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Building Portfolios Inside PPVA and

Use an evaluations metric to help improve future value

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private placement life insurance (PPLI) and variable annuities (PPVA) are attractive for many reasons, including their tax treatment. We've written several articles on the features, uses and considerations of these structures.¹

But, how should an investor select the asset classes to include in his private placement portfolio to maximize the tax-deferral benefit and, as a result, the future value of their overall portfolio? Hedge funds are a common choice for a number of reasons. But as we'll explain in this article, many other asset classes could be far more effective when held in PPLI and PPVA. Here's a framework for advisors and clients to evaluate asset classes and build appropriate private placement portfolios.

Hedge Funds

Hedge funds are a popular asset class for use in private placement. When asked why, investors and advisors typically credit the high tax rate applicable to hedge funds.

While it's true that hedge fund returns are generally subject to ordinary income tax rates, so too are investment grade bonds. But, you rarely hear of someone investing in investment grade bonds in their private placement portfolio.

What accounts for the difference? The benefit of tax deferral is measured not just by the tax rate, but also by the tax rate multiplied by the expected annual return of the asset class. This return, therefore, is as important as the tax rate, making hedge funds (and not core bonds) interesting in private placement portfolios.

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20

Tax Drag

While expected return and applicable tax-rate are both important factors to consider, they don't tell the whole story. Private equity, for example, can have expected returns at least as great as hedge funds but is rarely found in private placement portfolios. Aside from liquidity issues, why is that? The answer: Turnover. Generally speaking, asset class returns are subject to tax only when

they're realized. Therefore, any measure of tax deferral benefit should consider not only expected annual return, but also how much of the annual return will be realized each year and whether the realized annual returns are taxed as short- or long-term capital gains, taken together, "tax drag."

"Deferral Benefit," p. x, illustrates two hypothetical asset classes and demonstrates that tax drag can be a good predictor of the asset class that will exhibit the greatest tax deferral benefit in a given year, and that it's considerably more accurate than expected return or tax rate alone. Asset Class 1 has a higher expected return than Asset Class 2. It's also subject to a higher tax rate. Conventional wisdom would say that Asset Class 1 is

Deferral Benefit

Tax drag can be an effective predictor

Pre-Tax

Return Tax Rate Turnover Tax Drag

Asset Class 1

Asset Class 2

14%

8%

40% 20% 1.12%

20% 80% 1.28%

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the least tax-efficient. But, because of its much lower turnover, the benefit of tax deferral is much lower than Asset Class 2.

Based on the example in "Deferral Benefit," you might think that we've settled on tax drag as the best measure to determine the tax deferral benefit of an asset class. But, that's still not quite right. Though tax drag is a better measure of tax deferral benefit than tax rate or expected return alone, it fails to account for the effects of compounding on any tax deferral benefit.²

As "Effect of Compounding," p. x, illustrates, when we examine the returns over a long period of time, the tax deferral benefit of each asset class changes. After 20 years, the tax deferral benefit of Asset Class 1 is almost 300 percent, confirming conventional wisdom. So, why is this the result? Simply put, the tax liability saved each year will grow at the asset class's rate of return. The greater the annual return, the more powerful the cumulative tax deferral benefit, even if the tax drag is lower. In fact, return can have such an outsized effect on the long-term tax deferral benefit, that some asset classes that have a relatively low tax drag can exhibit surprisingly strong long-term tax deferral benefit.

New evaluation metrics

Taking all of this together, we make use of metrics that can help evaluate the utility of owning any asset class in a tax-free environment: one for vehicles like PPLI, in which taxes should never be realized, the tax-exemption multiple (TEM) and its counterpart for vehicles like PPVA, when taxes might ultimately be paid, the taxdeferral multiple (TDM). The multiples measure the combined effects of tax drag and compounding to understand the overall tax-exemption (or tax-deferral) benefit over a given period.

