10 Biggest Mistakes Planners Don’t Realize Their Clients are Making

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Financial Experts Network Presentation

Scott J. Witt, FSA, MAAA
Witt Actuarial Services, LLC

Confusion and Complexity

- **Complexity** and **confusion** are two of the best things that the insurance industry has going for it
  - Consumers have no idea what they are purchasing or what they have
  - Consumers can't tell a good product from a bad product
  - Consumers can't recognize and/or quantify the inherent conflicts of interest
- Goal today: shed some light on that complexity and confusion so you can lead your clients to better insurance decisions

My goal is to clarify the confusion

- Actuary – not an agent
- Fee-only insurance advisor working with client and their advisors
- Typical assignments
  - Evaluation of new/existing coverage or designing coverage
  - Problem solving
  - Mistake avoidance
  - Peace of mind
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10 Biggest Mistakes

- Not seeing the risk of lapse
- Believing illustration is the product
- Not recognizing true drivers of non-guaranteed policy performance
- Paying full commissions when cheaper alternatives available
- Not realizing that it is possible to buy certain cash value policies that are good investments

10 Biggest Mistakes (cont.)

- Failing to manage in-force policies
- Failing to recognize that mismanaged variable life policies can expire worthless
- Purchasing a "guaranteed" policy (Guaranteed UL) that exposes the policyholder to total loss
- Buying wrong type of annuity
- Not recognizing the illusion of "peace of mind" provided by most long-term care policies

Mistake #1: Lapse risk

- Buying a permanent life insurance policy that won't be held until death.
- Not realizing the true probability that the policy will lapse

A Harsh View on Lapses

- A lapse usually means a mistake was made at issue
  - Couldn’t afford it; didn’t need it; or didn’t understand it
  - Policy poorly designed; poorly priced; or from poor company
- Insurers assume that only 20-40% of permanent policies remain after 20 years
- Holding until death is critical to realize primary advantage of permanent insurance

Lapse risk: SVUL example

VUL Illustration

Policy Year	EOY Age	Premium	Gross Return	Cash Value	Death Benefit
15	68	44,243	6.0%	413,376	15,000,000
16	69	44,243	6.0%	450,120	15,000,000
17	70	44,243	6.0%	483,969	15,000,000
18	71	44,243	6.0%	513,955	15,000,000
19	72	44,243	6.0%	539,125	15,000,000
20	73	44,243	6.0%	558,372	15,000,000
21	74	44,243	6.0%	569,431	15,000,000
22	75	44,243	6.0%	570,398	15,000,000
23	76	44,243	6.0%	558,890	15,000,000
24	77	44,243	6.0%	532,027	15,000,000
25	78	44,243	6.0%	487,416	15,000,000
26	79	44,243	6.0%	421,834	15,000,000
27	80	44,243	6.0%	330,413	15,000,000
28	81	44,243	6.0%	208,345	15,000,000
29	82	44,243	6.0%	49,169	15,000,000
30	83				

Optimizing Permanent Insurance

- Get it right at issue
- Ongoing service
  - Will agent that sold you policy still be around?
    - Very low agent persistency
      - 20% retention after 5 years viewed as excellent
    - Even best agents may not be around for life of policy
  - Little or no financial incentive for optimal service
    - Especially orphan situations
    - Interests of company (agent) often opposed to interests of policyholder

Mistake #2

- Believing the illustration is the product
  - Unfortunately consumers – often under agent's direction – simply compare illustrations to make decisions
  - Illustration games run rampant
    - Interest rate bonuses
    - Unrealistic mortality charges
    - Unsustainable crediting rates
  - Never forget that the primary purpose of the illustration is to try to convince you to buy the policy!
  - Be especially wary of aggressive indexed UL policies

Mistake #3

- Not recognizing true drivers of non-guaranteed policy performance
    - Investment experience / philosophy
    - Mortality experience
    - Expenses
    - Persistency (and impact on above factors)
    - Company structure / philosophy
- Long-term performance will depend on the above – not on how attractive the original sales illustration was/is
- Difference between average and great? PV > 3 premiums!
    - All products are not created equal – even within the same company!

Mistake #4

- Paying full commissions when cheaper alternatives available, often within same company
  - Through product design, commissions can be reduced by up to 85% or in some instances eliminated entirely
  - Instead of a first-year cash value of $0, may be 80-90% of first-year premium
  - Long-term savings even greater because boosting early cash values lowers future mortality charges
    - PV savings usually 1-1.5x annual premium
  - For annuities, higher cap rates / payout rates

Mistake #5

- Falsely believing that cash value life insurance policies are good investments . . .

  but also . . .

- Falsely believing they are not!

