

INSURANCE DEDICATED FUNDS

How to Beat Performance Drag

By Richard Roche, CAIA®

Fiduciary advisors to decamillionaires (\$10 million+) and ultra-high-net-worth individuals or households (\$30 million+) should have a macro view of clients' balance sheets and use a multi-disciplinary approach to address all the goals of each client simultaneously. Fiduciaries should not view clients' specific goals in isolation, as if the goals were in silos. Advisors should consider investment income and capital gains, income taxation, asset security and preservation of purchasing power, philanthropy, and intergenerational wealth transfers in unison to achieve optimal client outcomes.¹

This article explores the utility and potential use of an insurance dedicated fund (IDF) as an essential yet under-utilized investment vehicle to improve portfolios' overall tax-efficiency. For decades, high-net-worth and ultra-high-net-worth taxpayers and their advisors have utilized insurance wrappers for legitimate insurance, wealth-creation, and tax- and estate-planning purposes. Over the past three-plus decades, IDFs have withstood the tests of time and Internal Revenue Service (IRS) scrutiny.

As a wealth accumulation vehicle, an IDF allows access to sophisticated investment strategies and provides tax sheltering of investment income and capital gains. As an income-tax planning tool, an IDF permits tax-free buildup of assets. As an estate-planning tool, IDFs offer multiple advantages to mitigate estate-tax liability and facilitate

orderly disposition of assets at death (income-tax-free death benefits). IDFs are versatile in that they also can be engineered to supplement clients' estates during their lifetimes.

Financial advisors and high-net-worth investors have relatively few proven vehicles to mitigate these drags on wealth accumulation.

As far as asset security, IDFs offer financial privacy, customization, and significant protection against future creditors. Assets held in a private placement policy are held in a separate account and are protected from the assets of all other policyholders and the general account of the insurance company. IDFs in particular can be powerful devices to augment and implement philanthropic objectives.

DRAG RACING AS METAPHOR

The Old English term "drag" was used to describe a sledge that was dragged by hand or animals to haul cargo or flatten roads.² Over time, wheels were added and the word drag evolved to mean "a sporting vehicle (horse-drawn carriage) for private driving."³

The thoroughfares along which these drags were driven also became known as "drags."⁴ The word commonly described the busiest street in a city or town, giving rise to the 20th-century "main drag."

After World War II, informal street races started popping up all over the United States. In southern California, these often were staged on dry lake beds or unused military airstrips. Hot-shot drivers took to racing hopped-up cars—"hot rods" or "dragsters,"—and drag racing was born.

In a drag race, two contestants line up in parallel lanes on a drag strip, a flat, straight course that's commonly a quarter-mile long. Between the lanes is a "Christmas tree," an electronic starting device with pre-stage bulbs (yellow), countdown bulbs (amber), a start bulb (green), and a foul-start bulb (red). The driver who gets out of the gate fastest "trees the competition."

Elapsed time (seconds) and final speed (miles per hour) are recorded for both dragsters, but the first to cross the finish line is typically the winner. Around 1960, Dragmaster, a custom hot rod shop in Carlsbad, California, sponsored a legendary drag racing team, with a promotional Dragmaster (Dodge) Dart that toured the country and could be counted on to tree the competition.⁵

So why use drag racing as a metaphor for an investment vehicle? Because there is a formidable array of drags or frictions on wealth accumulation and investment performance that an IDF can foil. Financial advisors and high-net-worth investors have relatively few proven vehicles to mitigate these drags on wealth accumulation. But an IDF is the ultimate wealth accumulation vehicle because it grows portfolios faster than

most other investment vehicles; it trees the competition.

IDF RULES OF THE ROAD

The IRS has established certain rules of the road for life insurance separate accounts that support non-qualified variable annuity and life insurance contracts. Section 817 of the Internal Revenue Code (IRC), enacted in 1984, requires life insurers' separate accounts (technically, "segregated asset accounts") to satisfy numerous complex standards.⁶ There are three essential standards:

