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# IUL AND VUL—CREATING A FAIR COMPARISON

**Although both Indexed Universal Life (IUL) and Variable Universal Life (VUL) policies offer account value performance based on equity performance, it can be difficult to compare them on a level playing field. VUL benefits from the addition of dividends and the increased risk-return profile compared to IUL. Over the last 65 years, the combined force of these factors has created a 493 basis points (bps) advantage in annual return for VUL. When IUL and VUL are compared, using the AG 49A calculation percentiles can help establish comparable rates.**

## BACKGROUND

IUL and VUL products have many similarities: both provide flexible premiums, the possibility of lifetime insurance, a variety of riders to provide additional benefits, and both can offer account cash value performance based on the performance of equities. VUL achieves this with direct participation in equities through variable subaccounts. IUL uses policy credits based on the performance of an index, commonly the S&P 500, subject to account parameters (i.e., caps, floors, participation rates, and multipliers).

**DEFINITIONS:**

**Account Parameters**—The account attributes that determine how index performance is adjusted to create policy credits (e.g., caps, floors, participation rates)

**Cap**—The upper limit of the index performance that is credited to the policy

**Floor**—The lower limit of the index performance that is credited to the policy

**Participation**—The percentage of the index performance that is credited to the policy

With so much in common, it stands to reason that both producers and policyholders may wish to compare IUL and VUL. This leads to a question: How do you create a fair comparison between IUL and VUL?

Imagine an IUL product with an S&P 500 capped indexed account and a variable product with a low-cost fund that tracks the S&P 500. How would the performance of these products differ?

Table 1 highlights the three key differences in performance that factor into the comparison.

### Table 1: IUL vs. VUL—Key Performance Differences

| | Indexed Universal Life | Variable Universal Life |
|---|---|---|
| **Caps and floors** | Yes | No |
| **Dividend participation** | No | Yes |
| **Fund fees** | No | Yes |

## ALIGNING VUL RATE OF RETURN WITH AG 49A

In 2016, the National Association of Insurance Commissioners (NAIC) prescribed the maximum allowable illustrated return on index segments based on the participation, cap, floor, and threshold rate, if applicable. Known as Actuarial Guideline 49 (AG 49) and later, Actuarial Guideline 49A (AG 49A), this guideline effectively put a speed limit on IUL illustrations to thwart overly optimistic assumptions. The AG 49A rate is essentially the average return of the index under the current IUL account parameters over the past 65 years. The actual calculation applies current indexed account parameters to annual returns every day for the last 65 years. Those returns are then grouped into 25-year time frames and compound annual growth rates are calculated for each segment, roughly 10,000 of them. The maximum AG 49A illustration rate is the arithmetic mean of these compound annual growth rates for the given account parameters.[1] For an IUL account with a 0% floor, 9% cap and 100% participation rate, the maximum AG 49A rate today is 5.75%

What is the equivalent rate of return for a VUL product? Applying the same methodology to a VUL product, we can calculate a hypothetical maximum AG 49A rate based on allocating the policy cash value to a S&P 500-based variable subaccount. Adjustments are made for dividends and fund fees on a monthly basis, cap and floor rates are removed, and the participation rate remains at 100%. The resulting rate of return is a hypothetical maximum AG 49A rate of 10.68% for the S&P 500 investment inside the VUL product. An IUL illustration run at the maximum AG 49A rate is equivalent to a VUL using a low-cost S&P 500 fund at 10.68% net.

Using the AG 49A calculation, table 2 shows how the compound annual growth rates for the VUL and IUL policies compare over the 25-year time frames.

### Table 2: VUL vs. IUL—Compound Annual Growth Rates

| S&P 500 Total Returns (20 bps fund fees) | |
|---|---|
| **Percentile** | **Return** |
| worst | 6.78% |
| 90th Percentile | 8.80% |
| 80th Percentile | 9.14% |
| 70th Percentile | 9.35% |
| 60th Percentile | 9.55% |
| 50th Percentile | 9.85% |
| 40th Percentile | 10.28% |
| 30th Percentile | 11.90% |
| 20th Percentile | 12.78% |
| 10th Percentile | 13.53% |
| best | 17.16% |
| Hypothetical Max AG 49A | 10.68% |

| 1-Yr S&P Point-to-Point (9% cap, 0% floor) | |
|---|---|
| **Percentile** | **Return** |
| worst | 3.69% |
| 90th Percentile | 4.88% |
| 80th Percentile | 5.23% |
| 70th Percentile | 5.48% |
| 60th Percentile | 5.71% |
| 50th Percentile | 5.87% |
| 40th Percentile | 6.00% |
| 30th Percentile | 6.11% |
| 20th Percentile | 6.23% |
| 10th Percentile | 6.43% |
| best | 7.22% |
| Max AG 49A | 5.75% |

[1] Additional restrictions may apply for certain indexed accounts.