- Most policies are NOT good investments, but it is possible to design a policy that is

Life Insurance as Investment

- Prerequisites:
  - Maxed out on juiciest qualified savings vehicles (401k match, HSA, Roth)
  - Desire to pass wealth on to heirs
  - Insurability
  - High tax bracket
- With above,
  - Non-variable policy can add 100-150 bps of after-tax return relative to bonds
  - Variable policy can add 100-150 bps of after-tax return relative to same equities held outside (may disappear in buy and hold scenario with step-up at death)

Life Insurance as Investment

- What you need to get right
  - Company choice (for non-variable especially)
  - Product design
    - Maximize long-term accumulation
    - Minimize (or eliminate) agent compensation
  - Funding strategy
  - Understanding of distribution phase (if any)
- Realistically – almost no chance of optimizing value without help from an expert looking out solely for you

Mistake #6

- Failing to manage inforce policies optimally
  - For most insurance policies (almost all but UL), you should pay annually if you have cash flow to do so – avoids unreasonably high modal premium charges
  - Be careful with policy loans on cash value life insurance – more costly than agents/companies would have you believe
  - If insured has had a significant downturn in health, then you may be able to exploit that by managing policy differently
  - Before you replace or sell a policy, make sure you have put its best foot forward

No Common Ground

- Agents and insurance companies have no financial incentive to provide optimal advice due to compensation structure
- In fact, the financial interest of the company is often exactly opposed to the financial interest of the policyholder

Mistake #7

- Failing to recognize that mismanaged variable life policies can expire worthless
  - Even if originally scheduled premiums paid, AND
  - Even if "average" returns have matched level shown on original sales illustration

- If you have a variable policy, then do yourself a favor and get an in-force illustration
  - Should really get illustration on all permanent policies annually

SVUL illustration example

VUL Illustration

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Remedial Actions

- To extend life of policy to age 100 (which itself carries >10% lapse risk) . . .
    - Increase premium from $44,243 to $184,000
    - Increase premium from $44,243 to $142,000 AND increase gross return from 6% to 8%
    - Lower death benefit from $15 million to $8 million, increase premium from $44,243 to $59,000, AND increase gross return from 6% to 8%
- – To manage toward eliminating lapse risk (cash value equals death benefit of $15 million at age 100) . . .
    - Increase premium from $44,243 to $144,000 AND increase gross return from 6% to 10%
    - Adjust annually as needed to stay on pace for "endowment"

Mistake #8

- Purchasing a "guaranteed" policy (Guaranteed UL) that exposes the policyholder to the possibility of losing everything
- Make sure you have the ability to guarantee coverage for life

Mistake #9

- Pursuing wrong type of annuity
  - Deferred annuities are oversold
  - Immediate annuities are undersold

Deferred Annuities

- Hard to justify “vanilla” annuities inside qualified accounts
  - Most popular – living benefit riders
    - Vary greatly and can be expensive
    - Might do better with combination of other products (but more complicated)
- Tax deferral for NQ – but ordinary income
  - Not great logically for equity exposure
- Not a great asset to hold at death

Immediate Annuities

- These are fantastic conceptually
  - Would be even better if true inflation-adjusted policies were developed
- Haven't gained much traction
  - Consumers can't stop viewing this as an investment instead of insurance
  - Protect against outliving your money
- Many consumers would benefit from a guaranteed income stream (Die with Zero)
- Consider laddering purchases
- Some good no-load options available now

Longevity Insurance

- With these products, money is deposited now but lifetime income stream doesn't kick in until some advanced age
- Very leveraged and effective risk transfer
  - Hard for consumers to embrace due to idea of losing everything if death occurs before income stream starts
- Market isn't deep enough for consistent and competitive pricing
  - Product to watch for the future – hasn't gained traction

Mistake #10

- Not recognizing the illusion of “peace of mind” provided by most long-term care policies

Typical LTC Sales Process

- Consumer motivated to protect against LTC risk
  - Perhaps scared due to statistics, personal horror story, etc.
  - Typically most worried about catastrophic loss

- Initial proposals shown by agent are way too expensive
- Consumer buys a policy but compromises
  - Short benefit period, no inflation, lower monthly amount, etc.

Typical LTC Coverage

- Result is that the vast majority of LTC policies purchased do not protect against catastrophic risk
  - Yet consumers act as if they do
  - Important to understand what you have and don't have

LTC Considerations

- Standalone LTC Policies
  - Provide best risk transfer
  - Consider partnership program in some states
    - Allows for assets to be protected on a dollar-for-dollar basis while still qualifying for Medicaid
    - If $200,000 in benefits paid, then consumer can qualify for Medicaid at normal threshold + $200,000
    - Certain policy parameters in order to qualify for partnership program

LTC Alternatives

- Hybrid policies
  - Less risk transfer than standalone LTC policies
  - But address some of common objections to buying LTC
- Life insurance with LTC rider
  - Similar issues as with hybrid policies
- Cash value life insurance
  - Tap into cash while alive or view death benefit as means to reimburse family members for cost of care
  - If care never needed then family gets death benefit
- Self-insuring
  - Possible if you can write $1 million check and still be OK

Staying in touch

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www.wittactuarialservices.com

Scott Witt

414.525.8212

scottwitt@wittactuarialservices.com