8 Reasons to Avoid Whole Life Insurance

[A Note From The Author: This is the most visited post on this blog. If this is your first time here, welcome! This post has generated more hate mail and hate comments than all of my other ones combined. There are over 850 comments on it, which may take you over 4 hours to read. However, after two years of arguing with whole life insurance salesmen in the comments section of this post, I did a series of posts called Debunking The Myths Of Whole Life Insurance that quite frankly is better written than this post. I suggest you read that series instead of this post as it includes all the useful information in this post as well as in the lengthy comments below it. Since there are already 850 comments on this post, if you sell whole life insurance, don't bother leaving a comment on this post. Just send me an email telling me how big of an idiot I am. Please put "Whole Life Insurance is Awesome!" in the title so I'll know to delete it without opening it.]

Whole life insurance has been a pillar of income to life insurance salesmen for years. It is often recommended, particularly to high earners, as a guaranteed investment with some wonderful tax benefits. Alas, its flaws generally outweigh its advantages. Here's why:

Cons of Whole Life Insurance:

1) Whole Life Insurance Costs Too Much.

When a whole life insurance policy is sold (and they're always sold, never bought), the buyer and seller generally focus on the investment portion of the policy, not the insurance policy. The silly buyer just naturally assumes he's getting the insurance portion at the going rate (such as what he would pay for term insurance.) Fool. Like any business, they charge what they can get away with. If you're not paying attention, you'd better believe the price gets jacked up. A bigger problem is that young people can't afford enough whole life insurance to cover their actual need for insurance, so they end up buying a separate term policy anyway, or worse, they don't and walk around under-insured.

2) The Fees are Too High.

You don't pay the fees directly, but you do pay them with lower returns. For example, the commission on a whole life insurance policy is generally 100% of the first year's premiums then 6% of premiums every year after that. That's money that doesn't get invested on your behalf. By comparison, the commission on a term policy is about 50% of the first year's premiums, then 4% of premiums after that. It's pretty easy to see what the financial incentive is. Sell whole life instead of term, and upgrade the policy at every opportunity. 100% of a new policy is far better than 6% of an old one. "But you don't pay the commissions, the company does" argues the salesman. Where do you suppose the company gets the money from?

3) You Don't Need a Middleman for Your Investments.

