Veralytic

Research. Rankings. Results.

Applying Fiduciary Principles to the Last, Largest, Most Neglected Asset on your Client's Balance Sheet

April 5, 2012

About Flagg …

Veralytic
Research. Rankings. Results.

- Youngest CFP® in College History
- Started in the Investment Business
- Interned 8 Years (4 Investments & 4 Insurance)
- Top-of-the-Table by age 28 & ranked as high as #5 firm nationally in 28th largest metro market.
- "No $3 TRILLION segment of the financial services industry would go withOUT published pricing & performance information" in 1999
- Awarded patents for life insurance pricing & performance database in 2002+

About Flagg …

Veralytic
Research. Rankings. Results.

- Accepted by the AICPA
- Endorsed by the New York Bankers Association (NYBA among others)
- Compliant with Industry Regulations and Established Case Law
- Author for ABA, ALI/ABA, Deloitte, FIRMA, Heckerling Institute, National Underwriter, Trust & Estates, etc.
- Featured Speaker for ABA, AFS, FPA, Grant Thornton, HSBC/WTAS, John Hancock, MDRT, NFP, Pacific Life, R Group, Texas Tech University, Valmark Securities, Wall Street Academy, etc.

Agenda

Veralytic
Research. Rankings. Results.

1. Situation: The Last, Largest, Most Neglected Asset on your Client's Balance Sheets
2. Problem: Definition**S** of "Client's Best Interest" are Different to Different Advisors
3. Solution: Applying Prudent Investor Principles to the Asset that is Life Insurance
4. Results: Case Studies Revealing Costs of the DIFFERENT Meanings of "Client's Best Interest"
5. Q&A

Veralytic

Research. Rankings. Results.

A $3 Trillion pool of assets in desperate need of <u>management</u>.

Situation

Veralytic
Research. Rankings. Results.

- Life Insurance is often integral to planning, but is the last, largest, most-neglected asset.
- Few know what they are being charged for Cost of Insurance (COIs), Fixed Admin Expenses (FAEs), “wrap fees” and/or premium loads.
- These costs vary by as much as 80%.
- Agents/Brokers/Consultants offering “policy reviews” to help determine/document suitability.

Problem

Veralytic
Research. Rankings. Results.

- "Client's Best Interests" can have different meaning for Agents/Brokers/Consultants.
- Litigation involving life insurance are on the rise.
  - Cochran v. ILIT Trustee
  - Larry King v. Insurance Broker
  - Micale v. ILIT Trustee
  - Schneider v. Attorney
  - Vagelos v. Stockbroker

Problem

Veralytic
Research. Rankings. Results.

- "Client's Best Interests" can have different meaning for Agents/Brokers/Consultants.
- Litigation involving life insurance are on the rise.
- Good planning degraded by bad life insurance.
- Comparisons of HYPOTHETICAL illustrations are "misleading" & "improper" according to Industry Regulations.
- Policy reviews comparing HYPOTHETICAL illustrations can lead to bad results & complaints.

Veralytic
Research. Rankings. Results.

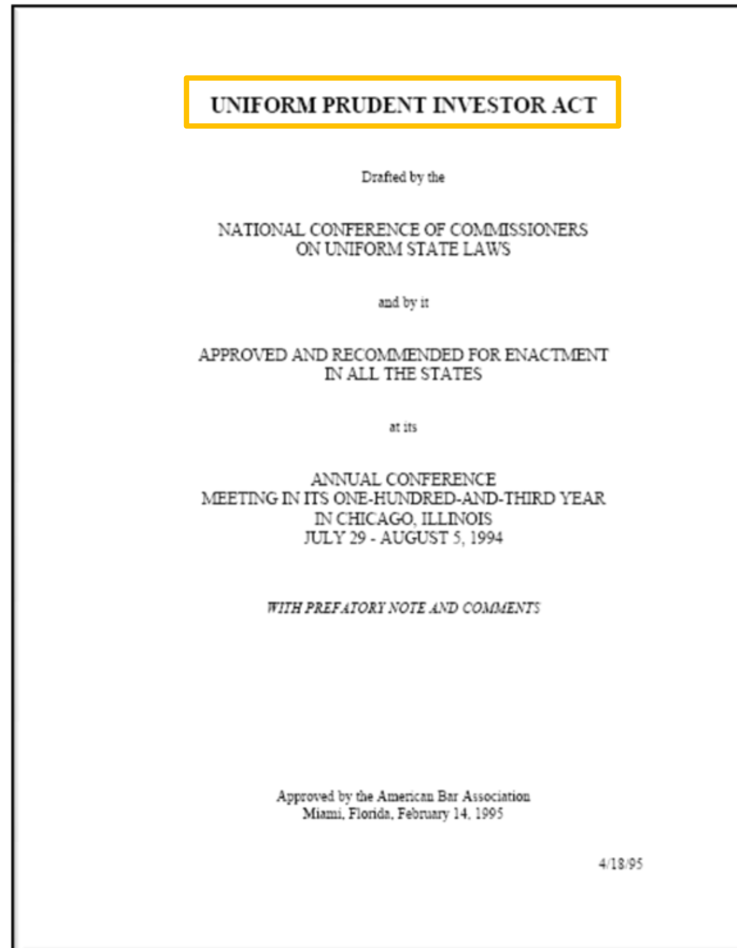
If you don't know where you are going you will probably end up somewhere else...

