Daniel M. Isard

Preneed Investing

There is no one answer to the question of how to best invest preneed monies. But the first step should be to determine your purpose for offering preneed.

Dear Dan,
Can you give me a one-handed answer to a question? By one-handed, I don't want a "on the one hand, you can do this and on the other hand that" type of response. I want a one-handed answer to the question of how to invest my preneed accounts. I have been in business for 30 years. I started when preneed was in its infancy. I have used insurers. I have used trusts. I have used state master trusts and my own bank-created trust account. I am confused, as each option looks good in some lights and bad in others. Then, when I finally think I've made a decision, I read stories about insurers failing or earning only 1 percent return in a trust. Dan, do you see my one hand waving for help?

Sincerely, One Hand Waving
Hot Springs, Colorado

Dear Hot Springs,
Can I give you a simple answer to the question of whether to invest preneed money via trust or insurance? No, so you should sit down, clench your jaw and read on. I agree that this should be a simple question; however, there is no simple answer. The problem is that we have screwed up preneed.

First of all, the advent of preneed goes back more than 5,000 years. It blossomed in England in the 1700s and gained popularity in our country during the late 1800s. The major growth in preneed came about in the late 1980s.

By my estimate, funeral preneed deposits represent about $4 billion of new deposits a year to either insurance or trusts. Based on work I've done for a government accounting agency, I estimate preneed to be a $40 billion depository of insurance assets and trust deposits waiting to pay out funds for five million to six million consumer funerals. The average funeral home has a financial backlog of about 140 percent of its annual revenue in preneed deposits – no small financial item.

Congress has changed the tax laws three times in the past two decades to make sure it got its share of the taxes on the earnings of these accounts. The publicans figured out that when taxation on a preneed trust was left up to the funeral home, the 1099s and K1s found their way to the circular filing cabinet. Prior to the computer era, this was such a small amount that the IRS didn't catch the omission. But as IRS computers got smarter and faster, they figured that trusts should be taxed at the trust level. Trust administrators would dare not ignore their responsibility to file. Unfortunately, as this happened, a funeral home had to find ways around the pesky phone calls from consumers. So funeral homes began to rely more on insurance than trust.

If growth is not the biggest reason in your choosing a preneed vendor, then figure out what that factor is. In some cases, the only goal is to put new business on the books. I get that. I understand that that is a compelling purpose to preneed.

Problem solved.

And new problem created!

My dear Hot Springer, let me take you to a place I have seen but to which few have traveled. No, this is not a place where there are unicorns. It is a real place. It is a convention of actuaries, the people who do the mathematical computation for insurance companies. If a probability exists, actuaries can figure out what the risk is and what the premium charge should be.

In order for actuaries to compute insurance company premiums, they need to get some assumptions. One such assumption is the return on the premium until the time of claim. For regular life insurance, they could have 30 to 40 years for a single premium policy from time of premium paid to claim paid. For preneed insurance, that time period could be three to 15 years as consumers are buying this specialty life insurance at older ages. So, with this limited period, what is the investment return? Well, actuaries went to trust companies to determine this, which is like McDonald's sharing its recipe with Burger King. But the two talked and discussed the yields.

The yield at the time of this meeting in 1995 was about 8 percent. Therefore, insurance companies felt they needed to take 2 percent of those earnings for their overhead, which left 6 percent for crediting on the death benefit.

Trust returns are pretax. If the trust paid a 15 percent to 25 percent tax, that left 6 percent crediting to the preneed trust account. The two were equal.

In today's market, the average insurer is getting about 3 percent to 4.5 percent gross earnings, so after their 2 percent overhead, that leaves a crediting rate of 1 percent to 2.5 percent. Again, trust companies earn the same gross amount. After-tax trusts are crediting the same amount. Do you see something diabolical here?

Hot Springs, trusts and insurance companies have about the same yield! They typically invest in the same investments and in the same percentages. Most trusts and most preneed insurers invest in mortgages and bonds. Most are invested in high-quality mortgages and high-qual-

ity bonds. They invest very little in equity. For the most part, they have small investments in real estate. The small insurers may invest a higher percentage of their money into real estate because they will make this real estate their home office. So if you have two opposing entities investing in similar investments in similar ratios, you are going to have similar crediting rates.

So, you want a one-hand answer? Here it is: There is no one-hand answer.

If you sell only single-pay preneeds, then there is one answer. Put that in trust. Trusts, even if you take out taxes, will have a higher yield than insurance single-payment crediting rates. However, I would make it so that the taxation is paid by the consumer, not the trust. If you are guaranteeing that the value of the trust will be accepted as payment in full for the service and merchandise, then taking taxes out of the earnings means you are taking more risk. Studies by the Government Accountability Office show that about two out of three preneed consumers are not paying any taxes. So even if the earnings are taxable to the consumers, there is no tax due. But if the trust pays the tax without regard to the consumer's tax rate, then you are making a voluntary donation to the government and risking your guarantee.

If you are having most preneed paid via installment funding, then insurance is the best product. Insurance is self-completing. It factors in the installment payment growth, which you probably can't or won't do if people were to fund into a trust.

So there are two products and, in my opinion, there are reasons to use either. If growth is not the biggest reason to choose a preneed vendor, then figure out what that factor is. In some cases, the only goal is to put new business on the books. I get that. I understand that that is a compelling purpose to preneed. If the insurance company provides you the marketing team, well, it is impolite to not fund this into insurance.

I challenge everyone reading this article to figure out what the purpose is for offering preneed. Once you know that, then set your criteria for the benefits of the opposing funding vehicles, trust or insurance, and make your decision. Know, however, that it might not be a one-vehicle solution. And that is not a problem – it's a benefit! ✶

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