Insurance Planning

Life insurance 101: An overview of term life policies versus whole life policies.

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Life insurance is commonly understood as a basic protection tool, similar to other types of property or casualty insurance. Most people are familiar with this concept – you pay a premium, and if the worst happens (in this case, the insured dies), the carrier pays out a benefit. By pooling the premiums of a large group of insureds, a small premium can offer a large death benefit, providing "leverage" of premium dollars. Insurance of this variety has been around in some form or fashion since ancient Rome, when Caius Marius, a Roman military general, created a burial club to help pay the burial expenses of troops in the event of an untimely death. Life insurance gradually evolved from closely related risk pools to large corporate carriers serving the public at large.

Many individuals likewise have experience with basic "term life insurance" through an employer provided "group term" policy or with a personal term policy. Such policies generally provide the lowest premium cost for a given coverage level (e.g., $1,000 annual premium for a $1 million death benefit). Of course, while low cost and maximum leverage is initially attractive, term policies are a pure cost for approximately 98% of purchasers—in other words, 98% of term policies never pay a death benefit.

Why is this so? As individuals get older, the cost of providing insurance protection increases (since the risk of dying increases). Term insurance becomes cost prohibitive for most individuals well before they reach life expectancy. As a result, most term policies are dropped, or "lapse" after many years of premiums having been paid. Where an individual's health has declined, a renewal of coverage at that point may be cost prohibitive as well, or unavailable altogether.

Cash Value Whole Life Insurance

Whole life insurance was developed to provide insurance coverage for one's "whole" or entire life, in contrast with temporary term life. To avoid the increasing costs and early lapse issues that affect term policies, whole life premiums are

typically much higher than term premiums. However, the higher premiums may not equate to a higher overall cost to the policy owner in light of the "cash value" component of whole life. While term insurance has no economic benefit apart from death proceeds, whole life policies devote a portion of each premium to an account tied to the policy. The carrier reinvests these proceeds and provides earnings back to the account in the form of interest or dividends.[1] As this cash value account grows, the pure death benefit portion of the contract is generally compressed, reducing the corresponding cost of insurance. At some point, the earnings attributed to the cash value may support premiums moving forward. Some whole life policies also can be designed to have a predetermined (shorter) pay period with guaranteed permanent death benefit.

Common Misperceptions with Whole Life

Whole Life and "Forced Savings"

Many people may be reluctant to provide larger premium outlays in exchange for a cash value tied to an insurance product. This "forced savings" pejorative belies two simple facts:

1. Budgeting for regular savings is generally sound financial advice.
2. Cash values are not simply a feature that helps support the coverage but rather liquid assets in their own right that can be accessed during lifetime without requiring additional premiums, in most cases.

For example, cash values can be withdrawn from a policy through surrenders or dividend payments (generally tax free up to basis in the contract), or more frequently, through policy loans. Loans against a policy accrue interest and decrease the death benefit and available cash surrender value by the amount of the outstanding loan and interest. Accessing cash value will reduce the available cash surrender value and death benefit.

Cash Values Offer Low Returns

When analyzing returns on any type of financial instrument, the primary question should be "in comparison to what?" Whole life cash values are meant to support decades worth of policy performance—as a result, the corresponding investments underlying the contract are more conservative. When comparing the performance of whole life cash values to alternatives, comparably secure options should be the basis. Additionally, when factoring in the tax benefits of whole life, cash values frequently outperform comparable options.

Whole Life is Too Expensive

While premiums in relation to term products are certainly much higher, the corresponding benefits and value provided should be included in any cost comparison: e.g., the net cost of the insurance should generally be the cumulative outlays less cash values. Additionally, the death benefit protection above and beyond, particularly when the term policy would lapse, should be included in any cost analysis.

It's Better to Buy Term and Invest the Difference

Perhaps the most common argument against paying higher whole life premiums is that it is better to simply buy the term (as a stop gap) and invest the difference of the whole life premium to effectively "self-insure." In some situations, this may make mathematical sense, but it ignores practical reality of savings habits, personal budgeting, and spending discipline. In many cases, the "difference" is never invested to begin with—making the budgeted "forced savings" of whole life a generally good thing.

For those confident in their ability to accumulate adequate savings nonetheless, a crucial facet of whole life remains worth exploring—namely, how life insurance cash values fit into one's portfolio from a tax and asset allocation standpoint.

When investing the difference, there are generally two options to choose from: fixed income (bonds) or equities (stocks). There are different types and tax features within these asset classes, and most investment accounts adhere to some type of blended arrangement with adequate diversification within each class.

FIXED INCOME instruments typically provided greater security and stability, as most bonds and bond equivalents offer a stated rate of interest. Of course, other than tax-free municipal bonds, bond interest is generally taxable as ordinary income. Ordinary income is taxed at potentially higher rates (up to 37%) than qualified dividends and capital gains (15% or 20%). Additionally, interest income is subject to the tax on net investment income (NII) of 3.8% once one's income exceeds a certain threshold. And while fixed income has a fixed principal (the original investment amount) repaid at maturity, changes in interest rates can impact the value of a bond at a given moment.

For example, in an increasing interest rate environment, the current value of a bond will generally decrease as the present value of the interest

1 Depending on the carrier and the type of policy, a portion of account earnings may be guaranteed, and an additional component may be the non-guaranteed dividend or earnings paid by the carrier.

payments is reduced. If liquidity from a bond's value is needed, a subsequent sale can result in a loss in the initial investment. Lower rated bonds offering higher interest payments may also pose a higher risk of default (i.e., an inability to repay the principal as promised).

EQUITIES have generally provided robust growth over the long term but are subject to greater risk and volatility as well. Dividends paid are taxable and likewise subject to the tax on NII, as are capital gains when securities are sold. A common blended portfolio may require capital gains realization during an up market as securities are sold to rebalance to the desired allocation. Additionally, as one nears retirement, common investment wisdom suggests a movement towards more fixed income to provide greater stability and reduce risk and volatility.

In Summary

Fundamentally, life insurance has savings attributes in addition to insurance features—but for too many people it is not viewed that way. As a result, many of them may opt for a term insurance outlay that offers nothing in return other than peace of mind, for a while.

For those able to take advantage of the benefits of whole life, however, the savings component can serve as an important conservative allocation of an overall financial portfolio, while the insurance component can provide peace of mind for a lifetime.



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