Debunking The Myths Of Whole Life Insurance

There are more than 400,000 insurance agents in this country, and almost all of them would love to sell you a whole life insurance policy. If you buy a policy with premiums of $40,000 per year, the commission would typically be somewhere between $20,000 and $44,000 for that agent. As you might imagine, that commission can be highly motivating, especially given the median insurance agent income of $47,000. To make matters worse, many of the worst policies offer the highest commissions. As a result of this ridiculous conflict of interest, agents can often throw out some serious myths in an effort to persuade you to buy their product, which might explain the damning statistic that 80%+ of those who buy this product get rid of it prior to death. Perhaps that is why Dave Ramsey calls it the “Pay Day Loan of The Middle Class.”

Intro To Whole Life Insurance

First, a little about how whole life insurance works. This product can be set up in many different ways, but in general you pay a monthly or annual premium for either a defined period of time, or until you die. The longer the period of
time over which you pay the premiums, the lower the premiums. Whenever you die, your beneficiary gets the proceeds of the policy. Since every whole life policy is guaranteed to pay out if you just hold on to it to your death, the premiums are much higher than a comparable term life insurance policy. A whole life insurance policy, like other types of permanent life insurance, is really a hybrid of insurance and investment. The policy accumulates cash value as the years go by.

That cash value grows in a tax-protected manner, and you can even borrow the money in there tax-free (but not interest-free.) Upon your death, whatever you borrowed (plus the interest) is taken out of the death benefit, and the rest is paid to your beneficiary. (You get the cash value or the death benefit, not both.) This investment aspect allows those who sell this product to find all kinds of creative reasons you should buy it and creative ways to structure it. The most extreme advocates may even argue that you don’t need ANY other financial products during your entire life since whole life insurance can apparently take care of all your needs including mortgages, consumer loans, insurance, investments, college savings, and retirement. The problem is that for every use of whole life insurance, there is usually a better way to deal with that financial issue. In this lengthy post, I’ll address 18 frequent myths about whole life insurance propagated by its advocates.

**Myth # 1 Whole Life Is Great For Pre-Retirement Income Protection**

Whole life insurance is not the best way to protect your income, term life insurance is. Before you retire, you can purchase inexpensive term life insurance to take care of your loved ones in the event of your untimely death. A 30 year level premium term life insurance policy with a $1 Million
face value bought on a healthy 30 year old runs $680 per year. A similar whole life policy will cost more than 10 times as much, $8-10,000 per year. That is money that cannot be spent on mortgage payments or vacations, nor invested for retirement.

Myth # 2 Whole Life Is The Best Way To Get A Permanent Death Benefit

Whole life isn’t the best way to get a permanent death benefit, guaranteed no-lapse universal life is. There are a select few people who need or want an insurance policy that will pay out at their death, whenever that may be. This can be useful for some unusual estate planning issues. However, there is a better product that provides this and is much less expensive than whole life insurance. It is called Guaranteed No-Lapse Universal Life Insurance. It does NOT accumulate any cash value, but simply provides a life-long death benefit. It only costs half as much as whole life insurance, so you won’t be surprised to learn that the agent’s commission on this sale will be far lower. Call me cynical, but I suspect that might be one of the reasons you’ve never heard of it. Whole life insurance provides a guaranteed death benefit that is PROJECTED (but not guaranteed) to grow slowly so that if you die at your life expectancy or later you’ll leave behind a
little more than the original policy death benefit.

A whole life policy I looked at recently projected the death benefit of a $1 Million policy, bought at 30, would be $3.17 Million at death at age 83. That sounds great, almost like an inflation protection of the death benefit. Except historical inflation is something like 3.1%. At 3.1%, $1 Million now would be the equivalent of $5.04 Million in 53 years. A whole life policy would be devastated by unexpected inflation, since the dividends are backed primarily by nominal bonds, whose values would be murdered in a high inflation environment. Therefore whole life insurance is neither the best way to provide a guaranteed life-long nominal death benefit, nor a guaranteed life-long real death benefit. So what is it good for? How about a guaranteed death benefit that might increase if the insurance company feels like increasing it? Would you be willing to pay premiums that are twice as high for that? I didn’t think so.

**Myth # 3 Whole Life Provides A Great Investment Return**

Whole life isn’t the best way to invest, traditional investments are. When you pay your whole life premiums part of the money goes toward buying insurance, part of it goes toward overhead and profit for the insurance company, and part of it goes toward the commission for the salesman. The rest then goes into the cash value portion of the policy. Each year, the insurance company declares a dividend, and if there is $10,000 in the cash value portion and the dividend is 6%, then $600 gets credited to your cash value. The dividend is only applied to the cash value, not the entire premium paid, so the average dividend rate is in no way, shape, or form related to your actual return on the policy as an investment. In fact, the return on investment is generally negative for at
least a decade. I recently analyzed a policy for a healthy 30 year old male with a 53 year life expectancy. The guaranteed return on the cash value was less than 2% per year AFTER 5 DECADES. Even if you use the insurance company’s optimistic “projected” values, you’re still looking at a return of less than 5%. In reality, you’ll probably end up with a return of 3-4%. Considering you have to hold on to this “investment” for 5 decades, that doesn’t seem like much compensation. If you have decades to invest, it is far wiser to take more risk with your investments and earn a higher return. An investment in stocks or real estate is likely to provide a return over decades in the 7-12% range. $100,000 invested for 50 years at 3% per year will grow into $438K. If it grows at 9% instead, you’ll end up with $7.4 Million, or 17 times as much money. The rate at which you compound your long-term investments matters, especially over long periods of time.

Myth # 4 Insurance Companies Are Great Investors

Some agents believe that insurance companies can somehow get investment returns that you or I cannot find elsewhere and pass those great returns on to their policy owners. It can be illuminating to look under the hood and see what is really in the portfolio of an insurance company. In 2010, insurance company assets were invested 70% in bonds (almost all in run-of-the-mill corporate and treasury bonds), 1% in preferred stock, 10% in common stock, 6% in mortgages, 1% in real estate, 4% in cash, 3% in loans to their policy owners, and about 5% in “other.” Thanks to the index fund revolution, an individual investor can buy nearly all that stuff for less than 10 basis points per year in expenses. Active management doesn’t work any better for insurance companies than for mutual funds.
As you might expect, the returns on a portfolio composed primarily of treasury bonds (currently yielding 1-2%) and corporate bonds (currently yielding 3-4%) aren’t particularly high. So where do dividends come from? Part comes from the return on the investment portfolio, part comes from the fees of those who surrendered their policies, and part comes from “mortality credits,” which is basically money they didn’t have to pay out to beneficiaries because fewer people died than they planned for (i.e. you paid too much for the insurance portion of the policy in the first place due to state regulations.) There are no magic investments that insurance companies can invest in that you cannot without the company. Every additional layer between you and the investment just increases expenses and lowers returns.

Tomorrow we’ll talk about 5 more of the myths of whole life insurance, but for now, let’s talk about these four. Agree? Disagree? Comment below! Please reference which “myth” you’re referring to in your comment and keep comments civil and on topic. Ad hominem attacks will be deleted.

Check out the other 5 parts of this series:

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