Comparison of Investment Returns of DRIP versus Tax-sheltered UL

Jim Otar

A reader called recently and asked me to compare investment returns of a DRIP portfolio with the tax-sheltered growth in a universal life insurance policy (UL). Apparently the reader received an insurance quote from his advisor, suggesting that he liquidate some of his DRIP investments over the next ten years and place the proceeds into a UL plan.

The first thing you should do is to see if you need insurance at all. If you do need insurance then check with your advisor for different types of insurance that are available. After studying the different alternatives, you can then decide on the most suitable one. You may find a Term-to-100 plan more cost effective than a UL, or vice-versa.

Assuming that you have made a selection, what gives a better return? DRIPs or the tax-sheltered investment side of the UL?

Following are the important points:

- Insurance illustrations almost always compare the UL to an interest-producing investment. DRIPs produce dividend income, which is taxed at a lower rate then interest income. The capital gains are also taxed at lower rate. Furthermore, in your DRIP portfolio you have a choice of deferring capital gains as long as you wish, in most cases until the death of the second spouse.

- Some insurance illustrations do not show the liquidation value of the insurance policy. You may find a footnote referring to surrender charges and potential taxes if part or all of the policy is surrendered (i.e. liquidated)

Keeping these in mind, in this particular case, I had the following information to work with:

- UL: Annual premium: $10,000 for 10 years
- UL: Minimum annual premium: $2,816 (cost of insurance)
- DRIP: Income Tax on Dividends: 31.33% (highest bracket)
- DRIP: Income Tax on Capital Gains: 23.20% (highest bracket)
- UL: Premium Tax: 2%
- UL: Surrender charges: first year: 50%, second year: 100%, third year: 150%, years four to ten: 200% of minimum premium
- UL: Manager Expense Ratio of the index fund (MER): 3.2%

I made the following assumptions:

- DRIP: Portfolio Growth: 8% per year
- UL: Portfolio Growth: 8% per year
- DRIP: Dividend Yield: 2% per year
- UL: Dividend Yield of the Index: 1.5% per year
- UL: Net growth: 6.3% per year (assumed growth plus dividend minus MER)
- DRIP: Annual Turnover in the DRIP Portfolio: 15%

After the tenth year, the insurance cost is paid out of the investments (fund value) in the UL plan.

By the same token, I made an allowance for the cost of insurance in the DRIP portfolio after the tenth year. The cost of insurance was deducted from the reinvested dividends and/or realized capital gains. This allowed me to compare apples with apples.

The tables for this comparison are too large to include here. If you are interested in the spreadsheet[1] (suitable for Excel97 or better), please drop me an e-mail and refer to this article.

The results are shown in Figure 1. The chart speaks for itself.

Keep in mind that there are numerous variations of UL plans. Each case must be studied on its own merits. And if the DRIP alternative looks better, as it did in this particular case, it does not mean that you should forego the insurance. Investment is only one aspect of financial planning and insurance is another.

Disclaimer: Investment returns do fluctuate, and nobody can really project any returns into the future. DRIPs are not suitable for everybody.

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[1] The spreadsheet is free by e-mail provided you promise to make a minimum charitable donation of $15 to cancer research.

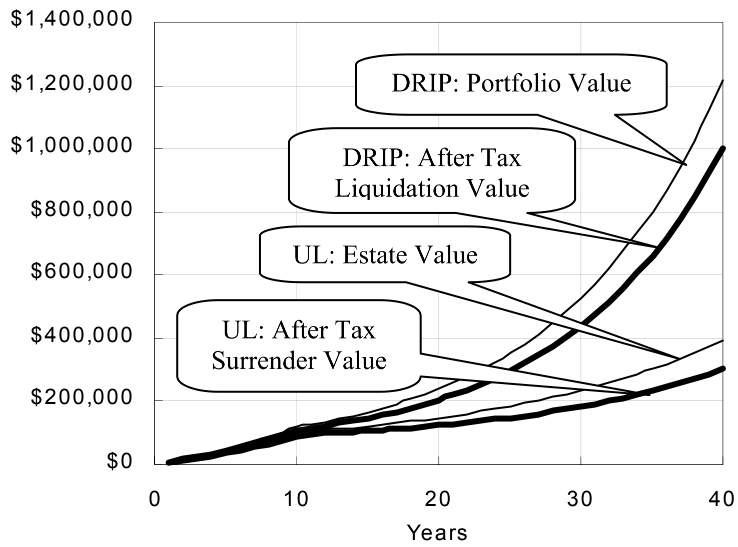

Figure 1: Investment value over time of a DRIP portfolio versus the tax-sheltered investment side of the UL.