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What You Need To Know About Life (part 2)

Term vs Permanent

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"Life insurance is sold, not bought."—A traditional saying in the insurance industry that may be outdated now that consumers are better informed.[1]

Traditionally, many in the insurance industry believed that prospective customers had to be induced to think about buying life insurance. Not only do people avoid contemplating death, but even those who are inclined to prepare their affairs might find the different insurance options dauntingly complicated. The first installment in this series about life insurance aimed to get you thinking about whether you need life insurance, and if so, how much.

This installment will present the basic features of different types of life insurance. I should note that the outset that I have a strong bias towards the least expensive option, term life insurance. Even so, I hope that the material in this article will enable you to make wise decisions that suit your own needs.

The least expensive option: term life

In general, the least expensive way to insure against the financial consequences of premature death is a term life policy. This is a policy with a fixed premium that remains in effect for a certain number of years (typically 10-20) if you make the payments on time. After the term ends, either the policy expires or you are allowed to continue to renew it at rates that are generally prohibitive.

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[1] "RIP Sold, not bought." http://www.thinkadvisor.com/2016/06/29/rip-sold-not-bought?page=2&slreturn=1509721765, accessed 11/3/2017

Term coverage can be viewed as a way to replace some of the earnings that you would forego by dying early. If that is your goal in purchasing term insurance, you would no longer need it once you retire. In my view, term life insurance should be your default option to cover the financial consequences of your mortality unless you have a specific and compelling reason to choose a different type of policy that will be much more expensive.

Before you can buy a term policy the insurance company will evaluate your health with a questionnaire and likely a medical examination and blood tests. If these uncover health risks you may not be able to purchase a policy at all, or may be subject to higher premiums. In general, the younger and healthier you are, the cheaper a term policy will be. Potentially harmful lifestyle choices such as smoking or undertaking dangerous hobbies such as skydiving will likely increase the costs of a policy that you would qualify for.

The objection that many insurance agents raise against term life is that if you happen to outlive the policy, as is expected, you have wasted all the premiums you paid. Maybe they will present the scenario where you pass away the year after the term ends. One insurance salesman I dealt with quoted me a statistic that 97% of term policies do not pay death benefits at all. (That is, the term ends or the owner stops paying premiums before the insured person dies.)

I do not view this as a reason to avoid term coverage. If you are fortunate, you will also go through life having “wasted” premiums paid on homeowners and automobile insurance too. However, it is important to choose the amount of coverage so that the “wasted” premiums are not so excessive as to cause you financial deprivation in the years after the policy expires.

You may have heard people speak of life insurance policies having a value or of being able to borrow against your life insurance. These concepts do not apply to term life policies, which have no value apart from the potential death benefit.

Cash value life insurance

There are two major differences between term insurance and cash value life insurance: First, cash value policies do not expire after a fixed number of years. (For this reason, cash value policies are also called permanent insurance policies.) Assuming that you can continue to pay the premiums, you can maintain the policy for the life of the insured, guaranteeing that the policy will pay the death benefit. Second, cash value insurance policies have an associated savings or investment account that is projected to grow in value over the years as you pay the premiums. The lack of an expiration date and the accumulation of cash value make cash value life insurance generally much more expensive than a term policy with the same death benefit.

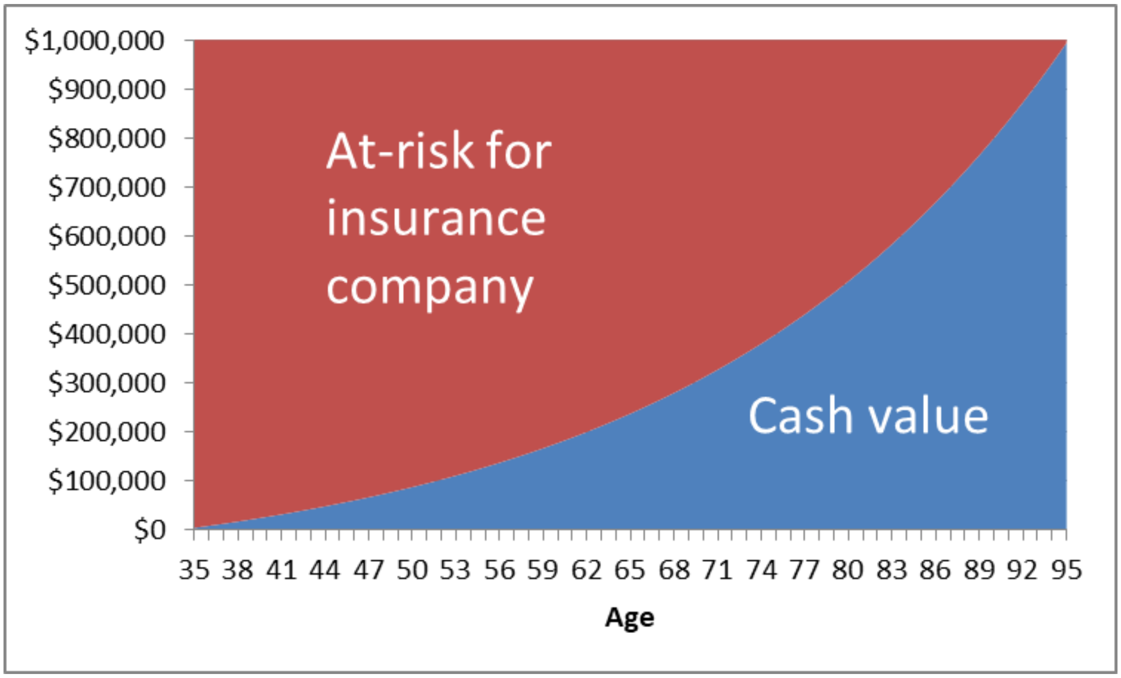
How much more expensive? Premiums on cash value insurance can be ten times as high as the same death benefit under a term policy. (The younger you are, the greater the savings by purchasing term instead of permanent life insurance.) You should therefore have a very good reason to incur the added expense.[2]