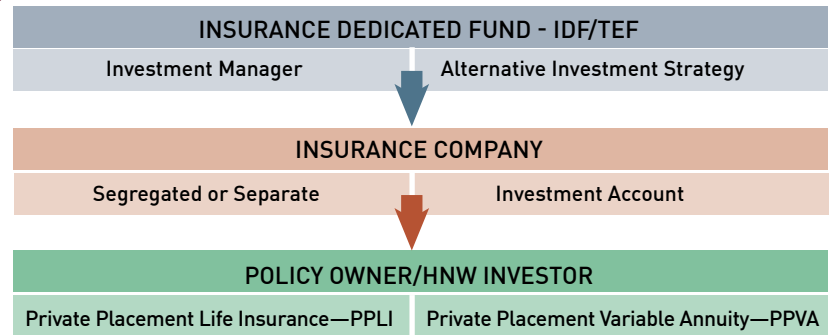
Diversification. Each IDF separate account must be "adequately diversified within the meaning of Section 817."⁷ The segregated account is considered adequately diversified if it contains at least five investments with: (1) no single investment accounting for more than 55 percent of the account's value; (2) no two investments accounting for more than 70 percent of the account's value; (3) no three investments accounting for more than 80 percent of the account's value; and (4) no four investments accounting for more than 90 percent of the account's value. For purposes of this test, the IRS can look through the segregated account's underlying investments to ensure at least two requirements are met.

Investor control. The owner of the private placement life insurance (PPLI) or private placement variable annuity (PPVA) account cannot influence the IDF manager, directly or indirectly, with respect to the selection of the underlying funds or portfolio securities. The IDF investment manager must select the underlying funds or securities on a completely discretionary basis.

Access. Insurance carriers must limit access to their IDFs to investors who purchase either an annuity or life insurance contract. To qualify for eligibility of a PPLI/PPVA policy, a client must be an accredited investor. But because most IDFs are structured as Section 3 (c) (7)

Figure 1

INSURANCE DEDICATED FUND FLOWCHART



Source: Richard Roche

investment vehicles under the Investment Company Act of 1940, as a practical matter the client must be both an accredited investor and a "qualified purchaser" under SEC rules to utilize a PPLI or PPVA contract (i.e., a natural person or a family-owned company owning not less than \$5 million in investments and certain trusts). If considering a PPLI policy, a target client must be insurable and undergo medical underwriting. Unlike PPLI, PPVA contracts do not have guaranteed death benefits so no underwriting or medical exams are required.

An IDF is a tested and true investment/insurance vehicle. When coupled with a PPLI and/or a PPVA policy, an IDF can enhance portfolio profitability and tax-efficiency dramatically.

Wealth accumulation requires eliminating frictions or drags on capital growth. There are four major drags on investment performance, and IDFs can mitigate each, as discussed below.

MAIN DRAG: FEDERAL AND STATE TAXES

The perennial drag on income and capital gains is the impact that taxes have on wealth accumulation. Indeed, federal and state taxes are the main drag on investment performance.

In 2020, the highest federal marginal tax rate on ordinary income is 37 percent, and the highest tax rate on capital gains

is 20 percent. The net investment income tax (NIIT), imposed by Section 1411 of the Internal Revenue Code, applies at a rate of 3.8 percent to certain investment income of individuals, estates, and trusts. The NIIT is levied on single filers whose modified adjusted gross income (MAGI) exceeds \$200,000 and married couples filing jointly whose MAGI exceeds \$250,000; these thresholds aren't adjusted for inflation. As a result, the total federal income tax rate for decamillionaires and ultra-high-net-worth individuals is 40.8 percent.

In addition, 43 states impose state income taxes. Seven states forego individual income taxes, and two states—New Hampshire and Tennessee—tax investment and interest income but not wages. The average state levies a 6.25-percent individual income tax; California (13.3 percent), Hawaii (11 percent), and Oregon (9.9 percent) have the three highest state burdens.⁸

Imagine for a moment you're a Golden State taxpayer with the highest federal marginal rate of 37 percent, plus California's 13.3-percent state tax, and by virtue of reaching the highest federal bracket you qualify for the NIIT rate of 3.8 percent. With a state and local tax (SALT)⁹ cap of \$10,000, you can write off only a small portion of your Bay Area home's property tax and none of your state tax liability. Your combined federal, state, and NIIT tax rate is 54.1 percent.

Table
1

FULLY TAXABLE INVESTMENT FUND—UNCLE SAM CHEVY

High-net-worth individual, lives in California (CA), invests in alternatives taxed at: 75% ordinary income/short-term capital gains; 25% long-term capital gains

Return after investment management fee	8.00%
Federal tax of 36.6% (40.8% × 75%) + (23.8% × 25%)	-2.93%
CA state tax at 13.3%	-1.06%
Deduction for CA state income tax with \$10,000 SALT limit exhausted	0.00%
Insurance costs	0.00%
Net After-Tax Return	4.01%

[Assumptions. Federal Income Tax: 37% + CA: 13.3% + LTGC: 20% + NIIT: 3.8%]

