10 Reasons Why IUL is A Bad Investment

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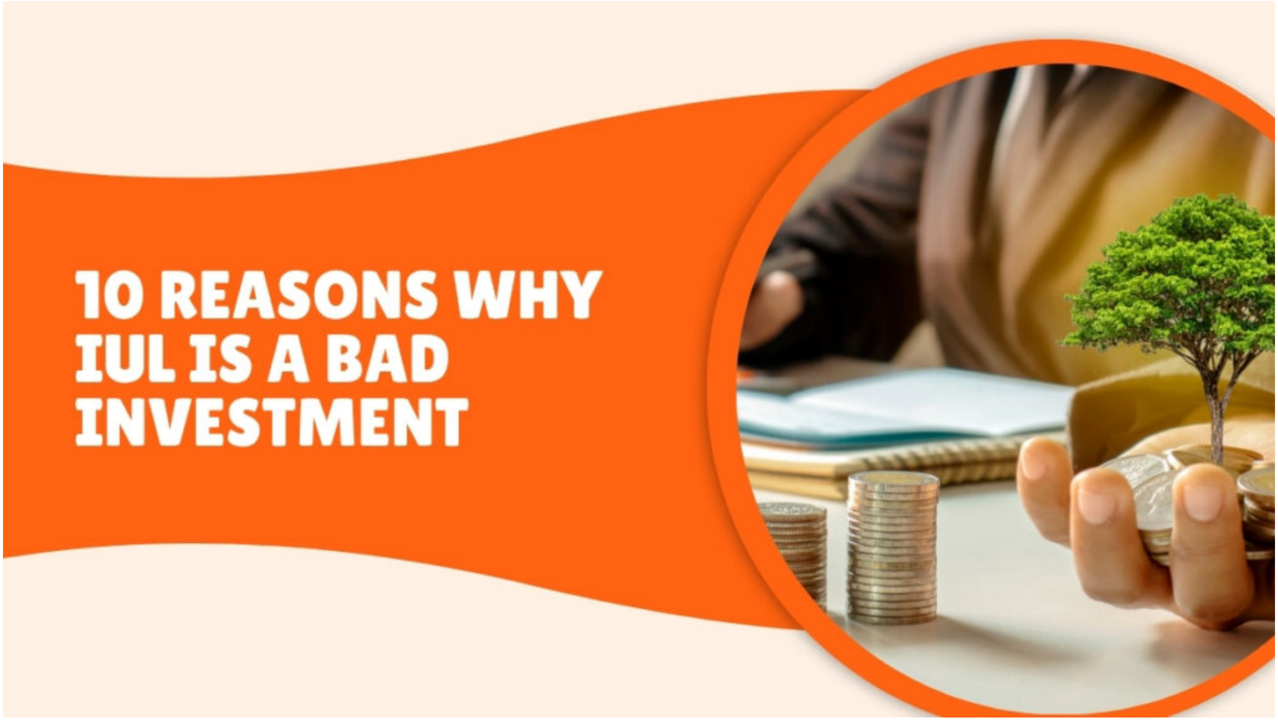

Jane was really excited. She just bought an indexed universal life (IUL) policy. The agent told her it would grow with the market, give her tax-free money later, and also protect her family if something happened to her. It sounded like a win-win.

But six months in, things didn't look so great. Her account barely earned any interest—less than 2%. There were fees she didn't know about.

And if she wanted to take her money out early, she'd lose a big chunk to surrender charges. She also learned that the cost of insurance goes up every year as she gets older.

Jane felt tricked. And she's not alone. Stories like hers show the **10 reasons why IUL is a bad investment**.

It's not just about fees or low returns—it's how complicated and confusing these policies can be. Knowing the downsides ahead of time can save you a lot of money and stress later.

Why does this matter?

Americans face a mounting retirement shortfall. According to the Schroders 2024 U.S. Retirement Survey, half of non-retired Americans report they are concerned about outliving their assets.

And only 9 percent have saved ten times their annual income, even though the “magic number” for a comfortable retirement remains around $1.26 million.

Many turn to IUL policies because they’re sold as a “tax-free” way to grow wealth and pass it on. But beneath the surface are complicated mechanics, high fees, and limits that often lead to disappointment.

It promises growth, tax perks, and lifetime coverage—but many people find out too late it’s not what they expected. Before you sign anything, here are 10 reasons why IUL is a bad investment.

Reason 1: High and Hidden Fees

IULs come with a long list of fees—many you won’t see upfront. From policy charges to cost of insurance and admin fees, these can quietly eat away at your cash value before you even notice.

Up-front commissions

Most people don’t know that their agent may earn 60–100% of their first-year premium as commission. That means if you pay $10,000 in premiums, your advisor could be pocketing all of it. These commissions aren’t always clearly disclosed, and they often reduce how much of your money actually goes to work.

