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The Roth TSP vs the IUL

Roth TSP or IUL?

Ever take **an IUL** application on Friday afternoon only to get a voice message from your prospect on Monday morning saying he's had a change of heart? Over the weekend he researched what the online "gurus" had to say about IUL and, based on his findings, he's not too eager to proceed.

If you're in **the IUL market** and this has never happened to you, well, just give it a little time. The truth is 90 percent of your clients are doing online research on you *and* your recommendations between appointments. And when they research IUL online, they all walk away with the same conclusion: IULs have high fees. Because of those onerous fees, they contend, they're much better off steering their retirement dollars towards a low-fee, **tax-free alternative like the Roth TSP**.

The Roth TSP vs the IUL

This of course begs the question: Is the Roth TSP *really* less expensive than IUL? Comparing an IUL's fees to traditional tax-free investment accounts can be a tricky proposition, especially if you fixate on first-year expenses alone.

Let me illustrate with an example. According to *USA Today*, the average expense ratio of a Roth TSP account is about 1.5 percent per year. So, if you make a contribution of $10,000 to your Roth TSP, your first year expenses will be $150. Conversely, if you contribute $10,000 to a properly structured IUL, your first year expenses might be closer to $1,500.

Based on this comparison alone, the Roth TSP seems the obvious winner. But comparing first year account balances hardly tells the whole story. Here's why: The fees inside the Roth TSP are low when taken as a percentage of the first year's balance (in our example, 1.5 percent per year), but when measured in actual dollars, the story changes dramatically over time. For example, if that $10,000 Roth TSP grew to $100,000, the annual fees would jump from $150 to $1,500. If it then grew to $1,000,000, the annual fees would balloon to $15,000. In other words, the more money you accumulate in a Roth TSP, the more fees you pay.

Contrast that with the ongoing fees of a properly structured IUL. Generally speaking, when an IUL is structured to maximize the cash accumulation within the growth account, the fees stay relatively level. This is accomplished by buying as little life insurance as the IRS requires while stuffing as much money into it as the IRS allows. Under death benefit option 1 or A, the amount of insurance you have to buy under IRS guidelines actually decreases as your cash value accumulates. Even though the internal cost of insurance is rising, you're actually buying less of it as time wears on. This keeps the IUL's fees relatively stable over the life of the program.

Even though the fees in the IUL are stable, they grow *smaller* over time when seen as a percentage of the overall cash value. For example, when an IUL account value grows from $10,000 to $100,000, that same $1,500 fee now represents only 1.5 percent of the total account value — the same as the Roth TSP. When the cash value of the IUL reaches $1,000,000, however, that $1,500 now represents only 0.15 percent of the cash value. The following chart demonstrates the IUL's cost-effectiveness over time when compared to the Roth TSP:

	account value	10,000	100,000	1,000,000
Roth 401(k)	fee as % of balance	1.50%	1.50%	1.50%
	fee as $ amount	$150	$1,500	15,000
	cash value	10,000	100,000	1,000,000
IUL	fee as % of balance	15%	1.50%	0.15%
	fee as $ amount	$1,500	$1,500	$1,500

And the winner is

So, given a full accounting of fees over the life of both programs, which alternative is the least expensive? By looking at the trajectory of fees in either scenario, it appears that, given enough time, the IUL eventually wins out.

But how can we be certain? A surefire way to determine the least expensive alternative is to perform a side-by-side comparison where you contribute equal amounts of money to both programs over a fixed time period (say 10 years). Next, distribute tax-free dollars from both programs for another fixed time period (say 25 years) starting in year 11. Be sure to apply the 1.5 percent expense ratio to the Roth TSP while letting the life insurance illustration system account for the internal expenses of the IUL.

In most cases, you'll find the IUL can distribute tax-free dollars just as productively as the Roth TSP. Equal distributions, by definition, mean equal fees. In fact, when you run the internal rate of return (IRR) on a properly structured IUL, you'll find that its annual expenses, averaged out over the life of the program, are around 1.5 percent.

The moral of the story: Whether you put your money into a Roth TSP or an IUL, someone is going to be making 1.5 percent. The real question is, what are you getting in exchange for that 1.5 percent? In the case of the Roth TSP, you're getting money management, third party administration and advisor fees. By the way, you pay those fees rain or shine, even in a down market. In the case of the IUL, you *are* paying 1.5 percent of your account value on average over the life of the program, but you're getting something very useful and impactful in exchange for it.

Upside market potential with downside protection

For starters, the IUL allows you to participate in the upward movement of a stock market index while guaranteeing against market loss. To illustrate how powerful this is, I ask my clients the following question: "If you lost 50 percent in your Roth TSP this year, what would you have to accumulate next year, just to break even?" Nine times out of ten, they say 50 percent. The truth is they'd have to get 100 percent just to get back to square one.

For those who lost 50 percent in 2008, it took them an astounding six years just to claw their way back to even. The guarantees in the IUL can safeguard your clients against market loss at a period in their life when they can least afford to take the hit: at retirement. Many IULs have back tested rates of return of nearly 8 percent. After netting out the 1.5 percent average fee, that's a 6.5 percent rate of return. If your clients can get a 6.5 percent rate of return without taking any more risk than they're accustomed to taking in their savings account, that can be a very safe and productive way to grow their money.

A life insurance death benefit

That 1.5 percent average annual expense in an IUL also goes towards the cost of life insurance. Many of our clients have already budgeted for the cost of term insurance. Instead of sending that term insurance premium off to an insurance company in the form of a premium payment, why not recapture it, divert it towards their IUL bucket, then let a portion of it drip out in the form of expenses? In other words, when our clients pay for the cost of term insurance, they're paying for much of the cost of an IUL, they're just not taking advantage of the unlimited bucket of tax-free savings the IUL affords them. The tax-free life insurance component of the IUL is one of the great benefits that 1.5 percent fee provides.

Doing double duty: life insurance as long-term care

There's one final benefit that clients get in exchange for that 1.5 percent cost: long-term care. Most IUL companies these days allow the tax-free death benefit to double as long-term care insurance at no additional charge. The stipulation is this: If somewhere down the road you can no longer perform two of six activities of daily living, and can find a doctor to write a letter to that effect, they will give you your death benefit while you're alive, for the purpose of paying for long-term care. Contrast this with traditional long-term care insurance where you could pay for 20 years, die peacefully in your sleep never having needed it, and then never get your money back. With IUL, you do pay the cost of insurance, but if you die never having needed long-term care, your heirs still receive a death benefit. So, there isn't the heartburn associated with paying for something you hope you never have to use.

When we fail to put the IUL's fees in the proper long-term context at the outset of the sales process, our clients often turn to the one source over which we have very little control: the Internet. And when the take their cues from the Internet, the IUL invariably gets painted as a clunky, onerous, fee-laden means of saving for retirement. The best way to neutralize the online naysayers is to illustrate how the IUL's fees compare to those of a Roth TSP when considered over the arc of one's retirement. Once you've demonstrated the IUL's cost effectiveness over time, you can spend the rest of your time explaining how its many compelling attributes make it a dynamic addition to a balanced, thoughtful approach to tax-free retirement planning.

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