Episode #281: The Truth Behind the Cost of an IUL

Hi. Welcome to another episode of "Money Script Monday." My name is Brian Manderscheid. Today, I want to uncover the truth behind the cost of an IUL. Now, there are a lot of ways to structure or design an IUL but only one way to do it correctly, and that is a maximum-funded design where we buy the least amount of life insurance that the IRS will allow and fund right up to the Internal Revenue Code guidelines. Today, I want to do a deep dive analysis on the cost associated with a maximum-funded IUL. First, I'm going to talk about the IUL expense ratio. Second, the IUL expenses versus alternatives. And lastly, the net rate of return of an indexed universal life policy.

First, let's talk about the IUL expense ratio. Now, what I'm going to use for this analysis is a 45-year-old male in good health, a million-dollar death benefit, funding the maximum premiums into the policy that the IRS will allow over a 10-year timeframe. Keep in mind, the IUL expenses will differ for each client primarily based on three things. First and foremost, the most important is the design of the policy. The maximum-funded design is going have lower policy expenses than a minimum-funded design. Second is the insurance company selection. Some insurance companies' policies have higher expenses or lower expenses than others. And lastly, the age, gender, and risk of the insured. Generally speaking, the older you are, the less healthy you are, the higher the expenses are going be.

What you're looking at here are the annual IUL expenses as a percentage of the account value. And you can see that the expense ratio is higher in the early years and lower over the years and in latter years. If you look at the IUL expense ratio to age 100, the average expense is 1.03%, which is in line with most other financial vehicles out there.

Now, to dive down a little further, what if we excluded the 10-year funding period? Again, with this policy, we're going to be funding the policy for 10 years and without any additional premiums, 11 plus. In looking at the policy expense ratio in 11 years and ongoing, the average expense was only 0.2% or 20 basis points, which is very inexpensive. Now, if we do the exact opposite and we exclude the 11 years plus and only look at the first 10 years, the funding period, the average expenses were 4.76%, which we would conclude that is expensive during the funding or building period of an indexed universal life policy. That is the IUL expense ratio. What we can conclude is that over time, a 1.03% expense ratio is in line with other vehicles. After the funding period, the policy expenses are inexpensive, and they are front-loaded and more expensive upfront.

Moving on to comparing the IUL expenses versus the alternatives, I looked at the same exact policy in funding into an alternative vehicle, which is a non-qualified equity account at the same exact illustrated rate of 6.9%. Now, I'm using the top marginal tax brackets because most of our clients who gravitate towards these tax-free alternative concepts are high-income earners. They pay a lot of taxes and are looking for a legal way of tax avoidance. If we compare the same exact money going in, the same exact gross rates of return of 6.9%, and look at the expenses through age 100, you can see that the IUL expenses were $542,000, versus $3.1 million of the alternative, the non-qualified equity account, with the same contributions going in, and the same 6.9% gross rate of return.

Now, we can break it down between the expenses, the management expenses at 1.03% of the equity account, the taxes, which are going to be based on the dividends, and the portfolio turnover. Could also look at the expenses of the IUL, as well as the cost of insurance. But to show this to you more visually, I looked at the total expenses of both at age 85. Now, the total expenses at age 85 for the IUL is $235,000. If we break that down, roughly half of those were administration or expenses, and the other half were COIs or cost of insurance, which is basically used to pay for a life insurance death benefit for your family or for your business.

When we look at the non-qualified equity account, same exact money going in, same exact 6.9% gross rate of return, the management expenses at 1.03% were $603,000. The taxes were $873,000. Again, those are the taxes on dividends and portfolio turnover, the frictional taxation along the way were a total sum of almost $1.5 million versus the $235,000 for the index universal life policy. We looked at the IUL expenses as an expense ratio and compared the IUL expenses to the alternatives.

Now, let's lastly look at the net rate return of the IUL. In the earlier years, the IRR of the policy will be lower due to those front-loaded policy expenses, and due to a surrender charge, which gradually decreases over time if you were to walk away from the life insurance policy. Again, if we look at it in a more visually appealing way, we look at the IRR and fee drag at age 85, you can see again, same exact 6.9% gross rate of return. The net IRR after the policy expenses was 6.22% for the IUL, with a fee drag of 69 basis points, 0.69%. When we compare that to the non-qualified equity account, again, same exact 6.9% gross rate return, the IRR was 4.23% with a much larger fee drag of 2.68%. Those are all the management expenses and taxes on the dividends, portfolio turnover, the frictional taxation.

Ultimately, what does this mean for your money? If you were to fund the same exact money or dollars into these two different vehicles, the maximum-funded indexed universal life or the non-qualified equity account, we're funding a total amount of $686,000 over a 10-year timeframe, the equity account grew to $5.7 million through age 100, despite all the fees and all the taxes. However, same dollars going in, same 6.9% gross rate of return, the IUL over that same timeframe grew to $15.7 million. That's a $10-million alpha or difference between funding into an equity account or funding into the indexed universe life policy, primarily due to the lower fee structure of the life insurance policy when we maximum fund.

You may be asking yourself, are you looking to pay less taxes? Are you looking to create more tax-free income for your retirement or are you looking to create more wealth for your family? You may want to consider a properly funded index universal life policy as part of your complete holistic financial plan. If you have any questions about the material discussed today or how an IUL may look for you, please contact the advisor who sent you this video to get started today. Thank you very much. We'll see you next time.