Table
2

INSURANCE DEDICATED FUND—IDF DRAGMASTER DART

High-net-worth individual, lives in California (CA), invests in alternatives taxed at: 75% ordinary income/short-term capital gains; 25% long-term capital gains

Return after investment management fee	8.00%
Federal tax at 40.8%	0.00%
State tax at 13.3%	0.00%
Deduction for CA state income tax	0.00%
Average IDF policy fees and expenses (average of PPLI and PPVA expenses)	-0.80%
Net After-Tax Return	7.20%

Current tax-free return of 8.0 percent equivalent to taxable 14.55-percent yield

[Assumptions. Federal Income Tax: 37% + CA: 13.3% + LTGC: 20% + NIIT: 3.8%]

Ladies and Gentlemen, Start Your Engines

So let's stage a drag race between a taxable investment vehicle versus the tax-advantaged IDF (see tables 1 and 2). Our two contestants line up at the Christmas tree. The taxable vehicle is the "Uncle Sam Chevy" and the tax-advantaged vehicle is the "IDF Dragmaster Dart." Three amber lights come on, followed by a green "go" light, and they're off to the races.

There's no question about which dragster wins this performance sprint. As shown in tables 1 and 2, the IDF Dragmaster Dart has a compound annual return almost twice that of the Uncle Sam Chevy. A tax-exempt return can be viewed as a tax-equivalent yield. A current tax-free return of 8.0 percent is equivalent to a taxable 14.55-percent yield for taxpayers at the highest marginal rate (including NIIT) who live in California.

The IDF and its offspring—PPLI and PPVA—benefit from tax-deferred equity buildup, as long as the policy doesn't

lapse or get surrendered or cancelled. Taking distributions from these private placement policies has very different tax consequences.

What Happens Upon Death of Policyholders?

Upon the death of insured policyholders, there is different tax treatment for PPLI versus PPVA. PPLI policies most often are designed with minimum death benefits relative to cash values to reduce policy fees and promote underlying asset growth.

When structured properly, cash can be accessed from PPLIs tax-free prior to the insured's death via premium withdrawals and tax-free policy loans (provided that the policy is a non-modified endowment contract wherein premiums are paid in over a fixed number of years).¹⁰ Withdrawals equal to the cost basis of the PPLI contract (cumulative premiums paid) and properly structured policy loans may be taken out on a tax-free basis (but the policy issuer charges interest on loans at a declared rate). However, it's important to note

that withdrawals and loans are like speed bumps because they slow the momentum of the IDF vehicle's tax-free growth of the underlying investment funds.

During the accumulation stages, PPLI policies enjoy tax-free equity buildup. When the insured passes away, all deferred investment gains are paid to beneficiaries as an income-tax-free death benefit. PPLI's income-tax-free death benefit creates a *de facto* step-up in cost basis of the underlying asset. To maximize wealth transfer, PPLI is best suited to "hold until death."

Estate tax liabilities still may be dependent on the terminal value of the PPLI policy. Most decamillionaires and ultra-high-net-worth families have a variety of trusts, partnerships, and other estate-planning entities. After pricing has been finalized, families typically engage outside counsel to discuss and decide on an optimal ownership entity. Families tend to own PPLI policies in off-balance-sheet trusts to mitigate potential estate tax liabilities. Trustees are particularly attracted to PPLI in the context of multi-generational trust planning.

PPVAs also are eligible for tax-free equity buildup, but distributions are taxed at ordinary tax rates. (In addition, policyholders who take distributions before age 59½ also are subject to a 10-percent early withdrawal penalty.) However, there is an innovative (and legal) way to avoid paying income taxes on withdrawals at PPVA policy surrender.

For clients who have charitable inclinations, a PPVA can allow them to set aside funds in an annuity, avoid tax on the investment gains during their lifetimes, and leave the proceeds of the annuity contract to a designated charity or private foundation at death. This allows the estate to take an unlimited charitable deduction for the fully accreted value of the annuity and the investment gains are never subject to income tax. This may be particularly attractive for clients with private

foundations, where charitable deductions for contributions made while living are subject to more severe limitations depending on the character and operation of the private foundation.¹¹

PPVAs allow these potential donors to control ownership and distribution of assets earmarked for future bequests to nonprofit charities or foundations. A philanthropist can name a favorite charity as the primary beneficiary of the PPVA and control the ultimate disposition of the assets.

Conversely, the investor may name a charity or foundation as the contingent beneficiary of the PPVA. That way, the PPVA policyholder maintains the option to change the terms and disallow any part of the annuity account value to be disbursed to the designated charity. It's more much flexible than making an irrevocable beneficiary designation.

