North American Company for Life and Health Insurance Since 1886 | Life

Understanding Point-to-Point Capped Index Versus Uncapped Point-to-Point with a Spread

You Can Be Your Client's Hero

When you are selling Indexed Universal Life insurance products, helping your clients to understand the differences between the Point-to-Point Capped Index and the Uncapped Point-to-Point with a Spread helps them make the decision that best fits their specific needs.

What makes indexed universal life different from other insurance is that it offers your clients the opportunity to earn tax-deferred interest[1] on the interest credits linked to the performance of one or more stock market indexes. This feature gives your clients the potential for strong cash value accumulation. Plus, it offers downside protection in a poorly performing market because your clients don't participate directly in the stock market and the credited interest rate is never less than zero percent.

Those interested in indexed universal life generally want the basics provided by traditional universal life insurance — permanent life insurance death benefit protection, flexibility of specified amount, and premium payment frequency. On top of this, they want the opportunity to grow cash value based on the upward movement of a stock market index without investing their money directly into the stock market.

The interest credited on Indexed Universal Life products is based upon the movement of an underlying market index. Yet results can vary widely based on the difference in index options and index crediting methods. The Index Crediting Method refers to the way that the change in the index value is calculated for each index period. The Index Crediting Methods offered (which vary by product) are Annual Point-to-Point, Daily Averaging, Multi-Index Point-to-Point, Monthly Point-to-Point (these are capped methods), and Annual Point-to-Point with Spread (an uncapped method). Let's look at the difference between a Capped Point-to-Point Index Method and an Uncapped Point-to-Point with a Spread.

Point-to-Point with a Cap

This index method looks at the movement of an index from Point A to Point B and a cap rate limits the index credit. For example, the cap rate may be 6.5%. This means that interest credits may be anywhere from 0% (the floor rate) up to the cap of 6.5%

Uncapped Point-to-Point with Spread

This index method also looks at the movement of an index from point A to Point B, but a cap rate does not limit the index growth. Rather, the interest credit is reduced from the underlying index growth rate by a "spread" factor. For example, the spread rate may be 5.75%. Therefore, the interest credit may be anywhere from the 0% (floor rate) up to whatever the index performance is (minus the spread).

Which is the Better Option?

The answer depends primarily on the underlying index performance. Using hypothetical example rates of 6.5% cap and 5.75% spread index growth, the capped option would yield a higher credit with index growth from .01% and 12.25%. When the index growth rate is above 12.25%, the 5.75% spread option would get a higher credit.

	-10% Index Movement	+7% Index Movement	+20% Index Movement
Point-to-Point with 6.5% Cap	0%	6.5%	6.5%
Point-to-Point with 5.75% Spread	0%	1.25%	14.25%

Source: www.bloomberg.com and calculations provided by North American actuaries, September 2017

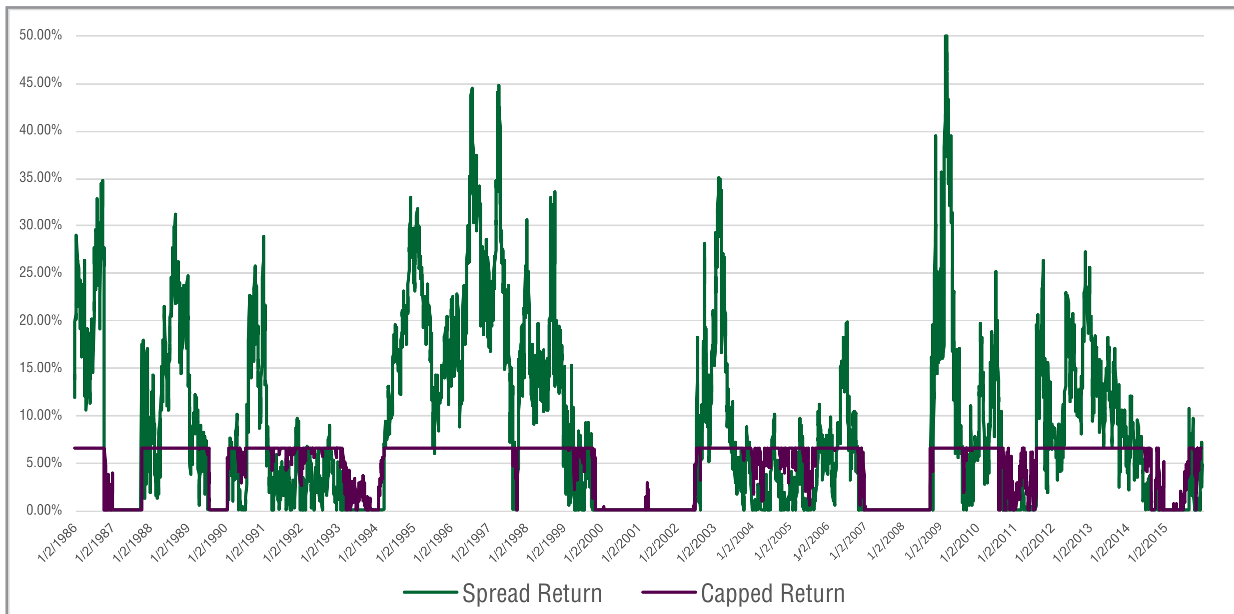
The next question becomes, "how can a client predict index performance?" Historical data can provide some insight. Here is a look back at over 16,000 data points of one year returns from January 1950 through December 2016.

