

# LARGE CASE DESIGN MEMORANDUM

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## Danger, Will Robinson!

Economic events of substantial magnitude (Internet boom and bust, sub-prime, Euro debt crises) tend to materialize as a wave of financial destruction spread out over long periods of time. You may not have regarded American mortgages as destructive assets teetering on a dangerous cliff between 2002 and 2007, but by 2008 the full impact of our financial system's malfeasance caused the value of those assets to fall into the abyss. And it isn't the financial institutions that paid the price, they were bailed out. Today, the negative effects of Wall Street's risk shifting strategies are still being felt by investors all over the world and will continue to be a problem for many years to come.

In fact, many of the most calamitous financial situations the global community faces are, at their core, failed attempts to shift risk from one party to another, as any holder of Greek sovereign debt with a credit default swap in-hand can attest. Global financial institutions have apparently decided that holding appropriate reserves for risk is more expensive, and more of a drag on their profits, than participating in the global Ponzi scheme called the 'credit default swap' market. CDS's are just one of a dizzying array of options financial institutions, including insurance companies, purchase and/or sell to shift risk and boost potential return. Unfortunately, like String Theory, the entire global financial system is interrelated. You can't take risk away from one party without creating more for another.

This brings us to the other unifying theory of risk economics, Fecal Flow Dynamics. This is theory that fecal waste flows downhill. The combination

of String Theory and Fecal Flow Dynamics explains the phenomenon of large financial institutions and hedge fund managers sucking all the cash out of the economy while retail investors lose their retirement money, homes, and businesses. I could draw you a diagram but I think you get the picture.

If at this point you are asking yourself: "How does this relate to large case insurance ideas?", please read on....

Life insurance carriers are by far the largest, (theoretically) socially responsible caretakers of our collective financial ineptitude. No matter how you faire in life as an investor, spouse, parent or business person, insurance companies always pay death benefits.

Stripped bare of the policy language, sales pitches, tax breaks, and fancy PowerPoint presentations life insurance is really a financial collective. We all accept a fair and reasonable rate of return on our cash during our lifetime so that our families may have a guarantee of cash in their hour of need.

The big variable in this implicit compact is that of mortality. We know that we will die, we just don't know when. A simple, yet immutable, law of nature dictates the outcome. The most important feature of this tacit cooperative is the carrier manages and assumes most or all of the risks. In return we accept the value proposition that some amount of our heir's future asset values will be returned in cash at the exact moment they need it. Simple, yet powerful.

At some point in our past, let's call it the decade of the 80's, consumers decided to abandon these most basic and valuable principles of protection by comparing their investment in life insurance policies to the return they might enjoy if they invested in the stock market instead.

Whether compared to CD's, mutual funds, real estate, stocks or bonds, insurance policies, particularly in the 80's, could not match the cash return these alternatives were believed to provide. But was that really the correct comparison?

Like most collective consumer decisions in this country, that comparison was and still is seriously flawed. Why? In my opinion, it was the risk shift. Although the disintermediation of the 80's was detrimental to the insurance carriers' bottom lines it was far more detrimental to clients who accepted the flawed interest rate assumptions and low or no cash policies they demanded. The road to financial success is littered with the carcasses of supposedly smart clients who purchased policies based on flawed risk assumptions. And yet the insurance carriers remain financially sound; maybe more so than any other segment of the financial marketplace. You can't beat the carriers at their own game. Just ask the life settlement buyers.

At the risk of impersonating Chicken Little once again, let me warn you about the latest huge risk shift in life insurance: *Indexed Life*. If you haven't already done so, please take a moment to think about the reasons for Indexed Life's sudden popularity:

*Interest rates are historically low, the cost to fund a policy is, in-part, determined by the interest earned, therefore, in this low rate environment the cost of insurance should increase. Insurance carriers realize that they can't affect interest rates but feel the need to stay competitive with their peers.*

*Mortality rate improvements have already been priced into the current crop of products. Insurance agents love to spreadsheet numbers. Therefore, a product with a fictitious interest rate 400-500 basis points higher than what could reasonably be projected by a competitor is a spreadsheeter's dream.*

Since the SEC has already thrown in the towel on their efforts to correctly (in my opinion) characterize Indexed Life products as a security I won't spend a lot of your time making that argument. However, if it acts like a duck and quacks like a duck, what's the probability it's a dog?

Forget the underlying investment in one or more indexes, how about the uncertainty of relying on one or more of the creative options-based index return mechanisms? Will your clients remember that they have a combination of 1 year point-to-point crediting and fixed account returns? Will they remember that the options market determines the participation rates, caps and floors? When the market is up 17% and your client receives 4% credited to the account will they remember how the rate was calculated? When the premium you calculated based on a 25 year look-back is too low because mortality costs expand when interest rates decline will they remember that they accepted this shift of risk to themselves?

If so, maybe they should have purchased VUL? If not, you better make sure your E&O coverage is paid up.

I've personally assisted several clients with indexed annuities which were purchased through other agents. None had any idea how the policies work. Every one of them believed that the policy return was purely a function of the index's return. None understood the participation rates, caps, floors or asset allocation among several strategies. All complained to the carriers. None were satisfied with the answers.

Reportedly, the anniversary of the first five year period of the original AIG Global Index product recently occurred. The overall return for the full 5 year period was approximately 2%. Considering most of these policies were financed purchases it would seem that the cost of credit handily eclipsed the return. Had the same clients purchased a fixed accumulation product they would have earned between 3 and 5% depending on the contract, with much lower expenses.

We all know that the past five years were among the worst ever and that past performance is no indication of future results. However, shouldn't we be counseling our clients to avoid letting

insurance companies shift ALL of the investment risk to them without commensurate opportunity for reward?

More importantly, shouldn't these products be restricted to clients for whom they are a suitable investment? If we don't, and we just accept the spreadsheet paradigm, where every decision is based on the lowest premium you can illustrate, *YOU* will be accepting the next big risk shift. That shift will place the financial burden of litigation squarely on your shoulders.

*Proceed with caution.*

~ Ron Sussman

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