



## Indexed Universal Life

Indexed Universal Life (IUL) offers death benefit protection and the potential for cash value accumulation based on interest credited from the S&P 500 Index.

Life Insurance creates an immediate reservoir of funds that, at death, can be used to help protect the financial security of your client's family or to help maintain their business.

In addition to the death benefit, IUL insurance also offers the potential to build cash value, on a tax-deferred basis, which may be accessed income-tax free during your client's lifetime through policy withdrawals and loans.<sup>1</sup>

The cash value accumulation is dependent on the interest crediting rate paid by the insurance company on the premiums in excess of the insurance costs. Besides the fixed interest crediting strategy, our IUL products offer the option to have interest credited based on the changes in the S&P 500 Index through the Point-to-Average strategy or the Point-to-Point strategy.

### How do the indexed strategies' cap and participation rates work?

Our indexed products offer a number of different strategies. At first glance, they may seem confusing, but they all function in the same basic way.

All of our indexed strategies credit interest by measuring differences in the S&P 500 stock index. IUL products do not directly invest in the index or in any other securities.

Each indexed strategy has a participation rate. The participation rate determines what percentage of S&P 500 change is used in the calculation of credited interest. The participation rate can be less than or greater than 100%.

Some of the strategies also have a cap rate. The cap rate limits the amount of interest that a strategy will credit.

Indexed strategy credited interest is determined by applying the participation and cap rates to the change in the S&P index.

First, the change in the S&P 500 is determined. This is measured over the course of a year. Each starting point or initial level is determined as of the 21st of each month. Premiums allocated to an indexed strategy will enter the strategy on the 21st of each month. If the premium is paid after the 21st of a given month it will be placed, or swept, to its allocated strategy on the 21st of the following month.

The starting S&P 500 value is compared to the ending S&P 500 value exactly one year later on the 21st of the 12th month. If the ending value is less than the starting value, the interest credit is 0%. This is the guaranteed floor of the indexed strategies and is often referred to as the "downside protection" offered by indexed products.

If the ending value is greater than the initial value, the percent change is calculated— (the ending S&P 500 value) / (the beginning S&P 500 value) – 1 = the % change. This percent change is then multiplied by the participation rate. If there is also a cap rate, this value is compared to the cap rate. If the value is greater than the cap rate, the credited rate is equal to the cap rate. If it is less than the cap rate or if there is no cap rate, the value is the credited interest.

Our Point-to-Average Strategy is slightly different from the Point-to-Point strategies that are explained

<sup>1</sup> Policy loans and withdrawals reduce the policy's cash value and death benefit and may result in a taxable event. Withdrawals up to the basis paid into the contract and loans thereafter will not create an immediate taxable event, but substantial tax ramifications could result upon contract lapse or surrender. Surrender charges may reduce the policy's cash value in early years.

above. There is no difference in the initial point used for measuring index change. The difference is that the ending point in the Point-to-Average Strategy becomes the average of all daily S&P 500 values, as measured at the end of each market day, over the course the year.

## Which strategy is best?

A common question that comes up often is which strategy is best? Many people assume that the strategy with the highest illustrated rate will perform the best since maximum illustrated rates are determined by historical S&P 500 results. However, as we see again and again, past performance is not an indicator of future performance.

In fact, there is no way to know which indexed strategy will perform the best, either over the long term or the short term.

There are several things that could be considered “best practices” when determining indexed strategy allocations.

When paying a large single premium or lump sum as in a 1035 exchange, it may be prudent to allocate at least a portion of the payment to the Point-to-Average Strategy rather than a Point-to-Point Strategy to minimize a potential “eggs-in-one-basket” situation. Better still, it may be better to allocate a portion of a large single premium to the Fixed Strategy. Then funds could be periodically moved from the Fixed Strategy to the indexed strategies.

The Fixed Strategy is a fixed interest strategy that credits a declared interest rate. It is not reliant on any index. The Fixed Strategy functions exactly like the fixed accounts we have on our regular Universal Life policies. Any amount of policy value and premium payments can be allocated to the fixed account.

Allocations can also be divided among some or all of the strategies. There is no way to predict which strategy will perform the best, but by spreading the allocation across all of the strategies, you can potentially capture at least some of the best returns.

## How do the companies of National Life Group invest to provide indexed credits?

Our insurance companies do not invest directly in the S&P 500 to provide indexed strategy credited rates. We transact in options to provide indexed credits as part of investment strategy known as hedging. Hedging is an investment technique designed to reduce or eliminate financial risk.

To deliver indexed credits, we purchase one year calls on the S&P 500 in sufficient quantity to cover the portion of account value eligible to receive indexed credits. If the S&P 500 increases we exercise our call options and receive amounts needed to cover our indexed credited obligations.

On strategies with cap rates, it is possible to offset the cost of purchasing the necessary call options by simultaneously selling call options. The calls we sell give the excess return of the index, above what is needed to cover our interest crediting expenses, to the purchaser of the call.

## How are the cap and participation rates determined?

Cap and participation rates are determined by several factors. The most obvious factor is the price of options. Generally, as option prices increase, cap and participation rates decrease. A number of financial factors cause option prices to increase. The primary driver of option costs is index volatility. The more volatile the underlying index is, the higher the option costs are. The index price level, the risk-free interest rate, and the option “strike” price are also factors in determining option prices.

Since Indexed Universal Life is a fixed insurance product, it is backed by assets in our General Account. These assets earn investment income. But the amount of this investment income can vary as interest rates change. Generally, the more investment income the company earns, the more we have to purchase options and the higher our cap and participation rates will be. In times of depressed investment earnings, the less we have to spend on options to back our indexed strategies and the lower our cap and participation rates will be.