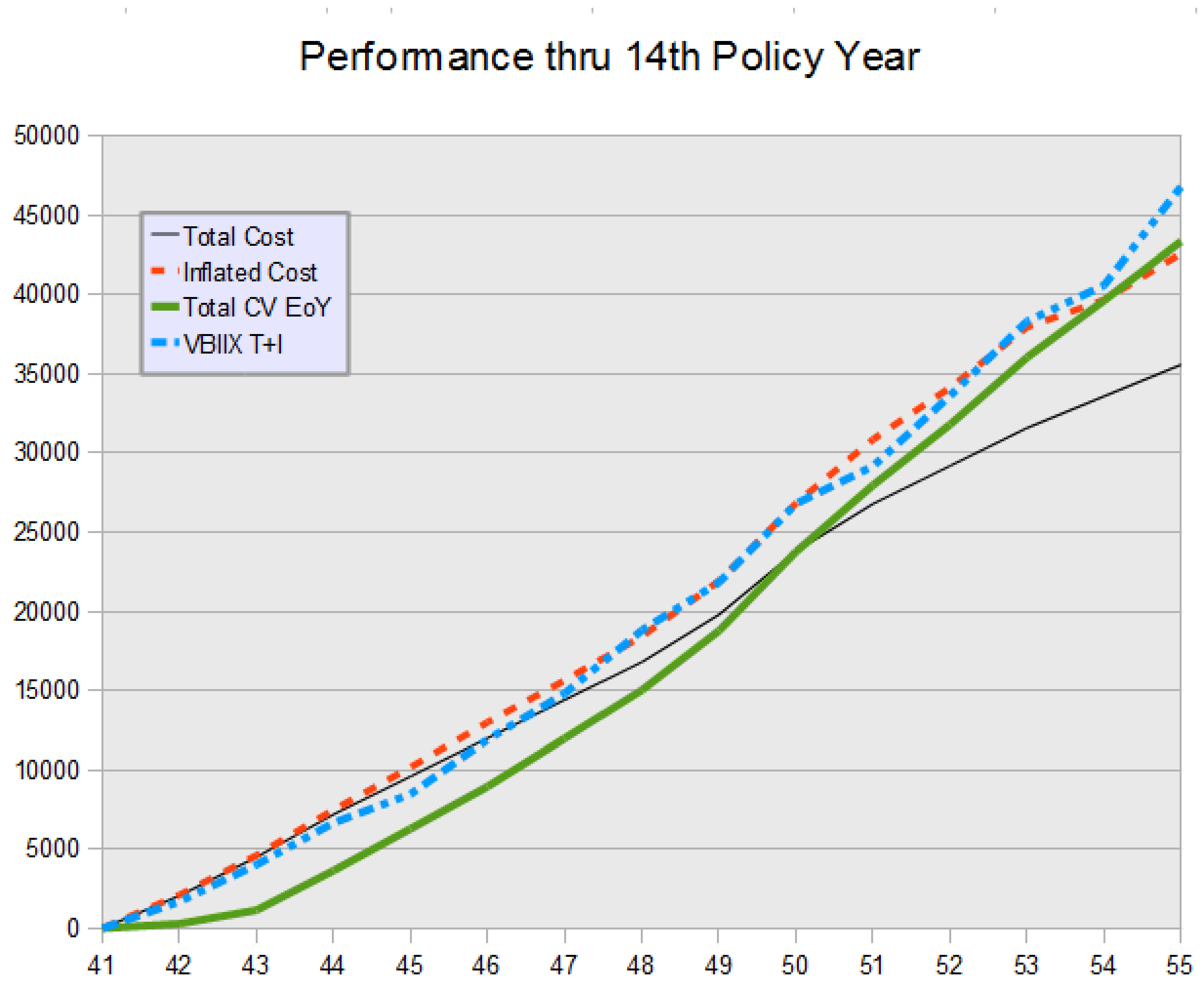
Consider what the insurance company does. It takes your premium each month, pockets its profit, puts a certain percentage of the premium into a pool to pay the benefits of those who die, and then invests the rest in a relatively conservative portfolio, such as bonds. You can invest in bonds directly. Which return do you expect to be higher- the one where they shave off some profit before investing, or the one where you invest your entire lump sum? It's like buying a load mutual fund. In fact, some cash value life insurance policies actually DO HAVE A LOAD. Can you imagine? Not only do you have to pay for an expensive insurance portion, you then have to pay just for the privilege of investing your money with them.

4) Complexity Favors the Issuer.

After a while, people figured out that whole life insurance was a rip-off. So to disguise that fact, the companies just made the products so complex that only their actuaries could figure them out. Even those who have spent a great deal of time trying to figure these policies out don't understand them. Even the guys selling them don't completely understand them, but you better believe they understand the commission structure. Suffice to say, the more complex it gets, the worse a deal it is for you.

5) Even When it Works Out Okay, it Takes a Long, Long Time to do So.

Most whole life policies, if you hold them long enough, actually have an okay return. The returns often even beat inflation. Unfortunately, that usually doesn't happen for a while. Take a look at this chart of the actual returns of a policy:



This chart, from the Visible Policy (great site by the way) illustrates 4 lines demonstrating the actual performance of the site author's whole life policy. The solid green line is the cash value of the policy. The thin line is the total of the premiums paid into the policy. The reddish-orange dashed line is the effect of inflation on out of pocket dollars, or the real total of the premiums paid into the policy. The blue dotted line is the total cash value of an investor who bought a cheap term policy, and then invested the difference between the whole life insurance and term life insurance into a good bond fund. The left axis is in dollars, the bottom indicates the policy holder's age.

There are several things to notice. First, it took this particular policy owner 8 years just to break even, 12 if you actually consider inflation. 12 years is a long time to have a negative return. This was particularly true for me. The policy I once owned was still in the red after 7 years when I cashed it out after realizing the error of my ways. It should be noted that this policy owner has done all he could to minimize the effects of the fees. He bought a good size policy ($100K), he pays annually instead of monthly, and he bought it from a mutual life insurance company. And still, after 14 years in the policy, he is barely beating the total of the inflation-adjusted premiums and cannot even keep up with the guy who bought term and invested the difference in lowly bonds. I'm a pretty patient guy, but that's a long time.

Now, these policies eventually do give you an okay return after 30-40 years, especially when considering that the proceeds are tax-free. Unfortunately, almost no one sticks with them that long. But if you've had one for many years (say, more than 10), think twice before cashing it in.

6) Your Return Will be Much Closer to the Guaranteed Amount Than the Projected Amount.

