Asset Allocation Advantage

Compare a private placement portfolio that's diversified and one with only asset classes for the highest tax exemption multiples (TEMs)

Asset Location Strategy	Difference in Future Values ($)			
Years	**5**	**10**	**15**	**20**
Identical Allocation in Private Placement	1,986,687.74	5,479,736.56	11,344,482.22	20,892,482.80
Asset Classes with Highest TEM in Private Placement	3,904,459.46	12,822,335.01	31,306,917.34	67,549,015.19

Assumptions:

- Long-term capital gains tax of 26%; short-term capital gains tax of 39%; and income tax of 39%. All tax rates remain constant.
- Asset class return and turnover assumptions listed in "Asset Class Assumptions and Tax Deferral Benefits," p. 23.
- An initial value of $60 million, 25% in a private placement life insurance (PPLI) portfolio and 75% in a taxable portfolio.
- Assets are not relocated between the PPLI and taxable pools after the initial asset location.
- Total asset allocation: U.S. Large-Cap Equity 20.25%, U.S. Small-Cap Equity 1.8%, European Equity 10.8%, Japanese Equity 2.7%, Pacific Ex-Japan Equity 2.25%, Emerging Market Equity 5.85%, Taxable Core Bonds/Municipals 27.45%, High-Yield Bonds 1.8%, Emerging Market Bonds 2.7%, Treasury Inflation Protected Securities 1.8%, Non-Directional Hedge Funds 5.4%, Directional Hedge Funds 3.6%, Private Equity 4%, Real Estate Investment Trusts 6%, Commodities 1.8%, and Cash 1.8%.

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carrier's platform.

A disadvantage is that the advisor would have to get the IDF added to the carrier's platform. In addition, the administrative costs of the custom IDF usually make this approach feasible only at levels over $20 million. And, if the investor elects to allow others to invest in his IDF, it could limit his ability to change the mandate.

As with any discussion of private placement, we should pause to consider the investor control doctrine. While an investor can design the broad allocation, select specific asset classes or themes for focus and even hire a specific manager, the investor should be certain not to participate (directly or indirectly) in security selection.

Bottom Line

It's broadly accepted in the wealth management and financial planning communities that certain asset classes offer a greater benefit from the tax deferral or tax-exemption features of private placement insurance vehicles. We've explored how best to measure the relative long-term tax deferral benefit of various asset classes and, in the process, have debunked some broadly held misconceptions.

The TDM or TEM, is perhaps the best measure of tax deferral benefit. It incorporates return, turnover and the compounding effect of tax deferral when comparing asset classes. It can be used to execute a variety of asset location strategies, each of which has its own advantages and disadvantages.

As with all investments, execution is key. We've shown several ways to build and execute an optimal private placement portfolio. In all cases, it's essential that an investor partner with an advisor with specific expertise in private placement structures, asset location and proven investment acumen to ensure that the portfolio is constructed with the goal of achieving the maximum future value.

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Endnotes

1. *See, e.g.,* Edward J. Finley and Michael Liebeskind, "Private Placement Variable Annuities," *Trusts & Estates* (December 2012), at p. 21; Mike Cohn and Edward J. Finley II, "An Advisors Guide to Frozen Cash Value Life Insurance," *Trusts & Estates* (January 2014), at p.14
2. For a worthwhile general description, *see* C.Reed, "Rethinking Asset Allocation Between Tax-Deferred, Tax-Exempt and Taxable Accounts," Aug. 28, 2013.