FAQs - Starting a New Career, Early to Mid Career, Ready to Retire

Life Insurance

My favorite saying when it comes to life insurance is: Wives don't believe in life insurance; widows sure do.

At some point in almost every interview I conduct with a husband and wife, one of them will make a statement that sounds something like: "I don't believe in life insurance." What the respondent really means is that they do not enjoy paying for life insurance. It is as if they are embarrassed to admit they do not want to pay for something they know they really need. Instead of telling the truth, they make a statement about faith, or in this case, a lack thereof: "I don't believe in life insurance."

Well, let's just state the obvious here: you will die. Given then that the odds are one to one that you will have the opportunity to collect on your life insurance policy, why would you not have one? In the case of auto insurance and homeowners' insurance, the odds of actually collecting on either of those is significantly less than "one in one", yet virtually everyone owns these types of insurance.

First and foremost, know this about insurance: insurance is the difference between a real plan and a bet. Without it, you are betting nothing bad is going to happen – and I'll bet your life experience tells you that is not so. If something bad does happen, insurance is the only instrument that guarantees a predictable and manageable financial outcome.

The simplest way to begin thinking about life insurance is to attempt to answer this question: If you died yesterday, what would you need your insurance to do for your family today? More specifically, who is going to need money right away? For what purpose will they need it? Who will pay next month's mortgage? How will your spouse educate your children? Will your business survive without your economic contributions? Should your partner buy out your spouse? The questions are endless, and your answers to them are very important.

Whenever you are evaluating life insurance, the most important aspect to define is how much insurance you need. Crude as this may sound, if your friends are huddled over your casket at your viewing, I guarantee not one of them is saying: "I wonder what kind of life insurance he had....I wonder what company it was with." Trust me, they are not asking that question. They're asking this question: How much insurance did he have?

I have just tried to bluntly hit you over the head with a large two by four. In case I missed, let me reiterate. How much insurance coverage you have is far more important than what kind you have. Once that is determined, the other details are easily worked out. What kind? How long should the coverage last? What company, etc.? These are the essential elements of any productive discussion about insurance with your financial advisor.

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After some discussion, most people will concur that we should determine how much insurance they should have.

I get very little push-back on this point. But when we actually do the calculations, most people are floored to find out how much insurance they really should have. They fail to recognize the true economic value of their own worth.

For example, assume you are 40 years old, and you make $80,000 a year. Assume you get run over by a bus tomorrow. If you would have worked to age 65, you would have brought home $2,000,000 in earnings during your remaining 25 years of work. That's even with assuming you never got a raise! In truth, your remaining lifetime earnings would likely have reached over $4M. How many 40-year-olds do you know who have insured themselves for $4M? Not very many.

People underestimate their true economic value when it comes to life insurance. I suppose it has to do with not wanting to contemplate what it costs to buy $4M of life insurance (which is actually a lot less than you might think for a healthy 40-year-old). But I also think that most people don't feel like contemplating their own demise. "I feel fine. Who needs life insurance?"

The only flaw in that thinking is this: if you are in perfect health now, can you get better or worse? Will your health improve or go downhill from today? When are you most likely to get insurance at the best rate? When you are at your peak of health and fitness, is your health going to continue upward or might it be on the downslide? The irony is that people are less likely to buy insurance when they are in fact at the absolute best place and time in their lives to buy it.

Unfortunately, insurance is a lot like a parachute. Once you realize you will need it, it's too late to get it. If you are already out of the plane and free falling, there's no chance to reach up into the overhead bin and grab a parachute. You either have it on or you don't. My point is this: buy the insurance when you know you need it and buy it when you are best able to purchase it at a favorable price.

I will not go into a lengthy discussion on the different kinds of life insurance. In general, life insurance comes in two basic flavors: term or permanent. Term insurance is like renting. You have the least cost of ownership and no commitment to equity. You pay for it as you need it and it ends at a particular time (the term). Use-it-or-lose-it is the basic format.

Permanent insurance is more expensive initially, but it provides additional benefits that may include tax favored accumulation, investment management, flexible premium payments, tax-free growth of equity that may continue to purchase the protection even after you stop paying, and unlimited death benefit. Regardless of whether it is term or permanent, almost all insurance proceeds are paid income tax-free.

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One aspect of life insurance ownership that is frequently misunderstood or overlooked entirely is whether the life insurance is coordinated with one's estate plan.

One jaw dropping question I often ask is: Did you purposely name the IRS as primary beneficiary?

The obvious answer is "no." Who would name the IRS as their beneficiary? No one would on purpose, but frequently, we find that folks do not fully understand the ramifications of ownership and beneficiary arrangements when it comes to their life insurance policies. Even people of sound mind and body inadvertently allow large portions of their life insurance benefits to get eaten up by income and estate taxes. With proper planning, however, there is very little possibility that this will happen.