Index Movement	Historical Frequency
0% (or less)	27%
.01% to 12.25%	31%
12.26% or More	42%

Source: www.bloomberg.com and calculations provided by North American actuaries, September 2017

This data suggests that the spread index option generated higher returns more often. However, that is just part of the story. When the cap selection does better, it is typically just a few percentage points better. When the spread selection does better it can credit at much higher rate. As illustrated by the graph below, it reaffirms that historically an uncapped Point-to-Point spread selection provided more potential.

30 Years of Cap Versus Spread Returns



Source: www.bloomberg.com and calculations provided by North American actuaries, September 2017

North American's Illustration software affirms the performance of the point-to-point spread option.

Average Rates of Return Rounded to the Nearest 0.1%

INDEX	INDEX CREDITING METHOD	5 YEAR	10 YEAR	20 YEAR	25 YEAR	30 YEAR	40 YEAR	MAX ILLUSTRATED RATE
S&P 500®	Annual Point-to-Point	4.9%	4.3%	4.4%	4.6%	4.6%	4.4%	4.23%
S&P 500®	Annual Point-to-Point with Spread	6.7%	6.6%	7.4%	7.4%	7.7%	7.8%	4.23%

Source: North American Illustration software

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Note: Actuarial guideline 49 limits the illustrated rate in an indexed universal life product. So although the historical look backs in an uncapped spread index selection may support an illustrated rate much higher than the S&P 500 Point-to-Point with Cap, a higher rate cannot be illustrated. Therefore, the Illustration software will be limited to the S&P 500 Point-to-Point rate as a maximum even if historical performance may indicate a significant difference. Consequently, the agent and client will need to make their own inference as to the potential value of policy performance if the index credits were higher than the maximum illustrated rate.

History suggests that the Uncapped Point-to-Point Spread Option provided the better underlying index performance. Of course, actual performance will not match historical. In the end, the financial professional and client have a choice as to how funds are going to be allocated. Use the fixed account, either of the index accounts or a combination. However, you can be a hero for your client helping to clarify the differences between the options and providing historical information on the performance of indexed universal life crediting methods. The goal is for the client to make an educated decision considering the positives and negatives of each choice to find an allocation that most appropriately meets their needs and goals.

1. The tax deferred feature of an indexed universal life policy is not necessary for a tax-qualified plan. In such instances, your client should consider whether other features, such as the death benefit and option riders, make the policy appropriate for your client's needs. Before purchasing this policy your client should seek competent tax advice both as to the tax treatment of the policy and suitability of the products.

Neither North American Company nor its agents give tax advice. Please advise your customers to consult with and rely on a qualified legal or tax advisor before entering into or paying additional premiums with respect to such agreements.

Indexed Universal Life products are not investments in the "market" or in the applicable index. They are subject to all policy fees and charges normally associated with most universal life insurance.

THE S&P 500® COMPOSITE STOCK PRICE INDEX
THE S&P 400® COMPOSITE STOCK PRICE INDEX

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