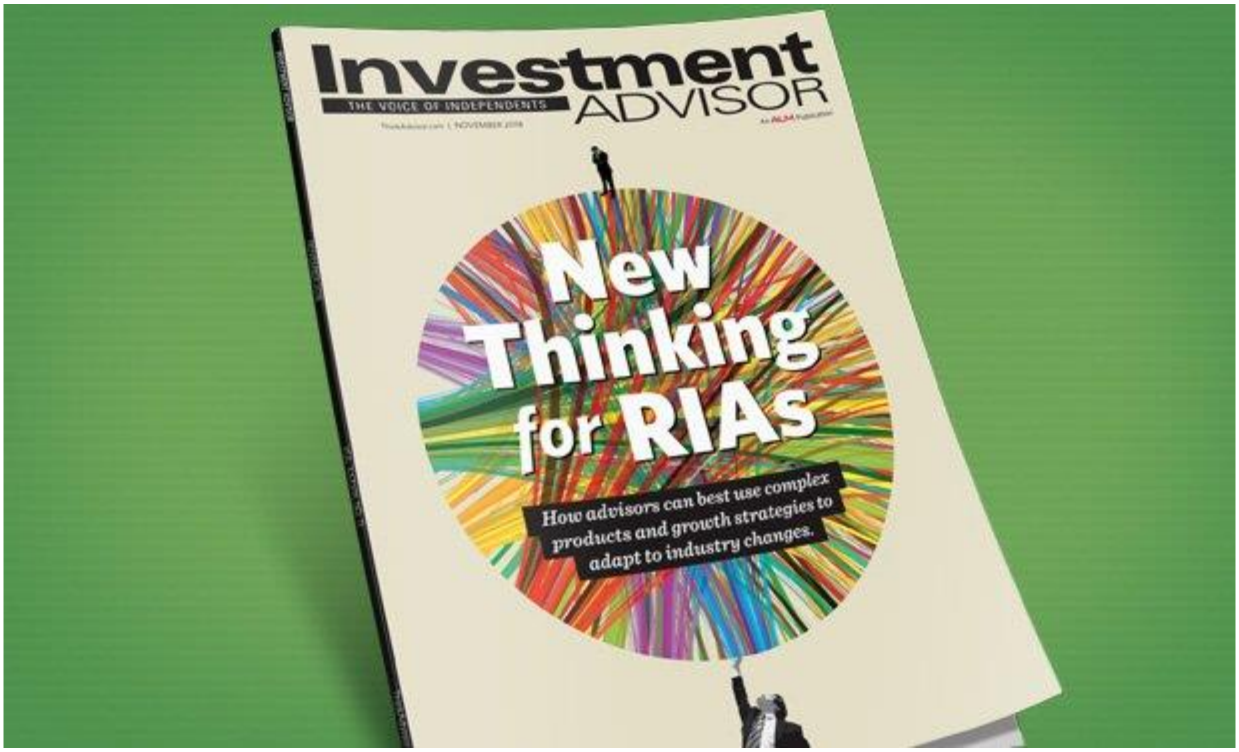
Time for RIAs to Rethink Insurance

Using complex insurance products isn't always easy, but advisors may find they serve as an optimal way to address clients' need for financial security.

By **Michael Finke** | October 25, 2018 at 12:00 PM



At a recent conference of financial planners who strongly consider themselves fiduciaries, I explained the benefit of tax-favored longevity insurance using a qualified longevity annuity contract (QLAC). I even called them a "no brainer" when building a retirement income plan for a client who doesn't have a pension.

A planner in the audience raised her hand. "I'm struggling with why I'd recommend a QLAC. I mean, I'd have $130,000 less in assets under management."

For fee-only planners, recommending costly insurance products presents a challenge. In a recent *Wall Street Journal* article, two financial planners debated the merits of life insurance. One argued, "Most people are very likely to outlive their coverage, which makes their rate of return on the policy zero. In fact, they will be getting a negative rate of return."

A negative rate of return is what insurance is all about. It's one of the reasons that insurance is less sexy and often more difficult to explain than accumulation.

The expected return on insurance needs to be less than zero for the insurance company to stay in business (though some types of insurance can provide a positive return net of taxes). This means that buying insurance results in lower expected financial wealth.

Why would a fiduciary recommend a strategy that results in lower wealth? People want security, and wealth maximization isn't the point of financial planning. The point is to provide expertise and guidance that helps people manage their finances to meet life goals.

