The top 10 IUL myths and how to debunk them

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Let's take an in-depth look at the 10 most insidious myths and attempt to debunk them in a balanced, open and fair-minded way.

The more IUL sales grow, the more its critics seem to froth at the mouth. Having surveyed a few of the more egregious IUL hit pieces over the years, I've noticed that the majority of the venom comes from a few distinct quarters: financial "gurus", Bank-on-Your-Selfers, and buy-term-and-invest-the-difference advocates. While each of these groups have different guiding philosophies, they all have one principal thing in common: they have absolutely nothing to gain by the **IUL's explosion in popularity**. It simply doesn't play into their marketing approach and doesn't further their narrative. As a result, they've perpetuated a number of myths about the viability of the IUL as a financial tool. In this article I take an in depth look at the 10 most insidious myths and attempt to debunk them in a balanced, open and fair-minded way. (As a side note, in an attempt to counter some of their most baffling criticisms, it was necessary to use real numbers and real track records from real companies which, in this article, shall go unnamed.)

Myth #1: Be wary of overly optimistic IUL illustrations.

Are the rates of return that agents are allowed to project in **IUL illustrations** not based in reality? IULs have been around since about the year 2000, so we have a full 15 years to test the track record of its unique crediting feature: participating in rising markets while protecting against downside loss. During that time period the market has been nothing short of a roller coaster ride. That notwithstanding, some well-regarded IUL companies have actual, verifiable rates of return of well over 8 percent during that time period.

For those who are not satisfied with the actual 15-year track record, insurance companies provide historical back testing. In other words, given current variables, had this product been around for the last 20, 25, 30 or 40 years, how might it have fared? While historical back-testing is never a predictor of future results, it does give us some sense for how we *migh*t expect an IUL policy to perform in the future. Leading IUL companies have consistently shown through back-testing results that over each of these time periods IULs, given today's variables, would still have averaged well over 8 percent per year.

The critics, however, will not be placated, insisting that 40 years of historical back-testing does not a track record make. The last 40 years, they maintain, have been an unprecedented bull market not likely to be repeated in the future. Keep in mind, however, that the last 40 years also includes the last 15 years, a period that included flat markets, bull markets, bear markets and one of the worst financial crises since the great depression. Yet, *actual* returns during that 15-year time period for some IULs were still over 9 percent! In short, whether we're using historical back testing or actual, verifiable track records, many IULs perform in anything but an "over-promise-under-deliver" sort of a way.

Myth #2: Flexible caps should have you thinking twice about IULs.

Many companies these days provide caps of anywhere from 12 to 15 percent, but reserve the right to lower those caps at any point. While it's true that caps can be lowered, we have to understand the circumstances that might lead an insurance company to do so. Index caps are determined by the price of the underlying options that insurance companies use to help the client "participate in the upside of the market." The cost of these options ebbs and flows based on the VIX index, which measures the volatility or unpredictability in the stock market. The more volatile the stock market, the less predictable it becomes, the higher the cost of these options. And, as the cost of these options rises, the cap invariably begins to fall. In short, for insurance companies to lower these caps, the stock market would have to be *even more* volatile and unpredictable than it has been over the last 15 years. Further, even in the wake of the 2008-2009 financial crisis, some well-regarded IUL companies only lowered their cap *by 1 percent!*

Additionally, as I tell my own clients, whatever road you take in your financial lives, it is fraught with uncertainty. Your 401(k) could lose 50 percent in one year, your real estate values could collapse, your whole life product could dramatically underperform dividend expectations and, in theory, your IUL company *could* lower its caps. So, our clients have to recognize the risk inherent in nearly every financial alternative (however small in the case of the IUL) and follow the course that gives them the greatest opportunity for safe *and* productive returns.

Myth #3: Avoid IULs because of non-guaranteed insurance expenses.

After having given your IUL illustration a look, potential clients may come back to the table with misgivings about the "guaranteed" column of the illustration. This column reflects the "worst case scenario," the limit beyond which the insurance company cannot legally raise the cost of insurance. While these expenses are staggeringly high and make any illustration look dire and apocalyptic, we once again have to revert to the "fraught with peril" argument from Myth #2. While every company does reserve the right to revert to a worst-case scenario, and is legally bound to disclose it in the illustration, we have to weigh this likelihood vs the risk of not utilizing the IUL's benefits at all.

Many well-regarded IUL companies haven't had to revert to these expenses in any of their products at any time in the last 100 years. So, while insurance companies do reserve the right to charge these expenses, should people start dying at a much more accelerated rate (i.e., pandemic, WWIII, etc.), it is not a likely scenario. The likelihood of having a repeat performance of 2008 is probably much greater by comparison (in turn, creating a greater need for the down-side protection of the IUL). Further, should insurance companies revert to guaranteed expenses, policyholders reserve the right to 1035 their surrender value into an annuity, effectively terminating the policy and eliminating those expenses.

