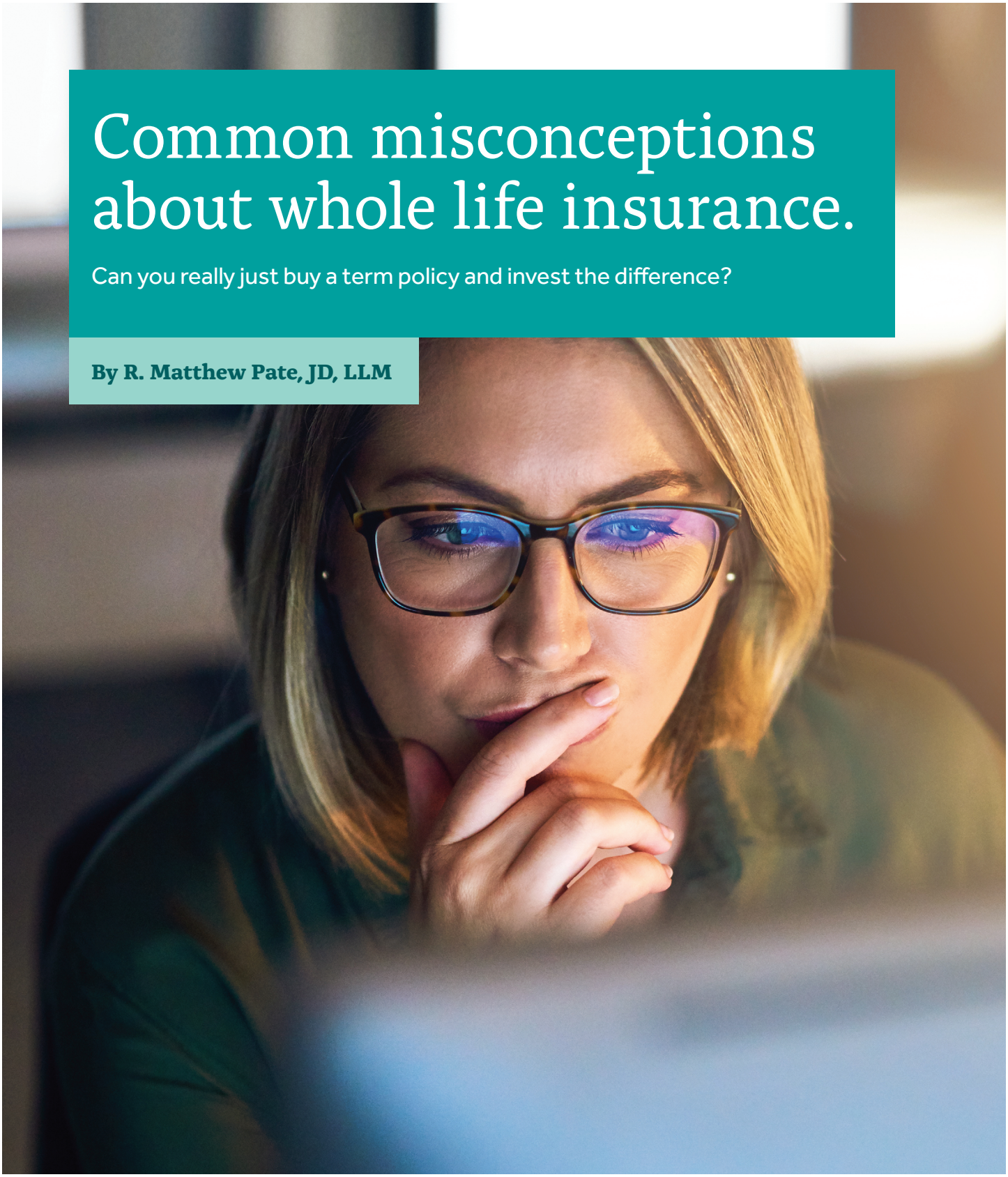
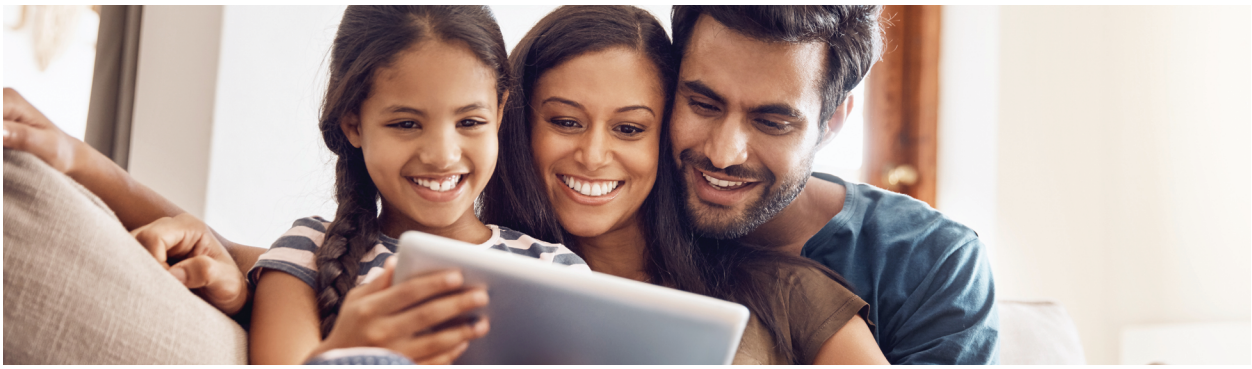
Common misconceptions about whole life insurance.