"Better Predictors," p. x, demonstrates that, compared to tax drag, both TEM and TDM more accurately predict the long-term tax deferral benefit of an asset class. In this example, we assume that in Year 20, the portfolio will pass without income tax (TEM) or will
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An interesting observation from our chart is that hedge funds aren't among the top five asset

classes offering the greatest utility in a tax-exempt environment.

hedge funds aren't among the top five asset classes offering the greatest utility in a tax-exempt environment. In fact, they aren't even in the top 10. This casts serious doubt on the conventional view that hedge funds are

Effect of compounding

Over time, the tax deferral benefit of each asset class changes

Difference in

Value After

Value After Value After One Year Value After Value After

One Year– One Year– (Tax Deferral 20 Years

Taxable

Tax-Free

Benefit)

128,000

Taxable

20 Years

Tax-Free

Difference in

Value After

20 Years

(Tax Deferral

Benefit)

Asset Class 1 \$11.3 million \$11.4 million \$112,000 \$112.8 million \$137.4 million \$24.6 million

Asset Class 2 \$10.7 million \$10.8 million

\$36.7 million \$46.6 million \$9.9 million

Note: Assumes an initial value of \$10 million, and capital gains tax rate remains constant. Returns exclude management fees. All values in U.S. dollars.

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be fully withdrawn and taxed (TDM). In both cases the

TEM and TDM are superior predictors of the asset class

with the greatest tax deferral benefit in Year 20.

Next, we put the metrics to work in actual asset classes.

“Asset Class Assumptions and Tax Deferral Benefits,”

p. x, shows a number of asset classes with our long-term

(10 year) expected returns, yield and turnover. We calculated

tax drag in the conventional way and also calculated

TEM (20 years) and ranked them by TEM.

An interesting observation from this chart is that

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21

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Better Predictors

Compare tax drag to the tax exemption multiple (TEM) and the tax deferral multiple (TDM)

Difference in

Value After

20 Years

Asset Class 1

Asset Class 2

Tax Drag

1.12%

1.28%

TEM

2.46

.99

(Tax-Exempt

Portfolio)

\$24.6 million

\$9.9 million

TDM

1.97

0.35

Difference in

Value After

20 Years

(Tax-Deferred

Portfolio)

\$19.7million

\$3.6 million

Note: Assumes an initial value of \$10 million, and capital gains tax rate remains constant. Returns exclude management fees.

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the most logical choice for use in private placement portfolios.

Which asset classes could be more powerful in a private placement portfolio? Emerging market equities have, by far, the most utility. The difference in the value of a dollar invested in that asset class in a private placement (versus taxable) portfolio over 20 years is more than three times the difference of a dollar invested in emerging market bonds, for example. The difference in the value of a dollar invested in developed market equities in a private placement (versus taxable) portfolio is anywhere from 1.5 to 2.5 times greater than one dollar invested in emerging market bonds. The combination of expected return, turnover and tax rate makes all the difference. It's important to note that these are our long-term asset class assumptions and are based on index returns. Actual returns might differ depending on the

particular manager. Moreover, they reflect Deutsche Asset & Wealth Management's views. With the help of a good advisor, an investor can combine their own views and the characteristics of their selected managers, to create a custom set of tax deferral metrics.

Once an investor has determined what percentage of their overall portfolio they'd like to place in private placement, and his advisor has calculated the tax deferral metrics for each available asset class, the investor and advisor still need to determine which asset classes should be placed in the private placement portfolio and which should remain in the taxable portfolio: the so-called

"asset location" strategy.

One asset location strategy that's perhaps the easiest to execute, is simply to mirror the target taxable allocation in the private placement portfolio, with minor adjustments to optimize for a tax-free structure. We'll call this the "mirror strategy." The results are a taxable portfolio and a private placement portfolio that are nearly identical from an asset allocation perspective. This method offers the advantage of limiting the administrative burden that arises when the faster tax deferred growth (and often higher growth asset classes) in the private placement portfolio cause the asset classes to become out of balance.

Because the allocations are near-identical, an investor needn't worry about reallocating between the private placement and taxable pools but only within each of the pools separately. A disadvantage of this method is that it inhibits an investor from taking advantage of the superior tax deferral benefit of certain asset classes by concentrating them in the private placement portfolio. "Asset Allocation Advantage, " p. x, demonstrates the effect of this disadvantage over time.