Myth #4: Beware of the IUL's non-guaranteed death benefit.
Critics claim that, while many IULs do have death benefits that stretch as long as 15 years, these guarantees expire at a time in the client's life when they need the death benefit the most: when they are older and more likely to die. First of all, many IUL companies *do* offer IULs with death benefit guarantees to age 120, not just the first 15 years. Second of all, the vast majority of clients who utilize an IUL do so because they are planning on taking money out in retirement. Guess what? Even if your IUL did have a death benefit guarantee, you run the risk of voiding it the minute you take money out of the policy. So, if the vast majority of IUL policyholders are planning on taking money out of their policies in retirement, then the death benefit guarantee can often be a moot point.
Here's the bottom line: if your client is interested in a death benefit guarantee *and* the ability to take tax-free policy loans in retirement, then they need two policies: one that provides a death benefit guarantee and whose cash value will not be touched, and another that is designed to build tax-free wealth that can be distributed as a tax-free income supplement in retirement.
Myth #5: The IUL has high fees.
Do IULs really have high fees? If so, compared to what? To establish a baseline, I decided to look at the average fees for America's most popular retirement account: the 401(k). According to *USA Today*, the total expenses for a typical 401(k) plan are about 1.5 percent of the entire account balance per year. These fees go to pay record keepers, financial advisors and mutual fund managers. In practical terms, this means that if your account's growth were 8.0 percent in a given year, your statement would show a net growth of only 6.5 percent.
Now that we have a baseline, we can see how the average fees in an IUL stack up by comparison. Generally speaking, the fees in an IUL are higher in the early years and lower in the later years. Considered over the life of the program, however, these fees can average as little as 1.5 percent.

The key to attaining this low level of expense lies in the proper structuring of the IUL contract from the outset. To maximize cash accumulation and minimize expense, the contract must contain as little life insurance as possible while being funded at the highest level allowed under IRS guidelines. This "maximum-funding" scenario ensures that the level of expenses, as a percentage of the overall contributions, remains as low as possible. **(See my previous article, "The Roth 401(k) vs the IUL" for a more comprehensive discussion of IUL fees.)**
Myth #6: Taking loans from an IUL in a flat market is risky.
Critics have long proclaimed the perils of taking distributions from an IUL in a flat market. The thinking goes that even if an IUL can never do worse than 0 percent, it still has to sustain the cost of insurance in those flat years. When you couple the cost of insurance with zero growth and then take a distribution, your policy could go into a tail-spin from which it may be difficult to recover.

Even if the above statement were true, I've long advocated that the IUL should be one of multiple streams of tax-free income upon which clients rely in retirement. When coupled with Roth IRAs, Roth 401(k)s, Roth Conversions and tax-free distributions from IRAs (up to the standard deduction and personal exemptions), tax-free distributions from an IUL can be a welcome *supplement* to a tax-free retirement. Should an IUL not perform well in any given year, this might be the ideal time for our clients to avail themselves of their other tax-free streams of income. The peril arises when clients put all their eggs into the IUL basket and don't diversify their sources of tax-free income.

Myth #7: The IUL shifts the risk of growing cash value to the policyholder.

This is an argument commonly put forth by advocates of whole life insurance. While whole life insurance companies assume the onus of growing their policyholders' cash value by depositing premiums into the insurance company's general account, IUL policyholders assume the "risk" themselves. They do so by linking the growth of their accumulation account to any of six to eight different indices. So the success of an IUL, the story goes, ultimately depends on the policyholder's ability to choose the "right" indices.

Well, many financial advisors advocate a balance of at least two or three different indices (for diversification purposes), each of which has back-tested rates of return that range from 7 to 9 percent over the last 40 years. For our purposes, let's assume these mixes of indices continue to provide a 7.5 percent average annual rate of return into the future. Let's also assume these contracts are properly structured (by minimizing the death benefit and maximizing contributions up to IRS MEC guidelines) and have average internal expenses over the life of the program of 1.5 percent. Well, that's a net rate of return after fees of 6 percent. Getting a consistent 6 percent net rate of return without taking any more risk than you're accustomed to taking in your savings account is not an inherently risky proposition. Once again, we make decisions every day with regard to our financial lives that involve risk. Having to choose the right complement of indices in your IUL with the help of your financial advisor should not be considered one of them.

Myth #8: IUL minimum interest rate guarantees are smoke and mirrors.

This criticism arises because of how IUL minimum guarantees are sometimes explained to the client. Some companies have a minimum guaranteed growth rate of between 2 and 3 percent. That doesn't mean, however, that they guarantee you'll receive a 2 to 3 percent credit in all down years. One such guarantee might work in the following way: Every five years (can be between five and eight, depending on the company), the company looks back at the growth in your accumulation account and asks: Did your money grow at a minimum cumulative rate of at least 2 percent over those five years? If not, they will go back and retroactively credit (or in industry parlance "true up") your account at a 2 percent cumulative rate for each of those five years. In other words, the worst your policy will grow over any five-year period is 2 percent.