Can you really just buy a term policy and invest the difference?

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Most people are familiar with life insurance as a basic protection tool, similar to other types of property or casualty insurance—you pay a premium, and if the worst happens (in this case, the insured dies), the carrier pays out a benefit. Life insurance is available in a wide variety of options, however, which makes it seem complicated to many people and creates a number of misperceptions along the way. One misperception is the notion that you can replicate the benefits of permanent, or "whole," life insurance on your own—by buying term life insurance at a lower cost and investing the cost savings yourself. To address this and other related misperceptions, let's start with the differences between these two life insurance options: term life and whole life.

Term life insurance:

Term insurance is "pure protection"; it provides a death benefit for a specific period of time. If the insured person dies during the term in which the insurance is in effect, a death benefit will be paid to the beneficiary. But there are no benefits to a term policy beyond that. Many individuals have experience with basic "term life insurance" through an employer-provided "group term" policy, and many also purchase personal term policies on their own. Term policies generally provide the lowest initial premium cost for a given coverage level (e.g., possibly a $1,000 annual premium for a $1 million death benefit). While the initial low cost and maximum leverage is attractive, term insurance becomes cost prohibitive for most individuals after they reach a certain age, since the risk of dying increases as you get older. Because of that, most term policies are dropped, or "lapse," after many years of premiums have been paid. When an individual's health declines during the insurance policy's term, a renewal of coverage may be cost prohibitive or may not even be available.

Whole life insurance:

In contrast with temporary term life, whole life insurance provides insurance coverage for one's "whole," or entire, life—with premiums and coverage guaranteed regardless of changes in future health. To avoid the increasing costs and lapse issues that ultimately affect term policies, whole life premiums are set for the policy owner's entire life. They are initially much higher than term premiums, but whole life also offers features that make it a considerably more versatile financial vehicle. Some of those advantages relate to the "cash value" component of whole life. While term insurance has no economic benefit apart from the death benefit, whole life policies devote a portion of each premium to the cash value of the policy. The carrier invests these proceeds and credits interest to the cash value.[1]

As this cash value account grows (both at a guaranteed and non-guaranteed rate), the cost of insurance declines over time. At some point, the earnings from the cash value may support premiums moving forward, although if premiums are paid from the cash value this would affect the growth of the cash value. Some whole life policies can also be designed to have a predetermined (shorter) pay period with a guaranteed permanent death benefit.

Common misperceptions about whole life:

'Whole life as forced savings'

Some people are reluctant to provide larger premium outlays in exchange for the cash value tied to an insurance product. The pejorative connotations of such "forced savings" belie two simple facts, though:

1) Budgeting for consistent regular savings is a sound financial practice.

2) The cash value is not just a feature to help support the coverage, but is an asset in its own right that can be accessed during your lifetime without requiring additional premiums in most cases. For example, cash value can be withdrawn from a policy through surrenders (tax free up to the basis in the contract) or, more frequently, through policy loans.[2]

'Returns on cash value are low'

When analyzing returns on any type of financial instrument, the primary question should be "in comparison with what?" Whole life cash value is meant to support the policy for decades, so the corresponding investments underlying the policy contract are conservative and safe. When comparing the cash value accumulation of whole life to alternatives, such alternatives should be equally safe and secure. In addition, we should factor in the added tax benefits of whole life.

