A Whole Life Insurance Success Story – The Friday Q&A Series

Some of the most popular posts on this blog are about whole life insurance (WL). For better or for worse, nearly every reader of this blog is approached by an insurance agent recommending whole life insurance at some point in his life. I generally recommend you don't mix insurance and investing. Most people don't need a permanent death benefit and should buy a 20-30 year level premium term insurance policy. Those few who do need (or desire) a permanent death benefit should get a type of universal life insurance policy called a guaranteed no-lapse policy. Those buying a whole life insurance policy at this time should expect a return of 2-5% over the long run, with a negative return for the first 10-20 years.

The Question

I recently had an email correspondence with a reader who had read through the posts on the blog about WL. He calculated out his return on his whole life policy and found it to be 7% after just 29 years. His initial email was asking me to show him where his error was because he was sure after what he had read that his return couldn't really be 7%. I quickly confirmed that, indeed, his return was 7%. He then said he wished he'd put more money into his life insurance policy instead of into the stock market, as his stock market return was closer to 3%. At this point, I figured we'd better get into the details to explain how this might be. As you might expect, he was comparing apples and oranges.

The Details

The Northwestern Mutual Whole Life policy was purchased in April 1983. A student of US financial history will recall that the early 1980s were a period of very high interest rates, and that market returns for both stocks and bonds were absolutely spectacular over the next ~20 years for stocks and ~ 30 years for bonds. He was comparing the return he got on the WL with a stock market investment that he made in mid 2000. Again, the student of financial history will recall that 2000 was the height of the tech stock bubble, and a particularly bad time to purchase stocks.

In order to compare apples to apples, you'd need to compare that whole life insurance policy with investments available in April 1983. So what was available then? Well, you could purchase a 30 year treasury that month with a yield of 10.48%, over 3% better than the return he earned. Even better, he could have sold that treasury at any point in the next 30 years at quite a premium. It's relatively easy to see what kinds of returns stocks and bonds have made over the last 29 years. Just to keep it easy, let's look at the Vanguard 500 fund and the Vanguard Long-Term Treasuries fund returns since inception (1976 for the 500 fund and 1986 for the treasuries fund.) Their returns were 10.51% and 8.6% respectively. I'd argue that if you used 1983 as a start date, the returns would be even higher, since treasury yields from 1983 to 1986 fell from 10.5% to 7.50 and the S&P 500 had returns of 22%, 6%, 31%, and 19% from 1983 to 1986.

So you could have invested in ANY combination of stocks and bonds in 1983 and had a better return than the whole life policy, by at least 1.5%. This isn't surprising when you consider what an insurance company does. It takes your money, pays the commissions, pays its business expenses including the insurance component, pays its profits (unless it's a mutual company), and then invests the rest. Since it doesn't have any magic investments, it can't get any better return than you can get without the insurance company, therefore your return MUST be less than what is available in the markets over the years the policy is in effect. It’s a mathematical certainty.

I also found it interesting to look at the original policy projections from 1983. He bought the policy at age 20, and at age 60, the policy guaranteed him a cash value of $23,548, after 40 payments of $514. I thought that was pretty pathetic, a return of 0.65%, way below inflation. NML certainly wasn’t taking much risk with this policy. The projected return was much higher, of course, projecting a cash value of $145,978 and a return of 8.06% by the time he hit age 60. After 29 years he isn’t getting the 8% return that was projected, but he’s doing a lot better than the guaranteed return!

A Success Story

All told, I consider this a success story compared to the experience of most investors in whole life. He did just a few things right (used the dividends to buy paid up additions, paid his premiums annually rather than monthly, didn’t cash out for nearly 3 decades, and kept the amount of insurance purchased relatively small to ensure he could afford to make the premiums) and thus has earned a return that is at least 3% better than inflation. Could he have done better just investing in the markets? Sure. But it certainly wasn’t an investing disaster. The reader expressed a desire to have bought a $500K policy instead of a $50K policy. While I agree he would be better off with a $500K policy than a $50K policy, he would have been even better off just buying a 30 year treasury every year for the next 29 years instead of buying any policy at all.

Keep in mind that buying whole life insurance today may yield a very different experience than that had by this investor, especially given current interest rates. I looked at a recent policy for a 30 year old. It guaranteed a return of 2.18%

after 29 years and projected a return of 4.81%. That doesn’t seem like much of a reward for tying up your money for 3 decades. Permanent life insurance is still unattractive when compared to a reasonable portfolio of stock and bond index funds unless you either need or desire a permanent death benefit, especially if you aren’t already maximizing your available retirement accounts. It is most reasonable as an investment for money you plan to leave to your heirs, although even then, it fails to outperform typical stock/bond portfolios.