Why do insurance companies make these guarantees? Because they realize that the likelihood they'll have to honor them is infinitesimally small. After all, given the track record of these policies over any historical five-year period, what's the likelihood that the index would be down in so many of those years as to average only 2 percent? Not very likely. The market would have to experience very little movement (or go straight down) over that five-year period, which the market rarely does. Even during the "lost decade" of the 2000s (where the market finished the decade pretty close to where it started) there were incredibly wide swings, which resulted in huge gains for IUL policies. In short, the IUL's critics are wasting a lot of hot air on a perceived deficiency (the minimum guarantee) that has a very low statistical likelihood of ever coming into play.

Myth #9: Clients risk a huge 1099 should the IUL run out of money.
As is often the case with IUL myths, this one has a kernel of truth but is shrouded in fallacy. First, let's parse out the truth. The IRS does require that any life insurance policy have at least $1 of cash value at the time of death, or the policy violates the definition of life insurance. If the client violates this rule, they risk receiving a 1099 on all the gain in the cash value above and beyond their basis. For policies whose accumulation funds exceed their basis (the vast majority of policies when structured properly), this poses a substantial risk. However insidious this risk, it can be mitigated in several ways.

First, as I mentioned in Myth #6, IULs should never be the only tax-free stream of income a client relies upon in retirement. It should always be perceived as a complement to multiple other tax-free sources (i.e., Roth IRAs, Roth 401(k)s, etc.). If the IUL doesn't perform as expected over a period of time, simply rely upon those other streams of tax-free income. If the IUL is only one of multiple sources of tax-free income, the likelihood it would run out of money falls dramatically.

Second, some well-regarded IUL companies offer an over-loan protection rider that insulates the client against the prospect of loaning too much money and bankrupting the policy. These types of features typically work in the following way: let's say that through a combination of too frequent (or too robust) loans in an underperforming market, your cash value descends to a dangerously low level. Companies will alert you of this danger and avail you of the opportunity to "pay-up" the policy. In this scenario, they reduce the death benefit to the point where the remaining cash value effectively "pays-up" the policy. This procedure disallows further loans, but also ensures that there will be at least $1 in the cash value at death, helping the client avoid a taxable event.

Third, this criticism is much more relevant to VULs where combinations of market downturns and ill-managed distributions can send policies into a death spiral from which they may never recover, resulting in a taxable event. The IUL is different than a VUL in a very fundamental way: while a VUL's cash value may be rapidly depleted in a down market, the IUL never gets credited worse than 0 percent. Certainly the cash value could reduce somewhat during a 0 percent crediting year due to ongoing insurance expenses, but never to the extent that it would during the down markets we've seen over the last 15 years. In other words, while this risk is worth discussing, it isn't a compelling reason to forego the financial benefits of an IUL.

Myth #10: Variable loans could sink your IUL ship.
Variable Loans are a unique feature of IULs that can enhance distributions by allowing the loaned portion of the accumulation value to continue to receive index credits (say 7 percent). The thinking goes that if the credit is consistently greater than the loan charge (say 5 percent), then the company

is effectively paying you to take a policy loan. This additional credit (2 percent in this example) can further build cash value and increase the cumulative loans over the life of the policy.

Critics target these types of arrangements because the client bears the full brunt of loan costs (5 percent in this example) should the index suffer a down year and the client receive a 0 percent credit. Two years in a row of full loan costs while taking distributions can be a dangerous drag on the accumulation value of the policy.

What critics fail to consider, however, is that some companies offer at least two different types of loans, the most common of which are variable loans and preferred loans. In the preferred loan, the amount being credited to the loan collateral account is the same as what’s being charged. Some well-regarded companies even guarantee that these two numbers will never change, ensuring that distributions will always be “tax-free” and “cost-free.” Further, some companies allow you to “toggle” between these two types of loans every year, giving the client an added measure of flexibility. So, if you take a variable loan in a down year, pay the full cost of the loan (5 percent in the above example) and don’t want to risk paying those loan expenses two years in a row, you can always revert back to the preferred “no-cost” loan.

Finally, we have to weigh the upside of the positive arbitrage of the variable loan in years where the index is up versus the downside risk of paying the loan costs when the index is down. To further explore this trade-off, let’s take a look at the S&P 500 index over the last 70 years. Since the decade of the 40s, the S&P 500 has been up roughly eight out of every 10 years. In two-thirds of those up years, the index has performed above and beyond many companies’ caps (assuming an average cap of 13 percent). That means that over the last 70 years, you would have experienced a positive 8 percent arbitrage (assuming an average loan charge of 5 percent per year) over half the time! Conversely, you would have experienced the full brunt of the 5 percent loan charge in only two out of every 10 years. For many clients who utilize the variable loan, this is a trade-off that’s well worth making.

In conclusion

The IUL is the fastest growing insurance product in our industry and for good reason. It provides safe, productive growth and can be a reliable supplement to other tax-free streams of retirement income while providing for basic death benefit needs. Because of its popularity, those who are heavily invested in non-IUL strategies have plenty to lose. The myths perpetuated by their criticisms, however, are often riddled with half-truths and logical fallacies that give the IUL short shrift. When these myths are stripped of their biases and addressed openly and fairly, however, the IUL is revealed to be a welcome component to a thoughtful, well-balanced approach to tax-free retirement planning.