Situations where it could be worth the added expense to purchase a cash value (permanent) policy are those where your beneficiaries need the death benefit, no matter how long you live. One example is if you have valuable assets (family business, house, collectibles etc.) that you do not want your heirs to have to liquidate to pay estate taxes. Another example is to fund a buyout of your share of a business.

There is one potential upside to cash value life insurance: If the insurance company's investments perform well enough, your cash value can grow to the point where you can dip into it to pay the premiums. If this occurs, you might earn a reprieve from paying premiums for some years. (This has happened to me on a policy I own.) But future returns are not guaranteed, and interest rates now are so low that it will be hard for insurance companies to generate pleasant surprises regarding the growth of cash value.

The major risk of cash value insurance is the possibility that your economic circumstances could deteriorate and you could become unable to continue making premium payments. In this case, your policy might eventually lapse and you would have wasted all of the much larger premiums (compared to term insurance) that you paid in.

[2] https://www.nerdwallet.com/blog/insurance/what-is-the-difference-between-term-whole-life-insurance/?trk=nw_gn1_4.0, accessed 11/2/2017



You can't collect both the cash value and the death benefit. It's one or the other.

A hypothetical scenario is shown in the chart above3 for someone who buys a $1 million permanent insurance policy at age 35 and pays enough premium to add $4,000/year to the cash value, which itself grows at 4%/year due to insurance company investment performance. Any time the insured dies, the policy pays $1 million. But if death occurs early, most of that $1 million comes from the insurance company. The later death occurs, the more of the $1 million death benefit comes from the policy owner's own savings and the less from the insurance company. In fact, if the insured lives until age 95, the accumulated cash value will have reached $1 million and the insurance company will not be on the hook for any death benefit.[4]

It bears repeating: The cash value does not add to the death benefit. If the insured passes away, the beneficiaries receive only the death benefit regardless of how much cash value has accrued.

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[3]Chart adapted from Michael Kitces' blog: https://www.kitces.com/blog/outliving-the-end-of-life-insurance-mortality-tables-the-age-100-tax-problem-when-life-insurance-expires/, accessed 11/7/2017.

[4] In fact, the policy will terminate, distributing the cash value equal to the death benefit. Unlike the payment of a death benefit, the distribution of a cash value before death will be taxable. We will cover this in more detail in the next installment of this series.

Term versus permanent—a case study

Suppose you do not need permanent insurance for estate planning purposes, and are deciding whether to buy a more expensive permanent policy or buy a less expensive term policy and invest the difference on your own. Which option will leave you better off?

As with so much else that applies to life insurance, it depends on how much longer you live. Let's look at sample premiums from www.nerdwallet.com for a healthy 40-year-old man. According to this website, such a man could expect to pay $13,700/year in premium for a permanent, $1 million life insurance policy. Alternatively, he could pay $1,281 in annual premiums on a $1 million, 30-year term policy. The lower premium would leave him the savings of $12,419 to invest each year. The chart below shows the outcomes of taking the different policies, depending on the age at death.

If he dies before age 70 he will collect the same $1 million from either policy as the death benefit. However, he will have saved on premium costs with the cheaper term policy and those savings would also be in his estate. So clearly, someone destined to die during the term of a policy would be better off with term than with permanent.

