APPLYING BOND STRATEGIES TO TERM INSURANCE

Veteran bond traders often rely on two tried-and-true techniques to help interest rate risk: the barbell strategy and the ladder strategy. The barbell strategy entails holding roughly equal amounts of long- and short-term bonds. In contrast, proponents of the ladder strategy value owning varying amounts of short-, mid- and long-term bonds. In both cases the goal is the same: If interest rates fall, you've locked in some of the portfolio at the higher rates and aren't caught holding exclusively assets of depreciated value. Conversely, if rates rise, you can replace some of your expiring bond portfolio to cash in on the higher interest-paying bonds. This can be particularly important for retirees who may rely on these fixed income securities for income in retirement.

Savvy life insurance producers – perhaps those who also manage assets or were bond traders in a prior life – have taken these strategies and applied them to life insurance. Essentially, they advocate a barbell or ladder approach to term insurance. While life insurance is a clearly different sort of investment – the cost of insurance won't fall over the years; it will only rise – there are some distinct advantages to diversifying the length of coverage in one's insurance portfolio.

Savvy life insurance producers advocate a barbell or ladder approach to term insurance.

THE CLIENTS

To bring out these advantages, let's consider our clients, Will and Grace. Will is a chemical engineer and rising star with a large energy company, and Grace an entrepreneur with her own rapidly growing media startup. Both Will and Grace are in their mid 30s and have two children — 13 and 3. After years of struggling, they now enjoy a combined salary of around $200,000 per year. However, most of their income goes to paying down their college loans, a large mortgage, private schools, saving for their kids' college and, of course, high taxes. To protect their family's income in the loss of one or both of them, they know they need life insurance, but they aren't convinced whether they can yet afford or if they even need permanent insurance. They imagine they can afford around $4,000 in premiums a year combined at this time. How might they best allocate their premium dollars?

At their ages, the cost of permanent insurance will range from $4,000-$10,000 each per million of coverage. Clearly, permanent insurance is outside of the budget of $2,000 each. What about term insurance? Below are the quotes they've received:

COST OF TERM INSURANCE

FEMALE, 35, PREFERRED, COST PER $1 MILLION		
10-Year	**20-Year**	**30-Year**
$285	$597	$865

MALE 35, PREFERRED, COST PER $1 MILLION		
10-Year	**20-Year**	**30-Year**
$335	$622	$1,075

Note that per $1,000 they can buy approximately $3 million each of 10-year term, $2 million each of 20-year term or $1 million each of 30-year term.

Here are some additional factors they're weighing as they make this decision:

- $3 million of death benefit each is closer to their calculated need, which has them leaning toward the 10-year term.
- They were hoping to protect their salary until retirement age – another 30 years out – and the 30-year term looks to be about perfect to meet this goal.
- One child will be graduating college in 10 years and the other will finish in about 20 years. So a bit of 10-year and 20-year would allow them to sustain coverage through their older child's graduation, while maintaining reduced coverage through their younger child's college years. Making sure there are adequate funds for the children to attend the college of their choice is a major priority for them.
- They suspect they could have significant premium dollars to spend in 5-10 years, if Will receives subsequent promotions or Grace's business continues to have increasing revenue. Moreover, they're projected to pay off their own student loans in 10 years, which will free up significant cash flow.
- They've expressed interest in converting to permanent coverage in 5-10 years should their budget allow. As increasingly high earners, they desire both tax-deferred growth and another savings vehicle to supplement their retirement income.

In the end, they get closest to covering all of their needs by employing a ladder strategy. This allows them to manage costs, lock in insurability, and cover both long- and short-term needs. Thus, they each buy $1 million of 10-year, $1 million of 20-year and $1 million of 30-year term insurance. Using this strategy, they'll have $6 million of combined coverage over the next 10 years, $4 million over
20 years and $2 milllion over 30 years. The upside to the ladder is also attractive to them. If Grace's business really pops or promotions arise, they can possibly convert all $6 million to permanent insurance incrementally as they age and free up cash flow.

The ability to convert incrementally shouldn't be underestimated. The couple has hedged the rising cost of insurance against their future needs and ability to pay for coverage. Converting in $1 million increments better allows them to fine-tune their portfolio in response to their future needs and budget.

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05/20 | 17-PCR-PF-PC-0997 | Copyright © 2020 NFP. All rights reserved.