Solution

Veralytic

Research. Rankings. Results.

- Not 2nd-guessed if follow a "prudent process"



UNIFORM PRUDENT INVESTOR ACT

Drafted by the

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

and by it

APPROVED AND RECOMMENDED FOR ENACTMENT
IN ALL THE STATES

at its

ANNUAL CONFERENCE
MEETING IN ITS ONE-HUNDRED-AND-THIRD YEAR
IN CHICAGO, ILLINOIS
JULY 29 - AUGUST 5, 1994

WITH PREFATORY NOTE AND COMMENTS

Approved by the American Bar Association
Miami, Florida, February 14, 1995

4/18/95

Solution

Veralytic
Research. Rankings. Results.

- Not 2nd-guessed if follow a "prudent process" to 1) monitor

Duty to monitor. Subsections (a) through (d) apply both to investing and managing trust assets. "Managing" embraces monitoring, that is, the trustee's continuing responsibility for oversight of the suitability of investments already made as well as the trustee's decisions respecting new investments.

Duty to investigate. Subsection (d) carries forward the traditional responsibility of the fiduciary investor to examine information likely to bear importantly on the value or the security of an investment – for example, audit reports or records of title. E.g., *Estate of Collins*, 72 Cal. App. 3d 663, 139 Cal. Rptr. 644 (1977) (trustees lent on a junior mortgage on unimproved real estate, failed to have land appraised, and accepted an unaudited financial statement; held liable for losses).

Abrogating categoric restrictions. Subsection 2(e) clarifies that no particular kind of property or type of investment is inherently imprudent. Traditional trust law was encumbered with a variety of categoric exclusions, such as prohibitions on junior mortgages or new ventures. In some states legislation created so-called "legal lists" of approved trust investments. The universe of investment products changes incessantly. Investments that were at one time thought too risky, such as equities, or more recently, futures, are now used in fiduciary portfolios. By contrast, the investment that was at one time thought ideal for trusts, the long-term bond, has been discovered to import a level of risk and volatility – in this case, inflation risk – that had not been anticipated. Accordingly, section 2(e) of this Act follows Restatement of Trusts 3d: Prudent Investor Rule in abrogating categoric restrictions. The Restatement says: "Specific investments or techniques are not per se prudent or imprudent. The riskiness of a specific property, and thus the propriety of its inclusion in the trust estate, is not judged in the abstract but in terms of its anticipated effect on the particular trust's portfolio." Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment f, at 24 (1992). The premise of subsection 2(e) is that trust beneficiaries are better protected by the Act's emphasis on close attention to risk/return objectives as prescribed in subsection 2(b) than in attempts to identify categories of investment that are per se prudent or imprudent.

The Act impliedly disavows the emphasis in older law on avoiding "speculative" or "risky" investments. Low levels of risk may be appropriate in

8

Solution

Veralytic
Research. Rankings. Results.

