flavor of the day" and do not understand the risks of the product itself and that is where the trouble begins…

If permanent life insurance is desired most of our clients are funding it with capital rather than budgeted income, therefore choosing the investment (life insurance) to use for the premium payments is an asset allocation decision. Life insurance as part of a diversified investment portfolio provides competitive overall returns and legacy values when compared to one without life insurance.

Life insurance as an asset class must be managed and acquired like any other investment. Life insurance is a complex financial asset with many moving parts. Everyone wants to optimize their return on their assets. Our company has access to proprietary actuarial insurance analytic tools not available in the traditional agent distribution channel. When you put together these tools and our wisdom we can create tremendous value by helping you maximize/optimize return.

Life insurance death benefit returns are an attractive non-correlated asset return component of an investment portfolio. Since health events cannot be predicted and they are non-correlated to traditional asset classes this type of diversification may be important in the overall plan.

Conclusion

These are many of the reasons, based on experience and research, that HNW families find where life insurance can play a vital and critical role in their planning. The value derived from the objective analysis and contemplation of the various roles life insurance can play will bring about the clarity and 'peace of mind' knowing that full consideration was given to one of the most valuable tools within the estate planning arena.