## How are renewal cap and participation rates determined?

For our products with one-year strategy terms, our renewal cap and participation rates have been the same as our new money rates. Determination of the renewal rates for one year strategies is identical to the determination of the rates for new money.

All of our indexed products are managed on a portfolio rate basis. This means that all assets backing the account value and all investment income from those assets are aggregated.

## How are maximum illustrated rates determined?

Our maximum illustrated rates for each strategy are determined by applying our current cap and participation rates to every hypothetical S&P 500 return sequence since 1984. In other words, we model the returns as though our products had been available since January 1984 and assume that money was deposited each month for the entire “look-back” period. The average annual return is calculated and becomes the maximum illustrated rate. Obviously, “back-casting” to determine maximum illustrated rates only compares the strategies’ historical results and can’t be used to predict future results. In addition, some states limit the maximum rate allowed to be illustrated on indexed products, so illustrations in those states will reflect that limit.

## What is the difference between a 5-year strategy (Provider/Ultra) and a 1-year strategy (Paragon/Ultra Select)?

Our products with 5 year strategies require that money allocated to those strategies remain in the strategy for 5 years before they can be reallocated.

Our products with 1 year strategies allow reallocation after 1 year.

## How often can allocation changes be made?

Allocations can be changed at any time. But money already in a strategy will only be reallocated according to any changes at the end of the strategy term.

## What is the Basic Strategy?

The Basic Strategy is a fixed account and does not earn interest credits. When paid, all premiums are allocated to the Basic Strategy prior to being allocated according to allocation instructions. Once an amount equal to the estimated amount of insurance charges for the next 12 months is in the Basic Strategy, excess amounts will be moved to the indexed strategies and Fixed Strategy according to the desired allocation. Amounts in the Basic Strategy also earn daily interest at an annual equivalent rate at least equal to the policy’s minimum guaranteed interest rate.

## How do loans work?

Policy loans are a contractual right of all permanent cash value life insurance. That means the policyowner has the right to borrow money from the insurance company by using policy cash values as collateral for the loans. Other than having sufficient policy cash value to use as collateral, there is no condition on being able to borrow money from the insurance company.

The mechanics of a life insurance policy loan are slightly different from a regular loan. Since the insurance company is lending and needs to earn a return on its assets, loan interest is charged on the amount borrowed. This interest can be paid as it is due or it can be “capitalized” by adding it to the amount borrowed thus increasing the policy debt.

We use variable loan interest rates on our policies. Variable loan rates may not exceed an amount determined from the current Moody’s Composite Yield on seasoned corporate bonds. Current variable loan rates are determined monthly by the company. However, for a given policy, the loan rate is only reset annually on the policy anniversary.

A policy loan differs from a normal loan because, while the loan is being charged interest, the collateral is also earning interest.

We offer two types of loans to our Indexed Universal Life policyowners: fixed net cost and variable net cost loans.

For our Fixed Net Cost Loans, loan collateral is moved to a special fixed account where it will earn an interest rate that is a fixed spread below the interest rate being charged on the loan. We also offer preferred loan terms that eliminate the spread between interest earned and interest charged after 10 policy years. These are often referred to, somewhat inaccurately, as “wash” or “zero-net-cost” loans.

In addition to offering fixed loan provisions described above, we extend “Variable Net Cost” loan provisions to policyowners. Variable net cost loans are unique to indexed universal life.

A Variable Net Cost loan provision means that loan collateral remains in the indexed strategies and earns indexed interest credits even while being used as loan security. The loan interest rate is charged normally. So, in times when indexed interest earnings exceed policy loan interest rates, IUL policyowners will actually earn more on collateral amounts than they are charged on the loan amounts. Obviously the opposite condition, or being “upside down” can be very harmful to the insurance policy.

All of our IUL products offer both Fixed Loans and Variable Net Cost Loans. With Ultra Select and SecurePlus Paragon an owner can switch the loan type once per policy year without paying off the existing loan. This can be a policy-saving difference if loans ever go upside down.

There are a couple of things to remember about policy loans:

1. Insurance deductions continue even if there is a loan, so sufficient unloaned account value must remain or extra premium payments may need to be made to continue coverage, otherwise a policy may lapse causing adverse tax consequences on loan amounts already received and loss of the policy and coverage.

2. Policy loan amounts reduce cash surrender values and policy death benefits.
3. Loans can be repaid; amounts meant for loan repayment should be clearly designated as such otherwise they will be considered premium payments.

## How do withdrawals work?

In contrast to a policy loan, withdrawals are an actual removal of cash surrender value from the policy. Withdrawals may be taken for any amount up to the cash surrender value of the policy less 3 monthly deductions. There is a withdrawal fee assessed on withdrawals.

The portion of the cash surrender that consists of premiums paid into the policy is known as “basis” with any amounts above that considered gains. Cumulative withdrawals up to the basis amount are non-taxable provided premiums were paid with after-tax money. Withdrawal amounts above basis are taxable as income. Once the basis is withdrawn from a policy, it is usually advisable to switch to loans to access any additional cash surrender value. This avoids any immediate tax consequence, but it is important to keep the policy in force, otherwise the loans become taxable on policy lapse.

For fixed loan types and for fixed Universal Life contracts, the most efficient way to draw on policy cash surrender value is often to use withdrawals up to basis and then take policy loans for further cash flow.

Keep in mind that:

1. Withdrawals reduce the cash surrender value of the policy.
2. For level death benefit policies, the death benefit is also reduced by the withdrawal amount.

**For more information on our Indexed Universal Life portfolio, Call 800-906-3310, Option 2 or visit [NationalLife.com](http://NationalLife.com)**

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All policies referenced are issued and underwritten by either National Life or LSW.