**Based on past performance of the S&P 500, illustrating the IUL at the maximum AG 49A rate of 5.75% is equivalent to illustrating the VUL at 10.68%.**

**It is best practice to illustrate VUL assuming a conservative rate of return. If one is using an assumed S&P 500 rate of return of 7% then the equivalent illustrated crediting rate for an IUL with a 9% cap rate on an S&P 500 index would be 3.96%.**

## IF BOTH POLICIES ARE CREDITED BASED ON THE S&P 500 INDEX, WHERE DOES VUL'S RATE OF RETURN ADVANTAGE COME FROM?

The differences in historical performance come from the three key differences between IUL policy index credits and VUL subaccount returns: caps and floors, dividends, and fund fees.

### CAPS AND FLOORS

While IUL floors protect against losses, IUL caps limit the potential for large gains. The collared nature of IUL accounts decreases volatility, but also reduces expected returns.

Let's return to the hypothetical AG 49A calculation to quantify the benefit of the higher risk-reward profile provided by the VUL product using a low-cost S&P 500 fund. Table 3 summarizes the outcomes of annual returns over the past 65 years assuming 100% participation, 0% floor, 9% cap, and no threshold.

### Table 3: Frequency and benefit/cost of exceeding the collar

| Outcome | Frequency | Benefit/(Cost) in basis points |
|---|---|---|
| Above the cap | 51% | 578 |
| Below the floor | 27% | (394) |
| **Total** | | **184** |

Removing the cap increases the hypothetical maximum AG 49A rate by 578 bps while eliminating the 0% floor decreases it by 394 bps. The net effect of removing the collar results in increasing the hypothetical maximum AG 49A rate by 184 bps (578 - 394) due to the increased risk-return profile offered by VUL.

### DIVIDENDS

Even though interest credits on an IUL policy can be based on the S&P 500, none of the account value is directly invested in the index or its constituents, resulting in the IUL policy missing out on dividends that the VUL policy benefits from. The impact of adding dividends to the calculation increases the hypothetical maximum AG 49A rate by 331 bps.[2]

### FUND FEES

Fund fees for low-cost S&P 500 funds currently range from 8-35 bps in M Carrier VUL products. For this analysis, we assumed a 20 bps fund fee. When converted to a monthly rate and applied to the calculation on a monthly basis, the hypothetical maximum AG 49A rate decreases by 22 bps.

### PUTTING IT ALL TOGETHER

**No Cap - No Floor + Dividends - Fund Fees = VUL Advantage**

**578 - 394 + 331 - 22 = 493 bps**

The 493 bp annual return advantage VUL has over IUL when compared using the AG 49A calculation is comprised of dividend yield and the cost of the cap and floor (i.e., the increase in the risk-return tradeoff compared to IUL). Fund fees are a disadvantage of VUL and are subtracted from the benefits.

### ADDITIONAL CONSIDERATIONS

- This analysis focused on long-term market returns and risk. IUL's 0% floor protects cash values in down markets and can help mitigate short-term/sequence of return risk.
- This analysis only considers market risk, not account parameter risk.[3] With the low interest rate environment putting pressure on insurance company general account yields, it is likely IUL account parameters will continue to move in an unfavorable direction in the coming years.

[2] The dividend yield for the S&P 500 as of Dec. 31, 2021 was 1.29%. (https://data.nasdaq.com/data/MULTPL/SP500_DIV_YIELD_MONTH-sp-500-dividend-yield-by-month)

[3] See the most recent M IUL Growth Cap Rate Model for more information. (https://members.mfin.com/marketinghub/Pages/M-Intelligence.aspx)

## A STRATEGY FOR USING EQUITABLE RATES TO COMPARE VUL AND IUL

**Example: Illustrate both product types using the same percentile. Using the 90th percentile results in a rate of return of 8.80% for VUL and 4.88% for IUL. Historically, this would give each policy a 90% success rate over a 25-year period.**

## CREATE A MEANINGFUL COMPARISON

Equity performance determines the account value of both IUL and VUL policies, but that's where the similarity ends. Materially different rate of return assumptions are needed to create a meaningful comparison. This exercise is important because it allows financial professionals to carefully evaluate each as a potential wealth building and estate planning tool.

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