We all face financial risks that can derail a carefully constructed investment plan. Failing to account for these risks as part of an investment strategy exposes the client to the possibility of financial disaster, which is a lot worse than missing out on a few basis points of return.

Time for a Change

One voice advocating a new approach to insurance among financial planners is Bob Veres, a longtime author and thought leader in the field. Veres sees the lack of pricing transparency among insurance products as a significant barrier for fiduciary planners. This is particularly true of more complex cash value life policies and variable annuities with an expense structure that can be challenging to unpack (even for academics).

Would a movement toward transparency and away from commissions increase the use of insurance products among financial planners? Veres argues that bans on commissions in the United Kingdom resulted in an increase in demand for financial planning services.

Advisors were incentivized to sharpen their value proposition to clients, and financial service companies had a greater incentive to focus on product characteristics that provided the greatest value to clients.

In the United States, comprehensive planners are essentially in one of three boats. Fee-only planners lose compensation by recommending insurance products that are paid for with assets they would otherwise be paid to manage. They could select from a small market of insurance products that provide fee compensation, or they could choose to be fee based and receive commission compensation for recommending insurance products.

As a researcher who often simulates the efficiency of various insurance products, I'm a little skeptical of those with businesses structured to throw off fees that aim to compensate for lost AUM. Why?

Commissions on many long-term insurance instruments, such as annuities and cash-value life insurance, can be far less expensive to the consumer than recurring 100 basis point fees. Many of these products don't require management over time; they are a set-it-and-forget-it instruments with sinking compensation that falls below the ongoing expenses of a fee-only advisor after a few years.

Before indicting commissions, let's revisit the history of insurance sales in the United States — specifically life insurance. For most of the 20th century, life insurance agents were the primary providers of financial advice to average Americans.

In a recent research paper, my co-authors and I document the decline in cash-value life insurance ownership among middle-class Americans that can be traced to the emergence of defined contribution savings plans in the 1980s. Commissions provided the incentive needed to call prospects or knock on doors to help families protect against the loss of a breadwinner and build wealth.

Between 1990 and 2000, the number of life insurance companies in the United States fell by 42%, from 2,196 to 1,269. In many ways, the rise in fee-compensated planning was fueled by employer-sponsored savings that required investment management expertise, as life insurance lost its comparative advantage as a combined tax sheltering and protection instrument.

Fee planners and insurance agents continue to clash online, each defending the legitimacy of their compensation model and the value of their approach to advice. According to fee planners, commissions encourage a culture where the focus is on the sale of a risk product, and too many view these products as the solution to all planning needs.

Investment advisors point to the superiority of portfolio strategies that supposedly solve all planning needs, even those that most economists believe could be more efficiently addressed through risk pooling. The reality, of course, is that a sound financial plan requires both.

A New Breed of Planner

At a recent research presentation in Des Moines, Iowa, I met Ross Junge, CFA, who mentioned that he considered working at a few local RIAs after he had left a longtime position in institutional investments: "Strategically, I believed very strongly in the wealth management philosophy of significantly improving financial outcomes by integrating tax efficient cash-value life insurance, deferred income annuities and a tax efficiently structured investment portfolio."

It's worth remembering that the tax efficiency of many insurance products, which the industry spends significant effort preserving, is often overlooked among fee-only advisors. In a convincing (if complex) article on the tax benefits of deferred annuities in the *Journal of Financial Planning*, Wharton Professor David Babbel and financial engineer Ravi Reddy estimate the tax benefits of sheltering investments within a deferred annuity wrapper to be as high as 200 basis points per year.

In another *Journal of Financial Planning* article, insurance gadfly (and very smart person) Brian Fechtel, CFA, breaks down complex cash-value policies to estimate when they provide value to clients. In addition to excoriating the industry for what he sees as intentionally opaque sales practices and illustrations, Fechtel finds that cash-value policies can in fact be recommended by a fiduciary planner for a high-income client who holds the policy for a long time and has a death benefit need.

Fechtel notes that "cash-value policies do not inherently constitute unattractive investments … [and] much conventional disparagement can be erroneous and misguided."

So, Junge took his knowledge of institutional investing strategies and selected a planning firm that provided the best opportunity to offer competitive insurance products and welcomed a fiduciary approach to investment and risk advising. "I had the advantage of experiencing the benefits of a 'liability driven' investment approach managing institutional assets for insurance companies, and it made sense to apply these same institutional concepts to wealth management for our high net worth clients," he explained.