What if he outlives his term policy, as he is likely to do? In that case the term policy pays him nothing and he will be left only with the amount he invested (along with its growth). If he earns 3%/year after taxes on his investments then at age 70 he will have accumulated $590,839. At 3%/year it will take him until age 81 until his savings exceed $1 million. So, if he is destined to die between ages 70 and 81 his heirs will end up better off if he had purchased the permanent policy. Starting at age 81, he and his heirs will again be better off with the term policy because he will have accumulated $1 million without having to die.

If this investor is instead able to earn 5%/year after taxes, which is consistent with the long term historical return from a low-cost S&P 500 Index fund, then the accumulated premium savings will reach almost $1 million at age 72. In this case, the only way the insured would be better off with the more expensive permanent policy would be if he happens to die between ages 70 and 72.

A 40-year-old man has a life expectancy of 38.6 years according to Social Security. However, the insurable population is healthier than average. So, this 40-year-old has a roughly 50% chance of living to age 81. Since he also has a small chance of dying before age 70, even under a conservative assumption for investment returns, the odds favor his being better off with term coverage. In addition, he will have access to his savings if he needs money in an emergency, whereas if he becomes unable to pay the premiums on his permanent policy he might end up with nothing.

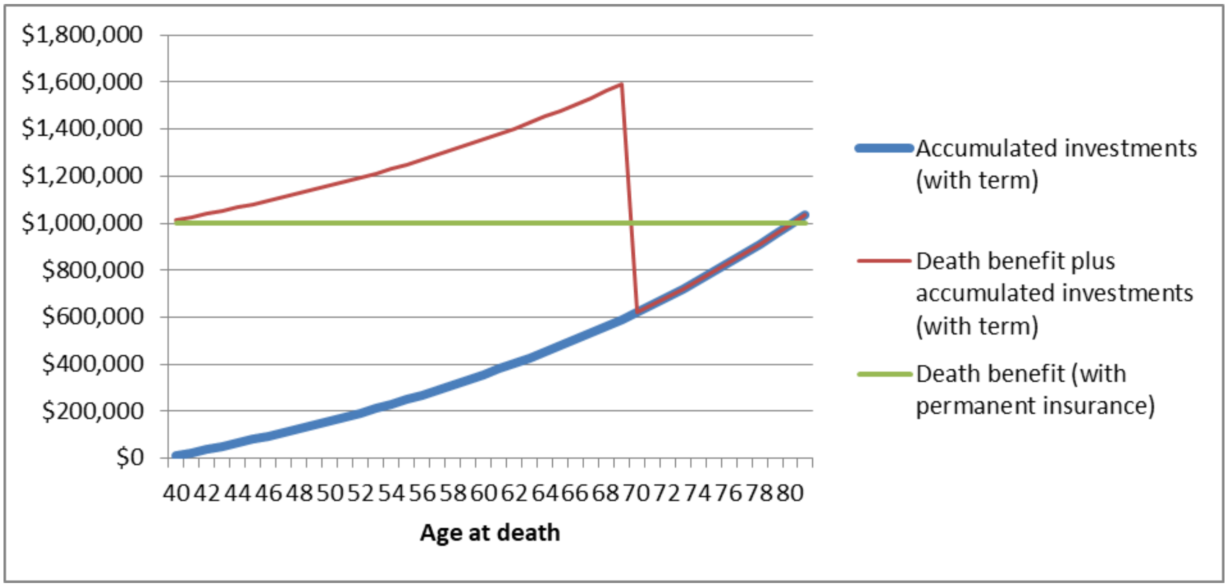

Figure: Comparison of hypothetical payoffs at death to a 40-year-old from paying premiums for a whole life policy versus paying for a lower cost term policy and investing the premiums savings to earn 3%/year after taxes.

Conclusion

So far, we have seen that there are two broad types of life insurance: term, and cash value (also called permanent). The advantage of term insurance is that it is much less expensive. It is particularly appropriate for someone wanting to insure his beneficiaries against the loss of his future earnings in case of premature death. The disadvantage, which is really a good outcome, is that there is a high likelihood that you will outlive the term of the policy. In that case, all the premiums you paid will be for naught.

Cash value life insurance does not have an expiration date, so if you can continue to make the premium payments you will be guaranteed to receive the death benefit. This is useful in situations where the beneficiaries are depending on receiving the death benefit no matter how long you live, which is the case in certain estate planning situations. Cash value life insurance is much more expensive than term, so for most people the burden of paying the premiums over a lifetime can be prohibitive.

In addition to the death benefit, the accumulated cash value in a permanent policy can be of use to you in certain situations. Term policies do not have a cash value, so in these situations only cash value policies will be applicable. The next installment of this series will describe scenarios where you could potentially benefit from the cash value before the death benefit is paid.

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