- Not 2nd-guessed if follow a "prudent process" to 1) monitor, 2) investigate

Duty to investigate. Subsection (d) carries forward the traditional responsibility of the fiduciary investor to examine information likely to bear importantly on the value or the security of an investment – for example, audit reports or records of title. E.g., *Estate of Collins*, 72 Cal. App. 3d 663, 139 Cal. Rptr. 644 (1977) (trustees lent on a junior mortgage on unimproved real estate, failed to have land appraised, and accepted an unaudited financial statement; held liable for losses).

Abrogating categoric restrictions. Subsection 2(e) clarifies that no particular kind of property or type of investment is inherently imprudent. Traditional trust law was encumbered with a variety of categoric exclusions, such as prohibitions on junior mortgages or new ventures. In some states legislation created so-called "legal lists" of approved trust investments. The universe of investment products changes incessantly. Investments that were at one time thought too risky, such as equities, or more recently, futures, are now used in fiduciary portfolios. By contrast, the investment that was at one time thought ideal for trusts, the long-term bond, has been discovered to import a level of risk and volatility – in this case, inflation risk – that had not been anticipated. Accordingly, section 2(e) of this Act follows Restatement of Trusts 3d: Prudent Investor Rule in abrogating categoric restrictions. The Restatement says: "Specific investments or techniques are not per se prudent or imprudent. The riskiness of a specific property, and thus the propriety of its inclusion in the trust estate, is not judged in the abstract but in terms of its anticipated effect on the particular trust's portfolio." Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment f, at 24 (1992). The premise of subsection 2(e) is that trust beneficiaries are better protected by the Act's emphasis on close attention to risk/return objectives as prescribed in subsection 2(b) than in attempts to identify categories of investment that are per se prudent or imprudent.

The Act impliedly disavows the emphasis in older law on avoiding "speculative" or "risky" investments. Low levels of risk may be appropriate in

8

Solution

Veralytic
Research. Rankings. Results.

- Not 2nd-guessed if follow a "prudent process" to 1) monitor, 2) investigate

PRACTICE A-4.3

CONTROL PROCEDURES ARE IN PLACE TO PERIODICALLY REVIEW POLICIES FOR BEST EXECUTION, "SOFT DOLLARS," AND PROXY VOTING.

The Investment Advisor has a responsibility to control and account for investment expenses—that the expenses are prudent and are applied in the best interests of the client. When the Advisor is utilizing a separate account manager, managers need to be monitored for:

Practice A-4.3: "The…Advisor has a responsibility to control and account for …expenses – that the expenses are prudent and are applied in the best interest of the client."

Suggested Procedure

One of the easiest ways for an Investment Advisor to monitor a separate account manager's practices for *best execution* and *"soft dollars"* is to watch where the manager is trading the client's account. When the same brokerage firm keeps popping up, additional scrutiny may be required; unless the client has agreed to "directed brokerage," where the client instructs the money manager to trade a percentage of the client's account with a specific broker. This often is the case when a client agrees to a wrap fee arrangement or managed account platform.

(57)

the interests of participants and beneficiaries in their retirement income to unrelated objectives.'"

SECTION 6. IMPARTIALITY. If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

…the trustee …respect the …n requires

…st, and the skills of the trustee."

Comment

Wasting beneficiaries' money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs.

The language of Section 7 derives from Restatement of Trusts 2d § 188 (1959). The Restatement of Trusts 3d says: "Concerns over compensation and

14

Solution

Veralytic
Research. Rankings. Results.

- <u>Not</u> 2nd-guessed if follow a “prudent process” to 1) monitor, 2) investigate

PRACTICE A-2.4

SELECTED ASSET CLASSES ARE CONSISTENT WITH THE RISK, RETURN, AND TIME HORIZON.

The Investment Advisor's role is to choose the appropriate combination of asset classes that optimizes each client's identified risk and return objectives, consistent with the client's time horizon. The Investment Advisor's choice of asset classes and subsequent allocation typically will have more impact on the long-term performance of the client's investment strategy than the selection of money managers.

CRITERIA

2.4.1 Assets are appropriately

Suggested Procedure

Computer optimization models can mathematically assist the Investment Advisor

(11th Cir. 1990); Leigh v. Engle, 858 F.2d 361 (7th Cir. 1988)

Other
Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1

Uniform Prudent Investor Act [UPIA]
§2(b)

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§3

Management of Public Employee Retirement Systems Act [MPERS]
§8(b)

[32]

prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims . . . .”

