Investment & insurance

Entry-exit flexibility

Opt for a combination of a term policy along with an ELSS instead of Ulip

Investment in equity and equity-related instruments is fraught with uncertainty. To add to the worry, one is never unsure about entry and exit in the equity market. Another grey area is cost. While plain vanilla products like mutual funds and direct equity are less complex, others likes unit-linked insurance plans (Ulips), structured products, and portfolio management may be tricky while navigating charges.

Portfolio management and structured products are generally targeted at high net-worth individuals or seasoned investors who understand the risks and costs involved in the product. Ulips, on the other hand, are pitched mostly to retail investors who look at it as a package solution to save tax and get an insurance cover along with an investment avenue to earn returns to beat inflation. But knowing the charges involved is very important in any investment avenue.

Ulips come with their own advantages. The convenience factor is the biggest advantage. Second is the switch facility from various options available. Investors can switch from one combination of debt and equity to other. For instance, from a 100% equity exposure to 60% equity-40% debt or even 100% debt in uncertain times when equities are underperforming other asset classes. The investor is eligible for tax benefit irrespective of the debt-equity combination he chooses. But these features come at a cost. Most Ulips allow a couple of switches in a year and charge a fixed fee for subsequent switches.

There is a long list of charges in any Ulip product. Some of the common charges include allocation charges on the investment amount. They are similar to entry loads that mutual funds charge investors. If an investor chooses to invest Rs 10000 per year in Ulip and the allocation charges for the first year are 15%, then Rs 1500 will be deducted and only the remaining amount of Rs 8500 will be invested. Generally, allocation charges are higher in the initial term of the policy and lower in the later term of the policy.

Cost of Ulips is the biggest drawback

Insurance companies have to manage investment on behalf of the investors. This amount is either managed by an in-house fund management team or outsourced to professional asset management companies. In either of the case, the insurance company has to bear the expenses of fund management, which it passes on to the investors after adding its margin. Thus, typically, an insurance company charges investors an asset management fee of 1.5% to 2% of the assets under management.

There is a common perception that Ulips give free insurance cover. But the fact is that investors pay for whatever insurance cover they enjoy while they are invested in the policy. But as investors do not pay separately for the insurance cover, they get the feeling that they are getting the insurance cover free of cost.

The mortality charge differs from one insurance company to another and also depends on the age of the insured person. The charges are deducted from the fund value at the beginning of each year. Most insurance companies levy administration charges to policy holders. These are fixed charges, deducted every month. Being fixed in nature, they do not vary with the premium.

The cost involved in Ulips is the biggest drawback of the product. All these charges make it difficult for Ulips to deliver good returns to investors. Apart from the charges, the long-term commitment of at least five years also make Ulips a rigid option. Also, being a combination of investment and insurance, exiting from Ulips means investors lose the insurance cover.

Most of these charges can be avoided if investors opt for a term policy along with an equity-linked savings scheme (ELSS). The combination will give investors the flexibility of continuing or discontinuing insurance at will. The charges of the term policy will be similar to the mortality charges and the asset management charges of the ELSS will be similar to the fund management charges of the insurance company. But the allocation charges and policy administartion charges can be easily saved in the combination.

Second, investors can chose to exit from an underperforming fund and enter another. Such an option is not available for Ulips. Investors have to stick with the fund managers even if they are unable to outperform their peers over a period of time.

Also, asset allocation can be changed to the extent of additional funds that are invested every year. After three years of lock-in, funds can be shifted to any other open-ended fund category like bluechip funds, midcap funds, balanced funds, monthly income plans, or liquid funds. This combination does not give the flexibility an Ulip can provide when it comes to asset allocation but still is very cost-effective.

Overall, it is always better to keep insurance and investment separate as this offers flexibility and is cost-effective. Though Ulips offer better asset allocation options, they do not give investors the flexibility to switch to another fund. Also, they do not offer the option of retaining the insurance cover even after withdrawing the investment.

— Rahul Mantri