Policy administration charges

Insurance companies charge recurring fees—sometimes monthly—that quietly drain your policy. These fees often total 0.5–1% of your cash value per year, compounding the damage over decades.

Cost of insurance (COI)

This is one of the most misunderstood costs. It’s not a fixed fee—it increases as you age. In your 60s or 70s, it can balloon and eat up your gains, especially if your policy isn’t heavily overfunded.

Surrender charges

Want out early? You could face a 7–15 year penalty schedule. That means you’ll lose a chunk of your cash value if you exit before the end of the surrender period.

Tip

Always ask your agent for a full 20-, 30-, and 40-year fee illustration. Demand a clear breakdown of every load, admin charge, COI, and surrender schedule.

See also 10 Reasons Why Homework is Important

Reason 2: Complex Mechanics and Illustrations

IULs are packed with confusing terms, charts, and projections that look great on paper—but often don't match reality. It's easy to misunderstand how the policy actually works until it's too late.

Illustration illusions

IUL illustrations are often based on best-case assumptions—like caps and participation rates staying high. But those assumptions are just that—assumptions. They're not guarantees.

Credit rate vs. index performance

The S&P 500 may return 12% one year, but your IUL might only credit you 7% because of the cap or participation rate. You're not investing in the index—you're just getting a limited version of its return.

Caps, spreads, and floors

Each policy includes rules that affect how much interest you get. For example:

- Cap: Max limit on return (often 6–12%)
- Spread: Percentage subtracted from the gain (e.g., 1.5%)
- Floor: Min return (usually 0%, protecting against market loss)
  These all sound reasonable—until you realize they massively cut into your upside.

Tip

Compare the guaranteed vs. non-guaranteed lines in every illustration. Then assume non-guaranteed values will shrink—often by 2–3 percent annually.

Reason 3: Capped Upside, Hidden Downside

IULs let you "follow the market"—but only partway. There's a cap on how much you can earn, even in strong years. And in bad years, fees keep coming, even when your gains don't.

Participation rate limits

If your policy only gives you 85% of market gains, and the market returns 10%, you're only credited 8.5%—even before spreads or other costs.

Cap rates

Historically, S&P 500 returns average around 10–12% annually. But IUL caps may stop you at 8% or even lower, meaning your returns lag the market over time.

Spread/margin fees

These silent charges often reduce credited interest by another 1–3%. Combined with caps and participation limits, they can leave you with just 3–5% returns even in a strong market.

Tip

Model credited returns under bull, bear, and sideways markets. Then compare to a low-cost S&P 500 index fund to see how often you come out behind.

Reason 4: Opportunity Cost of Alternatives

Every dollar in an IUL is a dollar not growing elsewhere. You could be building wealth with low-cost index funds, Roth IRAs, or even a simple high-yield savings account—instead of locking money into a complex policy with limited returns.

Low-cost index funds

You can invest in a total market fund with fees as low as 0.03%. Even a balanced portfolio of stocks and bonds costs less than 0.15% per year—far cheaper than IUL's fee stack.

Term life + separate investing

A 35-year-old male in good health can buy $500,000 of 20-year term life insurance for around $300 a year. The rest of the money could be invested in a tax-efficient index fund.

Real-life comparison

Suppose you invest $10,000/year:

- IUL: 5% net return after fees → $249,000 in 20 years
- Term + invest: 7% net return → $346,000 in 20 years
- That's a $97,000 difference—just by choosing simplicity over complexity.

Tip

Always run a "buy term and invest the rest" scenario alongside your IUL illustration.

Reason 5: Illiquidity and Access Issues

Need your money in a pinch? With an IUL, it's not that simple. Accessing your cash value can involve loans, interest charges, or surrender fees—making it harder to use your own money when you actually need it.

See also 10 Reasons Why School is A Waste of Time

Policy loans

Loans reduce your cash value and death benefit. They also charge interest—typically 4–6%—and if not repaid, the loan balance grows and could force the policy to lapse.

Partial surrenders

These might be allowed, but come with surrender charges, and if gains are withdrawn, they can trigger taxes.

Waiting periods

Many IULs require you to hold the policy for 8–10 years before accessing cash without major penalties. That's a long time to wait—especially if your needs change.

Tip

Treat IUL cash value as "locked away" money. If you need real liquidity, use dedicated savings or brokerage accounts.

Reason 6: Tax Complexity and Risk

IULs are often sold as "tax-free," but that's not the full story. If the policy lapses or loans aren't managed carefully, you could face surprise tax bills—right when you least expect it.

Loan-vs-withdrawal traps

Loans are usually not taxable, but if the policy lapses or is surrendered, the unpaid loan becomes a taxable distribution. Withdrawals above the policy's cost basis are also taxable as ordinary income.