ALTERNATIVE INVESTMENT TAX DRAG

Many alternative investment strategies—e.g., hedge funds, commodity trading advisors (CTAs), emerging market funds—involve frequent buying and selling of securities that result in lots of short-term capital gains. With short-term capital gains subject to a 40.8-percent federal tax (37-percent ordinary + 3.8-percent NIIT) and state income taxes averaging 6.25 percent (higher in some states), investors can forego half or more of their investment returns in higher turnover, tax-inefficient strategies.

A 2014 Deutsche Asset & Wealth Management report, published in *Trusts & Estates* magazine, stated that many hedge fund and emerging market strategies have an annual tax drag of 2.50–3.50 percent.¹² That means investors who own these strategies in taxable accounts forfeit 2.50–3.50 percent of annual returns to the tax man.

Asset location is a proven tax-alpha technique that assigns investment

products and strategies to the most appropriate vehicle to maximize after-tax returns. By owning potentially profitable and non-correlated assets in an IDF wrapper or chassis, investors can beat the drag effect on investment income and the capital gains taxation on selective hedge funds' inefficient tax treatment.

One road block that causes affluent investors to hesitate investing in alternative strategies is the drag associated with waiting for and filing K-1 forms. It's equivalent to a traffic summons issued for going 65 miles per hour (mph) in a 50-mph zone. But PPLI and PPVA investors aren't required to file a Schedule K-1 with their tax returns. This simplifies annual tax filing and may eliminate the need for extension requests or revised returns.

FEE DRAG: ADDITION BY SUBTRACTION

Focusing on fees can go a long way toward improving an investor's odds of picking a winner.

When looking for investment vehicles engineered to make your money grow faster, you want a chassis that is in race-ready trim. Actuaries have trimmed the cost of insurance (COI) and mortality and expense (M&E) charges from IDFs. For instance, the typical M&E charge for a retail variable annuity runs approximately 125 basis points (bps), but PPVA policies typically assess 30–50 bps.¹³

IDFs also strip out the guaranteed minimum riders: guaranteed minimum death benefit, guaranteed minimum income, guaranteed minimum accumulation, and guaranteed minimum withdrawal benefits. These costly riders may be nice to have, but they're often unnecessary. They create a drag on wealth accumulation. What's left is the core of a life insurance or variable annuity policy.

Two other taxing items must be considered when vetting an IDF insurance carrier. Ironically, policyholders need to

pay a one-time upfront federal and state tax toll charge. The federal surtax is called a "deferred acquisition cost," and it applies regardless of the policyholder's state of residence.

State taxes levied on life insurance premium deposits vary. The average state premium tax is slightly below 2 percent, but some states cap or limit the tax.¹⁴ The three highest insurance premium tax rates are found in Nevada (3.5 percent), Hawaii (2.75 percent), and California (2.35 percent). Alaska, South Dakota, and Delaware cap or lower the rate after the first \$100,000 worth of premium. Delaware charges a 2-percent assessment on the first \$100,000 premium on individual life insurance policies and zero percent thereafter.¹⁵ (Note: In Delaware this applies only to individual life insurance contracts, not corporate-owned, bank-owned, or trust-owned policies.)

Choosing an insurance carrier based on where it is domiciled can add to cash values by subtraction of state-imposed premium taxes. Advisors might well consider a Delaware-domiciled insurer as the preferred IDF vehicle. Ultimately though, evaluate the IDF issuer on its entirety. Using the insurer's state of domicile as a sole determinant is like buying a new car because you love its built-in dash cam or fuzz buster.

Finally, when evaluating a particular IDF, it's vital to perform a vehicle inspection. Look under the hood for vehicle defects such as hidden fees and unresolved or undisclosed conflicts of interest between the investment manager and the insurer. In addition to COI and M&E charges, annual administration fees, and fund management fees, many IDFs have performance incentive fees. Some incentive fees may be justified and reasonable for access to top-performing asset managers. Like any good mechanic, weigh the trade-offs.

Fiduciary advisors know that what a client keeps, net-of-fees, is more

important than the gross-of-fee earned. Just as federal and state taxes erode and impede wealth creation, excessive investment management and incentive fees also can take a toll.

TAIL-RISK PROTECTION PREMIUM DRAG

The final drag concerns the engine used in your IDF vehicle. The IDF is the insurance wrapper or chassis used to shield wealth creation from the main drag of taxes. The investment strategy is the engine, and the investment manager is the driver of the vehicle. So an IDF has a chassis, an engine, and hopefully a proven driver to power wealth creation.

