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Reduce Portfolio Risk Using Cash Value Life Insurance

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When thinking about life insurance, most people see it as a product that is strictly about covering the financial risk associated with the loss of an individual's life. This is true, as income replacement was the original purpose of life insurance since its conception in the mid-1700's.

What many people do not know, is that if a life insurance policy is structured properly, it can act as a risk-mitigating tool for a financial portfolio. This article will illustrate how whole life insurance can be a versatile risk reduction asset in your financial portfolio.

Fixed Income Diversified by Life Insurance

Consider the case of a couple in their early 50s who invests all of their assets into fix income securities. They do so with the hopes of maintaining a relatively low-risk portfolio with decent returns that has no exposure to equities. Let's assume their portfolio is weighted to have an average rating just below investment grade, at BB. While this may not be the absolute safest portfolio, it also doesn't have terrible yields. While this is a good mix of risk with reward, the couple can still reduce their risk even further with the purchase of a whole life insurance policy.

The main ways a whole life insurance policy can reduce the risk of a portfolio are through interest rate risk balancing, providing better liquidity, reducing income taxes, and reducing the portfolio's overall credit profile. Mechanisms for how these benefits manifest are explained below.

Interest Rates Risk Balancing

Interest rates can be a particularly risky aspect of a non-diversified, fixed income securities portfolio like the one mentioned earlier. We are currently experiencing exceptionally low interest rates, but if they were to rise, the entire value of a bond portfolio could decrease proportionality. Conversely, a whole life insurance policy, with its minimum guaranteed rate and increased returns on its cash due to increased interest rates via dividends, would effectively hedge the portfolio against the interest rate increase risk. If properly constructed, a portfolio comprised of bonds and a whole life policy can effectively eliminate the interest rate increase risk outright. As always, this form of portfolio engineering should be conducted by professionals qualified in both financial products.

Liquidity Risk

One of the other risks associated with a non-diversified, fixed income securities portfolio is its lack of liquidity. While of course bonds can be sold on the open market to provide liquidity in a pinch, it would be less than ideal to sell bonds if the market for them had recently declined. Additionally, the bonds can be borrowed against, but there are often strict conditions against borrowing more than half of a securities value. A whole life insurance policy, on the other hand, can be borrowed against almost to its full value, all while maintaining favorable loan rates.

Reducing Income Taxes

The tax liability for a non-diversified, fixed income securities portfolio is significant, in that up to half of the portfolio's returns are subject to state and federal income taxes depending on the circumstances. Life insurance can limit the tax liability for the portfolio due to its accumulated value being shielded from taxes, and this accumulation can be borrowed against as mentioned in the previous section.

Reducing Credit Risk Profile

Finally, let us look at how a whole life insurance policy can balance the credit risk profile of a portfolio. A portfolio consisting of purely BB rated bonds, inherently holds the risk of such less than investment grade bonds. If the portfolio also contained a whole life insurance policy insured by a AA+ rated company, this would spread the portfolio's credit risk, as a AA+ rated company is far less likely to default on its credit in comparison to BB rated bonds.

As always, it is advisable to work with qualified professionals when purchasing a life insurance policy and making financial investments, as there are many specifics that need to be addressed to obtain the benefits mentioned in this article. When the time comes to act on your financial goals, remember to think outside the box when it comes to your portfolio structuring.

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