In a recent conversation with Matt Barthel, the executive editor at Dow Jones Wealth and Asset Management, who oversees *Barron's* rankings of the top 1% of financial advisors, we discussed the benefits and the dangers of advisors who present themselves as fiduciaries but also are paid to sell insurance products. "Insurance is a neglected part of many clients' investment plan. As long as advisors are behaving as a fiduciary, their proximity to insurance products is a real benefit," according to Barthel.

The danger, of course, is the longstanding criticism that insurance advisors see life insurance as the hammer best suited to any individual planning nail — whether it be accumulation, education or retirement income planning. “There’s a case to be made that advisors are going to provide solutions that are comprised of things they know,” said Barthel.

“If they don’t understand the risk mitigation of insurance products, it’s not going to be incorporated into a client’s portfolio. Clients often don’t know what to ask. You’re hoping you’re going to an advisor with a complete toolbox,” he continued, and one who understands which tools are most appropriate for the job.

Josh Frazier, a financial planner from Dublin, Ohio, and a CFA, agrees that the “tendency for insurance and annuity products to have upfront commissions and less recurring revenue often lends the products to be misused.” But he also sees his firm’s sophisticated approach to insurance planning as a benefit.

“Our firm has been registered as an RIA since the 1990s,” he said. “We have always been fee based, but offered life insurance, disability insurance, annuities, and long-term care insurance.

“Many advisors recommend that their clients buy low-cost term insurance but don’t offer a fiduciary approach to securing that valuable coverage,” Frazier continued. “They may send them away to an insurance agent, and the client comes back with an expensive permanent life policy that wasn’t a good fit. I think our industry needs to focus more on fiduciary vs. suitability and not so much on fee vs. commission.”

In a conversation I had with an executive from a large financial planning software firm, he mentioned the remarkably low percentage of financial planners who complete the risk-management planning sections.

The CFP curriculum learning objectives on annuities include only “compare and contrast annuities with other investment alternatives.” (That might be news to the couple in the new CFP Board public awareness advertisement, Cal and Valerie, who are worried about having enough money to last their entire lives in retirement.)

To Ray Sclafani, CEO of the advisor-training company ClientWise, advisors often recommend what they know. “Ask your fee-only advisor whether your retirement strategy has a level of risk protection that you’re comfortable with, and a guarantee to provide the right level of comfort.

The answer is likely that there is no structural guarantee to your income,” he said. “Why not? Because they don’t represent those products. So where is the best interest of their client being served, simply because they don’t have those tools in their toolbox?” asked Sclafani.

Using insurance products effectively isn’t easy. I’m constantly learning about new strategies for charitable giving or small business planning from sophisticated insurance advisors and the faculty at The American College. I’m often surprised by the sophisticated tax strategies presented at Society of Financial Services Professionals’ conferences that I’d never heard of in the fee-only financial planning community.

In many ways, the learning objectives in the CFP curriculum stem from the roots of a fiduciary, comprehensive, emerging planning community that was eager to move beyond the products sales approach of the traditional insurance industry. It's not surprising then that sophisticated insurance planning strategies often get short shrift. But planning isn't just about accumulation.

The Need for Security

After I gave a presentation on retirement income planning in California, an 81-year old retiree came up to me and discussed his own experience working with financial advisors. He was a client of a famous RIA firm with ads that often appear at the top of my Gmail account.

After working with the famous advisor, he met with another planner who provided a comprehensive plan that included a decumulation strategy using a mix of guaranteed income and drawdowns from risky assets. He fired the RIA. "I want security," he said.

Security seems to be an increasingly appealing pitch among a new generation of defined contribution retirees looking for a plan to live free of risk.

I've conducted several consumer surveys in recent years asking investors to rank the most important elements of a financial plan. Security consistently ranks at the top of the list — far more important than investment performance. People, especially those who have saved dutifully for the future, want to know that they'll be OK even if bad things happen.

In my ongoing research, I investigate life satisfaction and spending patterns in retirement. Retirees without a pension don't feel comfortable spending down assets. They avoid eating out, going on vacation and spending money on the things that really make them happy in retirement.

Increases in guaranteed income result in higher life satisfaction even among those who have more than enough wealth in retirement. Protection against long-term care risk has as great an impact on life satisfaction in retirement as hundreds of thousands of dollars in the bank. Risk protection matters.

As the financial profession evolves, consumer demand for protection will favor fiduciary advisors who understand how to use each tool in the tool box and don't hesitate to pick the right one — even if it involves taking away some of their AUM.

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