MEC rules

If you overfund your policy—even by accident—it may be reclassified as a Modified Endowment Contract. That removes many tax benefits and makes all withdrawals taxable and subject to a 10% penalty before age 59½.

Estate tax myths

Many think IULs are automatically estate-tax free. Not true. If the policy is not properly held in an irrevocable trust, the death benefit may count toward your taxable estate.

Tip

Consult a fee-only tax advisor to map out worst-case scenarios—and be wary of "tax shelter" promises.

Reason 7: Poor Long-Term Performance in Practice

On paper, IULs look promising. But in the real world, many don't deliver. After fees, caps, and rising insurance costs, long-term returns often fall short of basic investment options like index funds.

Real-world studies

A 2022 study from Milliman showed that actual IUL performance often falls below projected returns. In many cases, returns were closer to 3–5% net of all fees and costs.

Sales bias

Insurance companies often show the best-case scenario in their illustrations, which includes high cap rates and low COI assumptions. But these are rarely what clients actually experience.

Policy reviews

Many policyholders report that their IULs didn't perform as expected. Some saw their cash value stagnate, while others had to increase premiums just to keep the policy from lapsing.

Tip

Seek independent, historical "back-tested" data for your specific policy design—ideally from a fee-only consultant.

Reason 8: Suitability and Sales Incentives

IULs are often pushed by agents who earn big commissions—not because they're right for you. Many people are sold these complex policies when simpler, cheaper options would have been a better fit.

Advisor bias

Insurance agents often earn 10–15 times more selling an IUL than selling term life. That commission structure can influence the advice you get—whether it's in your best interest or not.

Unsuitable recommendations

IULs are frequently sold to middle-income earners who don't have the surplus income to keep funding these policies long term. When cash values underperform or premiums rise, these clients are the most vulnerable.

See also 10 Reasons Not to Buy A Car

Regulatory scrutiny

Several state insurance departments have issued bulletins warning about the sale of complex, poorly understood policies like IUL. Some call it "an inappropriate retirement solution for the average investor."

Tip

Always ask advisors to disclose their first-year and renewal commissions on your sale vs. term policy.

Reason 9: Market Timing and Crediting Method Risks

With IULs, when the market gains happen matters just as much as how big they are. The crediting formulas are tricky, and bad timing can mean you earn little or nothing—even in a strong market year.

Point-to-point vs. monthly averaging

Different methods calculate your credited return in different ways. For example, monthly averaging may water down returns in volatile markets, while point-to-point can result in 0% returns if the index closes lower.

Lock-in lag

There is often a delay between when the index closes and when your interest is credited. This lag can cause you to miss out on rallies—or get hit harder by drops.

Poor transparency

Many clients don't realize how their interest is being calculated until they get a disappointing annual statement.

Tip: Review your policy's prospectus for the exact crediting method—and run sample calculations for bull, bear, and sideways years.

Reason 10: Behavioral Pitfalls and Overconfidence

IULs are often sold with rosy projections that make people feel too confident. But overestimating returns, underestimating costs, and not fully understanding the risks can lead to poor decisions—and real financial pain down the road.

Overfunding mistakes

Trying to "beat the system" by stuffing in high premiums may accidentally trigger MEC status, which cancels the tax advantages.

Cashing out too early

Many policyholders become frustrated after a few years of poor growth and decide to surrender. Unfortunately, early exits often mean surrender charges and lost principal.

Under-monitoring

IUL is not a "set it and forget it" product. If you don't regularly check fees, COI changes, cap adjustments, and market performance, your policy may quietly erode.

Tip

If you don't relish tracking fees, cap changes, and crediting rates annually, IUL will likely catch you off-guard.

Conclusion

Let’s recap in one sentence each:

1. Up-front commissions and hidden admin fees can consume 2 percent+ of your cash value annually.
2. Sales illustrations rely on optimistic, non-guaranteed assumptions.
3. Caps and spreads leave you with far less growth than the underlying index.
4. Term life plus investing typically outperforms net IUL returns.
5. Policy loans and surrenders are subject to fees, taxes, and penalties.
6. Complex tax rules and MEC traps can trigger immediate taxation.
7. Independent studies show IUL often underperforms balanced portfolios.
8. High commissions incentivize unsuitable sales to middle-income clients.
9. Opaque crediting methods add market-timing risk.
10. Behavioral missteps—overfunding, early surrender, and under-monitoring—compound losses.

IUL can look great on paper—but hidden fees, complexity, and behavioral traps often make it a poor bet.

Before you commit, compare term + invest strategies, review low-cost index funds, and seek truly independent, fee-only advice. Your retirement depends on seeing the fine print—not just the hype.

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Maroc Jameson is a dedicated educator with a strong commitment to enhancing learning experiences. He specializes in presenting information through concise “10 tips” formats, covering various topics such as “10 reasons to pursue a new skill” and “10 important benefits of reading.”