When evaluating the hundreds of IDFs to choose from, advisors and analysts are well-advised to consider tactical equity exposure management as the engine to power this wealth-creation vehicle.

Without going into the tail-risk literature, suffice it to say that finding truly uncorrelated asset returns is difficult and that when market turbulence strikes, correlations rise (“go to one”) just when you need uncorrelated assets the most. It also is difficult to overstate the importance of positive compounding as a source of long-term excess return. So, a strategy that captures most of the return in rising markets while avoiding full exposure to declining markets will, over time, outperform a strategy that participates fully in both advances and declines. Tail-risk strategies can mute volatility, boost portfolio profitability, and prevent negative compounding of returns, but they come with a cost.

Following the Global Financial Crisis of 2007–2009, State Street Global Advisors (SSgA) published a study about the cost

of tail-risk protection strategies.¹⁶ SSgA used 20 years of monthly data to analyze four methods of controlling tail risk. SSgA defined portfolio tail-risk as “the conditional mean portfolio return in months where equity returns exceeded a loss of five percent.”

The four methods examined were (1) long volatility, (2) low volatility equity, (3) trend following, and (4) equity exposure management. Each of these methods was analyzed, on a stand-alone basis, for the period March 1990–March 2011. Together they comprised 10 specific strategies investors could deploy to mitigate and manage tail risk.

SSgA’s study quantified two components, performance drag and certainty, to determine some degree of confidence that a tail-risk strategy would pay off when needed. Performance drag is the reduction in annual return when adopting a tail-risk strategy. The annual drag on performance (the price of the protection) is a major reason that most institutional and high-net-worth investors opt not to insure against the very real risk of left tails. (An Allianz Global Investors 2015 survey found that only 27 percent of institutional investors made use of tail-risk protection strategies.¹⁷)

Tactical Equity Engine Outpaces Performance Drag

In the race against performance drag, the ideal tail-risk strategy has low performance drag and a high certainty of protection. Stated another way, the tail-risk strategy with the least drag on investment returns wins.

The performance drag of the 10 tail-risk strategies ranged from a low of 21 bps for a generic trend-following strategy to a high of 355 bps for a strategy that used one-month VIX futures contracts. The sizable drag of one-month VIX futures is due to the historical contango relationship in VIX futures where short-term VIX usually trades at a pre-mium to spot VIX. The commonly used

tail-risk insurance method of buying put options exerts a very large annual drag of 268 bps.

Of the 10 strategies examined, however, one outlier did not exert any performance drag on portfolios. Tactical equity exposure management was far and away the best tail-risk strategy. Instead of creating a negative drag, tactical equity exposure added 25 bps in return annually while still reducing tail risk by 20 percent. This tactical equity strategy used a simple trading rule of going long or short the S&P 500 using a 10-month moving average.

SSgA used a 1.0 certainty measure as a reasonable minimum confidence threshold from tail risk. The tactical equity exposure management clocked in at 1.32. Depending on investor willingness to trade return (performance drag) for lower risk (certainty of protection), tactical equity exposure appears to be a viable strategy for managing tail risk.

When evaluating the hundreds of IDFs to choose from, advisors and analysts are well-advised to consider tactical equity exposure management as the engine to power this wealth-creation vehicle. There’s no good reason to drag one’s tail when it comes to tail-risk protection. One key to wealth accumulation is to avoid negative compounding, which we would all agree occurs with greater frequency than normal distributions predict.

THE PERFORMANCE DRAG WINNER IS ...

In drag-racing jargon, a “beast” is an exceptionally fast car that “prunes” or beats another car. An IDF is a beast that decisively prunes taxable vehicles. It handily defeats the main drag of taxes and outmaneuvers the short-term capital gains tax burden imposed on inefficient strategies such as hedge funds and CTAs.

Advisors and their clients who want to go the extra mile also should consider

proven tactical equity exposure strategies as a cost-effective way to protect portfolios against the negative compounding that occurs during tail-risk events.

This performance drag exposé is for more than just motorheads. Holistic advisors to decamillionaire and ultra-high-net-worth investors can rev up an advisory practice by test-driving the potential advantages of this insurance/investment chassis. ●

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USING MARKET VOLATILITY . . .

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Volatile markets are always difficult to navigate, but at least they create opportunities for investors and financial professionals who seek to lower their tax bills throughout the year. We believe ETFs offer an attractive vehicle to book losses in equities, while staying out of cash and remaining invested to participate in a potential recovery. ●

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ENDNOTE

1. DataTrek Research, as of June 30, 2020.

The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States.

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