Life Insurance as a Wealth Planning Tool

It is an asset class that can add value to any portfolio and meet life's changing needs

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In the world of investing, diversification is a common terminology used to describe the process of allocating capital with the view of reducing exposure to a particular asset or risk.

When you invest in the financial market, you are exposed to systemic - the market risk and unsystemic risk - the unique risk. So investment managers use diversification to reduce volatility by investing in various asset classes.

But diversifying your portfolio does not guarantee a positive performance or the ability to protect against losses. Hence, another strategy used by investment managers to protect against financial loss is to hedge against the risk using derivatives such as options, futures or forwards.

Similar to the concept of derivatives, the death benefit in life insurance is a hedge against the risk of a contingent or uncertain loss. So the main objective of buying life insurance has always been its death benefit, as it can act as a source of funds for debt repayment or income replacement at death.

Hence, most people perceive that the purpose of purchasing life insurance is mainly for risk management. To a greater extent it is true, replacing an individual's economic life value with liquidity (money) that can support any immediate financial needs, making life insurance an important part of wealth planning over your lifetime.

UNIQUE CHARACTERISTICS

Besides providing liquidity at death, there are other unique characteristics of life insurance compared with the other asset classes.

In today's complex world, it is even more important to incorporate life insurance into wealth planning to protect assets and ensure funds are properly transferred when the time comes.

The death benefit is paid in the event of the policyholder's death instead of a financial market event. That means the death benefit is largely insulated from the market's ups and downs. So no matter what happens, the death benefit is a guaranteed payout upon death, thus providing financial certainty at a predictable cost.

Another characteristic that makes life insurance a unique asset class is the death benefit payout, which is typically protected from a creditor or liability claim. The fact is, the transfer of assets from an insurance policy is passed by contract and not through a probate. Moreover, the contract of life insurance policy cannot be contested thus, ensuring that your beneficiaries can receive the death benefit in full.

In addition, life insurance provides potential cash value where the policyholder can withdraw or borrow against it, creating an avenue for retirement income, education funding, or whatever reasons you may need it for in the future.

Furthermore, life insurance helps to diversify your investment portfolio, especially when the financial benefits from the insurance policy are not correlated to traditional asset classes like equities or bonds.

When thinking of a portfolio of financial asset class, life insurance may not come to mind immediately, but it should. Often, investors may not realise that life insurance is also a very effective tool when it comes to diversification.

WEALTH TRANSFER AND ESTATE PLANNING

Think about it this way: Because of its uniqueness, the role of life insurance can extend into wealth transfer, estate planning and even for charitable purposes.

If you have a family business, you may have developed a succession plan to ensure a smooth transition of your business to the next phase, whether to sell it, pass it on to the next generation, or get external professional help to run it.

In scenarios like these, unforeseen circumstances like premature death before the handover of the business will trigger a liquidity event, which will have a negative impact on your succession plan.

Similarly, in many small businesses, it is the founder who holds the firm together and its success depends on him (the key man).

In a tragic situation, such as the premature death of the founder, there will be a detrimental effect on the continuity of the business. To prevent this from happening, key man insurance is a solution to help the firm survive the blow of losing the main person who makes it work.

The family members can use the insurance death benefit to sustain the business until an alternative solution is found. Thus, key man insurance gives the business some options to extend its life other than immediate bankruptcy.

That is why involving life insurance in a succession plan or business continuity planning is appropriate. Though the primary role of life insurance is to protect against the consequences of premature death, it is also a useful tool to create liquidity to keep your business running after you are gone.

Life insurance can also help you to divide your estate equally and fund the inheritance for your child who is not involved in the family business, which may help to prevent family squabbles.

In most cases, the fate of a family business is a challenging and emotional process. So you need to plan ahead to avoid potential conflict and to allow your firm to continue, to preserve family harmony and to thrive for generations to come.

For those with a philanthropic heart, life insurance can help to accomplish your goal by donating the death benefit to your favourite charity. Naming the charity of your choice as the beneficiary of your life insurance policy will provide a lasting legacy for a cause you believe in. This will allow you to gift into perpetuity.

Finally, given our longer lifespan, it may not be sufficient to implement financial plans that focus only on income accumulation through investment alone.

In today's complex world, it is even more important to incorporate life insurance into wealth planning to protect assets and ensure funds are properly transferred when the time comes. At the same time, to generate sufficient liquidity for the family, business and other financial needs at the time of death.

This is where life insurance can play a critical role in protecting your family and your legacy, and should be one of the pillars in planning for your financial future.

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