

THE MODERN PORTFOLIO THEORY OF LIFE INSURANCE

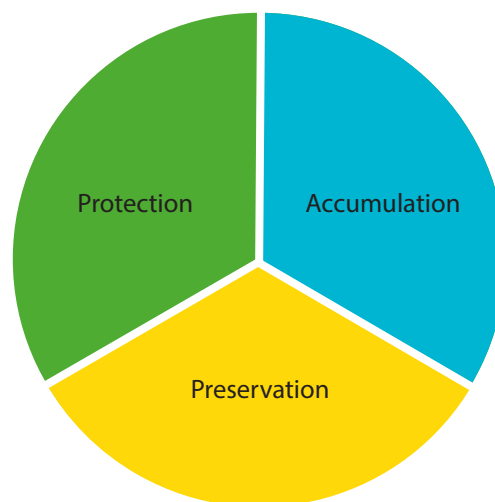
Two dominant species of bird have emerged in finance: the passive investing sparrows and the active managing hawks. They're constantly at odds over the meaning of their personal songs. On the one hand, the active managers squawk, "No risk, no reward," while the passives warble, "Don't put all your eggs in one basket." Yet somewhere in the middle lies a third bird, one that flies comfortably with both flocks, reaping the benefits of compromise.

Over the years, the competing tunes have perhaps been muted a bit with the widespread recognition of modern portfolio theory, the key principle of which is that investors are rational and will try to maximize their expected return for a given level of risk. Possibly the most significant advance to emerge from this theory is the notion of the benefits of diversification. By assembling a diversified portfolio of uncorrelated assets, an investor minimizes risk for a given level of return. Depending on a number of factors, such as an investor's age, risk tolerance and other preferences, it's possible to construct an investment portfolio that matches those specifications.

In practice, balancing the forces of risk and return typically leads to an investment portfolio with assets allocated to distinct risk categories. The typical portfolio includes accumulation-type, preservation-type and protection-type assets in various proportions like the one below:

A substantial life insurance portfolio should be diversified to meet shifting goals and negotiate the tradeoff of risk and reward.

DIVERSIFIED INVESTMENT PORTFOLIO



Although many perhaps don't possess this particular, even division of assets in their portfolio – or perhaps refer to them by different names – most would probably concede that an investor should own some numerical balance of each portion of the pie in a shifting proportion over the years. But what about life insurance? Should it be similarly diversified?



A substantial life insurance portfolio should be similarly diversified to meet shifting goals and negotiate the tradeoff of risk and reward. Just as you might build an investment portfolio of protection-type, accumulation-type and preservation-type assets according to an individual's needs and preferences, so too should you with an insurance portfolio. Products often fit squarely into one of the three categories. However, an ideal balance for a client may consist of several products that fit only broadly into these divisions. What's more, hybrid (e.g., protection-accumulation) products often defy easy categorization and need to be considered in light of how they fit into the overall portfolio.

For illustration purposes, let's consider a client with various short- and long-term goals and temporary needs. Our client Carrie's needs are several:

- 1. Protection:** She has a short-term need for guaranteed coverage to secure business debts and to replace family income in the event of early death.
- 2. Accumulation:** She has a desire for tax deferral to fund her children's college education and supplement retirement income.
- 3. Preservation:** She wants to earmark some insurance for estate liquidity or bequests.

In short, Carrie's portfolio may end up looking much like our modern investment portfolio above, with a balance of protection, accumulation and preservation-type products.

There are numerous advantages to a portfolio rather than a one-product-fits-all product approach:

- Diversification in the event of an underperforming or failing carrier
- Paying only for what you need at the time
- Mitigating a carrier's imposed retention limits
- Locking in insurability across several carriers
- Perhaps most importantly, allocating premium dollars to various types of risk according to your unique needs and preferences.

Remember: life insurance is an asset like any other you might purchase, so the key to ensuring a solid strategy for insurance is to apply a portfolio theory that can mitigate risk, minimize the amount of premium dollars due and maximize the potential return for the client — all while providing plan completion through the death benefit.

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