[1] Depending on the carrier and the type of policy, a portion of account earnings may be guaranteed based on the claims-paying ability of the issuer, and an additional component may be the non-guaranteed dividend, if declared by the carrier.

[2] Note that any access to cash value during the lifetime of the policy owner will reduce the corresponding cash surrender value and the available death benefit.

'Whole life is too expensive'

While the premiums of whole life are certainly high in relation to the premiums of term products (at least initially), the corresponding benefits and value should be included in any cost comparison: e.g., the net cost of the insurance should be calculated as the cumulative outlays minus cash value. In addition, the death benefit protection should be included in any cost analysis, paying particular attention to it after the end of the period covered by the term policy.

'Can't I do it better myself by buying term and investing the difference?'

Perhaps the most common argument against paying higher whole life premiums, however, is that it is better to simply buy a term life policy for the period in which you are most likely to need insurance (until you pay off your mortgage and your children graduate from college, for example), research the amount you would be paying for a whole life policy with comparable coverage, and invest the amount you are saving. In some situations, this may make mathematical sense, but it ignores the practical reality of savings habits, personal budgeting, and spending discipline. In many cases, the "difference" is never invested to begin with, and in other cases the amount that is invested drops off as time goes by—making the budgeted "forced savings" of whole life insurance a good thing.[3]

Even for those confident of their ability to accumulate adequate savings, a crucial facet of whole life is still worth exploring: namely, how life insurance cash value fits 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.

Fixed-income instruments typically provide greater security and stability, as most bonds and bond equivalents offer a stated rate of interest. But outside of tax-free municipal bonds, bond interest is generally taxable as ordinary income. Ordinary income is taxed at potentially higher rates (a top rate of 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, if interest rates are increasing, the value of a bond purchased before interest rates started to climb would generally decline. If liquidity is needed, the sale of a bond 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).

[3] Note that any whole life product has a risk of coverage lapse if premiums are not paid as scheduled, requiring a long-term commitment to keep the policy in force, and cash value access in the form of policy loans and surrenders to basis may generally be less liquid in comparison to cash and cash equivalents.

Equities have generally provided robust growth over the long term, but they are subject to greater risk and volatility. Dividends paid on equities 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 recommends a movement toward more fixed income to provide greater stability and reduce risk and volatility. Lastly, whole life cash value accumulation can cushion negative performance periods in an overall portfolio. Rather than compounding investment losses with retirement-income-related withdrawals, a policy owner can shift and access the life insurance policy cash value and possibly cushion the decline in portfolio value. For example, if retirement income is taken from an equity position during a sharp downturn, those losses are locked in, with no ability to recover gains on such principal during a recovery. Cash values can therefore provide strategic liquidity on an as-needed basis.

Whole life cash value generally has similar characteristics to the fixed-income component of a portfolio. As a result, the accumulation within whole life can help transition one's asset allocation gradually toward fixed income, without sacrificing the growth opportunities inherent in equities. In contrast to taxable fixed income, however, cash value accumulates tax free and can be accessed in a tax-preferred fashion, as long as the policy is managed to avoid overfunding it. The guarantees within the contract provide a floor on the policy value and ensure that death benefit coverage will remain in force. Death benefit coverage typically increases alongside cash value and is generally income tax free when paid to your beneficiaries.



On a final note.

Fundamentally, individuals should know that life insurance is neither a commodity nor a pure insurance product. For too many people, though, it is viewed that way. As a result, many will be left with a term insurance outlay that offers peace of mind (for a while), but none of the other benefits of whole life. For those able to take advantage of the benefits and able to make the long-term commitment to keeping a whole life policy in force, however, the insurance protection wrapper can act as a gateway to a more tax-efficient and less volatile portfolio, while providing peace of mind—for life.

About the author.



Matt Pate is the head of Nautilus Plus at the Nautilus Group, a division of the New York Life Insurance Company serving the complex planning needs of New York Life's top select advisors and their high-net-worth clients. Matt has extensive experience in sophisticated estate planning, business succession, closely held businesses, life insurance, asset protection, and charitable planning techniques. Matt received his undergraduate degree from Georgetown University, then obtained his JD from the University of Texas School of Law and his LLM from SMU. Matt lives in Dallas with his wife, Catherine, and their children, Presley, George, and Sam.

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