Prior Restatement. The Restatement of Trusts 2d (1959) also tracked the language of the *Amory* case: “In making investments of trust funds the trustee is under a duty to the beneficiary . . . to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived . . . .” Restatement of Trusts 2d § 227 (1959).

Objective standard. The concept of prudence in the judicial opinions and legislation is essentially relational or comparative. It resembles in this respect the “reasonable person” rule of tort law. A prudent trustee behaves as other trustees ...ective rather than ...ctors that bear on

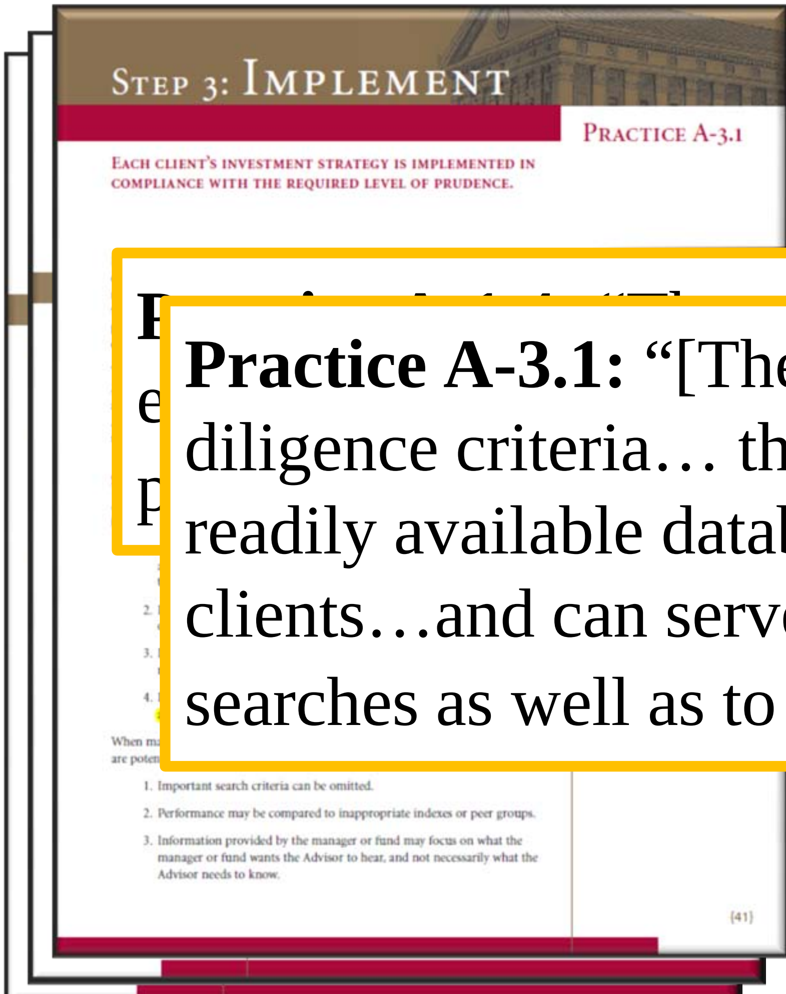
...t rules, that is, ...s forward this ...s the beneficiaries

Practice A- 2.4: “The…Advisor’s role is to choose the appropriate combination of asset classes that optimizes each client’s identified risk and return objectives, consistent with the client’s time horizon.”

...VES:
...gy
...l to
...ider … the expected total return”

Solution

- Not 2nd-guessed if follow a "prudent process" to 1) monitor, 2) investigate, and 3) manage.


STEP 3: IMPLEMENT

PRACTICE A-3.1

EACH CLIENT'S INVESTMENT STRATEGY IS IMPLEMENTED IN COMPLIANCE WITH THE REQUIRED LEVEL OF PRUDENCE.

1. Important search criteria can be omitted.
2. Performance may be compared to inappropriate indexes or peer groups.
3. Information provided by the manager or fund may focus on what the manager or fund wants the Advisor to hear, and not necessarily what the Advisor needs to know.

{41}

Practice A-3.1: "[The Advisor]… should develop due diligence criteria… that can be applied to any of the readily available databases… easily understood by clients…and can serve a dual purpose – apply to searches as well as to monitoring."