When you are shown an illustration, they always show you the projected amount, but you don't ever get that. There may or may not be a chart of the guaranteed amount, which will be significantly lower. But you ought to pay far more attention to that, since the company has just about zero incentive to pay you any more than the guaranteed amount. In my limited experience, I barely made more than the guaranteed amount and didn't get anywhere close to the projected amount.

7) You are Not Adequately Paid for the Loss of Liquidity.

Stocks, bonds, and mutual funds can generally be cashed out any day the market is open. You can change investments or use the money for living expenses without much hassle. There are only two ways to get money out of a whole life insurance policy. The first is to surrender the policy. Since your returns don't even start becoming decent until after the first decade or so, it doesn't make sense to be surrendering policies frequently. That just enriches the salesman and the company at your expense. The second way to get to your money is to borrow it from the policy. This has a few issues. First, borrowed money is no longer available to your heirs as part of your death benefit. Second, just because it's your money you're borrowing doesn't mean the interest you're paying on that money goes to you like with a 401K. Some of it usually does, but not all of it. Lastly, in some complex cash-value policies, borrowing too much can actually require you to have to put more in each year to keep the policy in force. Heaven forbid the policy collapses on you and then you have to pay back all the money you've borrowed. Not a good thing when you're obviously short of cash (or else why would you be borrowing the cash value in the first place.) The buyer of a whole life insurance policy should be well paid for giving up this liquidity. Unfortunately, he is not. In fact, he won't even perform as well as an all-bond portfolio.

8) You Probably Don't Need the Income Tax or Estate Tax Benefits.

Insurance salesmen are quick to point out that since loans from your insurance policy are tax-free they're somehow better than 401K or IRA money. Never mind that you paid all those premiums with after-tax dollars. The proceeds should be free! The death benefit is also tax-free, which provides a way to avoid estate taxes for wealthy people. Of course, under current law, a couple doesn't even start paying estate taxes until $10 Million, a sum most doctors won't reach. And if you start getting close, there are other things that can be done, such as trusts and gifts to reduce the size of the estate. You could even, heaven forbid, spend the money on something fun or give it away to charity.

Pros of Whole Life Insurance

Now, I can think of a few reasons why whole life may be beneficial to you. Here are four:

1) You Don't Have the Discipline to Save Enough Money.

The idea behind buying term and investing the difference is that you actually invest the difference and then at a certain point are wealthy enough to self-insure against your death. If you can't do that, or don't want to, then you might be better off buying whole life insurance. Like a mortgage forces you to accumulate equity, a whole life insurance policy forces you to accumulate cash value. It might not be at a very good rate, but at least it accumulates. Many people don't save any money. Many of those who do bounce around from investment to investment, trying to time the market unsuccessfully. You're better off slightly under-performing a bond portfolio long term than dramatically under-performing a bond portfolio by being a crappy investor.

2) You Like Guarantees.

A whole life insurance product has a guaranteed return, no matter what happens in the markets. That guarantee is worth something. Probably not as much as you're paying for it, but it's worth something. If the next 30 years looks like the 2000s in the markets, those who bought a big fat life insurance policy instead of investing in stocks and bonds might have the last laugh.

3) You Have Already Been in a Policy for a Long Time.

As mentioned previously, after a decade or two, remaining in a whole life policy can actually be a good idea. The commissions and fees are water under the bridge now, so you might as well take what you can get. Especially in an era of low interest rates like now.

4) You Have a Need for Permanent Insurance, Especially as Part of an Estate or Business Plan.

Many undersavers have a need for permanent life insurance because they never become financially independent and have someone depending on them, such as a disabled child, even in their later years. If your child or spouse is dependent on your social security or pension payments, you'd better have a policy in place to protect that income stream. Most of the time, your spouse will get at least 50% of your benefits, so that doesn't become a big issue. If you save adequately, you can provide for a disabled child's future using your savings instead of life insurance proceeds.

More commonly, a wealthy person might have an illiquid asset, such as a farm, some rental properties, or a business. When that person dies, the asset may have to be liquidated rapidly at an unfavorable price to pay out the will proceeds or perhaps even pay the estate taxes. The death benefit of a whole life insurance policy can cover those costs. A partnership might also buy a whole life insurance policy on each of the partners so that in the event of death, the proceeds of the policy can be used to buy out the heirs of the deceased, avoiding turbulence in or even failure of the business. A term life insurance policy can often be used for these purposes, but not always.

There you go, 8 reasons to avoid it, and 4 to consider it. Try to resist the urge to leave yet another comment on this post. I know it’s hard, but you can do it.