How much will it cost? Several variables go into the cost calculation for life insurance. The overarching issue will be your life expectancy. Clearly, age plays a role as does one's medical history. When you buy term insurance, you are essentially making a bet that you will die in that year. The life insurance company is betting that you will not die.

Thus, the cost is predicated on the risk that you will die that year. The older you are and the worse your health, the more expensive the coverage will be. Conversely, the younger and healthier you are, the cheaper the coverage will be. Each year, you and the insurance company will decide if you want to play this high stakes gambling game again. If you want to play, you pay your premium.

Because term insurance costs more as you age, many companies have begun to offer "level" term coverage. Instead of starting at a low rate and having the rate rise over time, the "level" term policy will average out the cost over the 10, 20, or 30 year term of the policy. The "level" rate does not change year by year. As an example, a $1,000,000 20-year level term policy for a healthy, non-smoker, male is about $1,000 per year. If you are a similarly situated female, you will pay about 15-20% less because women generally live longer. If you are a smoker, you will pay an extra 20-50% simply because of the health risks associated with tobacco use.

In the case of permanent insurance, like "whole life" or "universal life," the basic cost will still be predicated on age, health, and obviously how much coverage you want. On top of this though will be an "equity" portion, or investment component, of the premium. For example, the $1M policy from the above example would continue to have the basic term cost of $1,000 per year, but the full premium on a whole life or universal life" policy with the same death benefit would require a premium of $4,000 to $20,000 in addition, depending on the insurance company. Obviously, the more equity you wish to build and the sooner you would like the policy to be self-sustaining, the higher the initial premium will be.

But why build equity in a life insurance policy in the first place? If we already know that term insurance is less costly year to year than whole life or universal life, and if we know that life insurance is not a good investment, why would you want to build equity in a life insurance product?

The most obvious reason is to defray the long-term cost of insurance if the coverage is meant to be permanent rather than temporary. Recall that term insurance is cheaper because it only covers you for a set period of time, whereas permanent coverage, like whole life or universal life, is meant to cover you for your entire life, no matter how long you live.

We already know that the cost to insure you against death is obviously much higher when you are 80 years old than when you are 30 years old. Suppose you wanted to make sure your family received $4M at your demise. Buying term insurance at age 30 would likely be the better use of money – first, because the cost of insurance at that age is relatively low, and second, most 30-year-olds don't have a lot of disposable income to "contribute" to the equity portion of a $4M policy. However, by age 80, the cost to buy $4M of insurance – term or any other kind – would be astronomical.

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The concept behind permanent insurance is very similar to a mortgage.

In a 30-year mortgage, the early payments are almost all repayments of interest with only a small fraction paying off the indebtedness. However, over time, the amount borrowed decreases, which in turn decreases the amount of interest that must be paid each month. As this occurs, more and more of each monthly payment goes toward the principal borrowed and less goes to interest. This process continues in an orderly fashion until the final payment is almost all principal and only a tiny sliver is interest. By the end of this process, you have built equity in the ownership of your home.

We can also apply this idea to the understanding of permanent life insurance. Think of the premium payment as the mortgage payment and the amount borrowed as the total amount of life insurance. The premium payment is split into the cost of buying the insurance coverage each month (interest in our mortgage scenario) and into the equity (principal repayment). The idea is that over time, part of each premium payment buys the insurance in case you die during that month, and the other part of the premium goes into building equity or "cash value" in insurance-speak.

The upshot of this mechanism is that over time, you make the same premium payment, but more and more goes toward building equity and less and less goes toward buying insurance. It may sound odd, but it's true. If the policy is for $4M, your first premium is buying $4M insurance. However, your 300th premium payment may be buying only $2.1M of insurance since the equity built by that time would be $1.9M. The ultimate payout of your policy is still $4M – the amount of insurance ($2.1M) plus the return of your equity ($1.9M).

On the surface, this may not seem like a very compelling reason to own permanent insurance. Most people who need $4M of insurance at age 30 rarely need it at age 80. So what's the real value of building equity in a life policy? Part of the appeal is that permanent insurance is a "forced savings" vehicle. It obligates you to set aside funds every month (or every year) for your future, the same way a mortgage payment does. It's not always enjoyable setting aside these funds every month while you are starting out in life, but I have yet to meet anyone who gets to age 60 or 70 and says, "I wish I hadn't bought a house or a permanent life policy."

The buildup of wealth over time, due to the "forced" monthly savings started at a young age, can be significant. Equity in life insurance products has the added benefit of favorable tax treatment. Earnings are tax deferred until withdrawal, similar to IRAs. If withdrawn before age 59 ½, the funds are subject to income tax and a 10% penalty. If taken after that time, then they are simply taxed as ordinary income. Unlike IRAs, funds from life insurance policies can be borrowed on, usually at favorable rates and the proceeds are normally tax-free. Sophisticated use of these attributes is quite complicated and beyond the scope of this section. I suggest consulting a Certified Life Underwriter (CLU) for complicated insurance issues.