Solution

Veralytic
Research. Rankings. Results.

- Due Diligence Criteria for the five (5) major factors of suitability
  - ★ Financial Strength & Claims Paying Ability
  - ★ Cost Competitiveness
  - ★ Pricing Stability
  - ★ Cash Value Liquidity
  - ★ Historical Performance of Invested Assets Underlying Policy Cash Values

That which is to be managed must first be <u>measured</u>.

Results: Example #1

Veralytic
Research. Rankings. Results.

- Client needed $5M of additional life insurance.
- Client consulted large multi-family office (MFO).
- MFO requested assistance from “trusted” broker.
- Broker was (supposedly) independent, unbiased & committed to client’s best interest.
- Broker compared quotes from 35 insurers & assured MFO all suitable products considered.
- Trustee (separate from MFO) refused to serve without verification of broker’s claims.

The following case studies are based on actual client situations but are meant for informational purposes only. The case studies are in no way intended to be used as a primary basis for insurance or investment decisions. Similar results are not guaranteed and will vary based the individual client situations. Clients should consult with their own financial, tax, legal, and accounting advisors before implementing any insurance or investment plan. Neither the information presented nor any opinion expressed constitutes a solicitation for the purchase or sale of any security or investment product.

Results: Example #1

Veralytic
Research. Rankings. Results.

- Independent research revealed …
  - 48 available products suitable to client circumstances (i.e., Broker considered only 73% of the market).
  - The recommended product was $110,000 more costly than products known to be available in the market (i.e., in the Veralytic database).
- Without Independent research …
  - Client could/would have over-paid by $110,000.
  - Trustee exposed to breach of fiduciary duty.
  - MFO stood to lose $10s of millions in investments.
  - Broker lost $100,000+ in commissions.

Results: Example #2

Veralytic
Research. Rankings. Results.

- Client had $8M of life insurance but told to pay additional $1.45M premiums.
- Client consulted international CPA Firm
- CPA Firm requested help from “trusted” broker.
- Broker was (supposedly) independent, unbiased & committed to client’s best interest.
- Broker compared quotes from 48+/- insurers & assured CPA Firm all suitable products considered.
- CPA Firm separately requested independent research to verify the broker’s claims.

Results: Example #2

Veralytic
Research. Rankings. Results.

- Independent research revealed …
  - 57 available products suitable to client circumstances (i.e., Broker considered only 84% of the market).
  - The recommended product was $167,000 more costly than products known to be available in the market (i.e., in the Veralytic database).
- Without Independent research …
  - Client could/would have over-paid by $167,000.
  - CPA Firm exposed to breach of fiduciary duty and stood to lose a largest client account.
  - Broker lost $100,000+ in commissions.

Results: Example #3

Veralytic
Research. Rankings. Results.

- Client had $8.0M VUL but told coverage would lapse without additional premiums.
- Client consulted a “trusted” broker who proposed $2.5M GUL guaranteed for life.
- Broker was (supposedly) independent, unbiased & committed to client’s best interest.
- Trustee (policyowner) refused to exchange without verification of broker’s claims.
- Independent consultant questioned the exchange then agreed.

Results: Example #3

Veralytic
Research. Rankings. Results.

- Independent "research" revealed …
  - ☐ Consultant considered only 1 other product.
  - ☐ Consultant only compared illustrations of HYPOTHETICAL policy values.
  - ☐ Recommended product cost $107,000 more than inforce policy.
- Without Independent research …
  - ☐ Client over-paid by at least $107,000.
  - ☐ Trustee sued for breach of fiduciary duty.
  - ☐ Court ruled for trustee but trustee lost opportunity to manage $2.5M proceeds and legal defense costs.

Results

Veralytic
Research. Rankings. Results.

- Shows your best clients you are taking care of them in ways most agents/brokers canNOT.
- Avoids "misleading" & "improper" comparisons of HYPOTHETICAL illustrations.
- Helps protect you against increasing risk of litigation, arbitration and/or complaints.
- Can Optimize your planning.

Veralytic

Research. Rankings. Results.

Q&A

www.Veralytic.com
f/k/a www.THEInsuranceAdvisor.COM
1301 W. Fletcher Ave., Tampa, Florida 33612
Toll Free #888.908.8242