The most potent approach is to locate in private placement portfolios only the asset classes with the highest TEM. If the client views the assets in both the taxable and private placement pools as a single portfolio, this approach has a distinct disadvantage: the considerable administrative burden of reallocating between the private placement and taxable pools. This process is a very manual one and, at times, becomes impossible to fully execute without changing the overall allocation. Another approach is to consider the private placement portfolio as distinct from a broadly diversified

asset allocation. This "tactical" portfolio would consist of certain "high conviction" asset classes that are also best suited to the benefits of private placement. The goal of this pool would be absolute returns rather than risk-adjusted returns. In this way, TEM is an excellent metric to determine which asset classes from the high conviction set offer the greatest benefit from tax deferral or tax-exemption.

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Asset class Assumptions and tax Deferral Benefits

Hedge funds aren't even among the 10 least tax-efficient
Expected

Annual Return

Asset Class

emerging market equities

Pacific ex-Japan equities

european equities

U.s. small-Cap. equities

U.s. mid-Cap. equities

U.s. Large-Cap. equities

Private equity

Japanese equities

Commodities

High-Yield Bonds

Directional Hedge Funds

emerging market Bonds

Real estate investment Trusts

Non-Directional Hedge Funds

international Bonds

(Including Yield)

12.20%

11.84%

11.60%

10.58%

10.35%

10.12%

10.30%

9.43%

8.51%

7.71%

7.90%

6.72%

6.75%

5.60%

4.32%

Treasury inflation Protected securities 4.07%

Taxable Bonds

Cash

3.43%

1.43%

Expected

Annual

Yield

1.40%

0.50%

1.25%

0.40%

0.80%

1.20%

0.00%
0.90%
1.70%
6.50%
0.00%
3.70%
2.50%
0.00%
3.00%
3.50%
3.43%
1.40%

Tax
Expected
Turnover

60%
60%
70%
60%
40%
40%
21%
60%
60%
80%
80%
150%
20%
80%
150%
100%
75%
0%

Tax
Exemption
Drag Multiple

3.59% 4.78
3.52% 4.43
3.69% 4.40
3.15% 3.28
2.89% 2.95
2.86% 2.81
2.69% 2.77
2.78% 2.44
2.70% 2.03
2.91% 1.86
2.46% 1.69
2.52% 1.40
2.14% 1.23
1.75% 0.84
1.64% 0.63

1.55% 0.58

1.34% 0.45

0.56% 0.14

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executing the Portfolio

Having designed a robust tax deferral metric and chosen the appropriate asset location strategy, we now turn to considerations in executing the private placement portfolio.

One of the most common methods is to construct a portfolio of registered and/or insurance dedicated funds (IDFs) available on your carrier's platform. The benefit of this approach is that an investor can add or remove asset classes from their portfolio easily as their views change or to adjust their overall portfolio allocation.

There are disadvantages of this approach to consider. For many asset classes, the investor's manager of choice
june 2014

might not be available on the insurance company's platform, the managers that are available might not be best-in-class or their advisor's due diligence team might not have sufficient coverage of those managers. In some cases, there might not be a manager to express an asset class or investment theme available at all. (This is often the case for certain international equity and fixed income sub-asset classes.)

Investors who allocate a significant amount of assets to private placement could hire a manager to manage a custom IDF. An advantage of this approach is that the portfolio can be tailored precisely to the investor's goals and constructed using best-in-class managers and vehicles, regardless of whether they're available on the trusts & estates / trustsandestates.com

23

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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

Years

identical Allocation in Private Placement

Asset Classes with Highest TEM in Private Placement

Assumptions:

5

1,986,687.74

3,904,459.46

Difference in Future Values (\$)

10

5,479,736.56

12,822,335.01

15

11,344,482.22

31,306,917.34

20

20,892,482.80

67,549,015.19

- 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

24
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. [trusts & estates / trustsandestates.com](http://trusts&estates.com)

june 2014