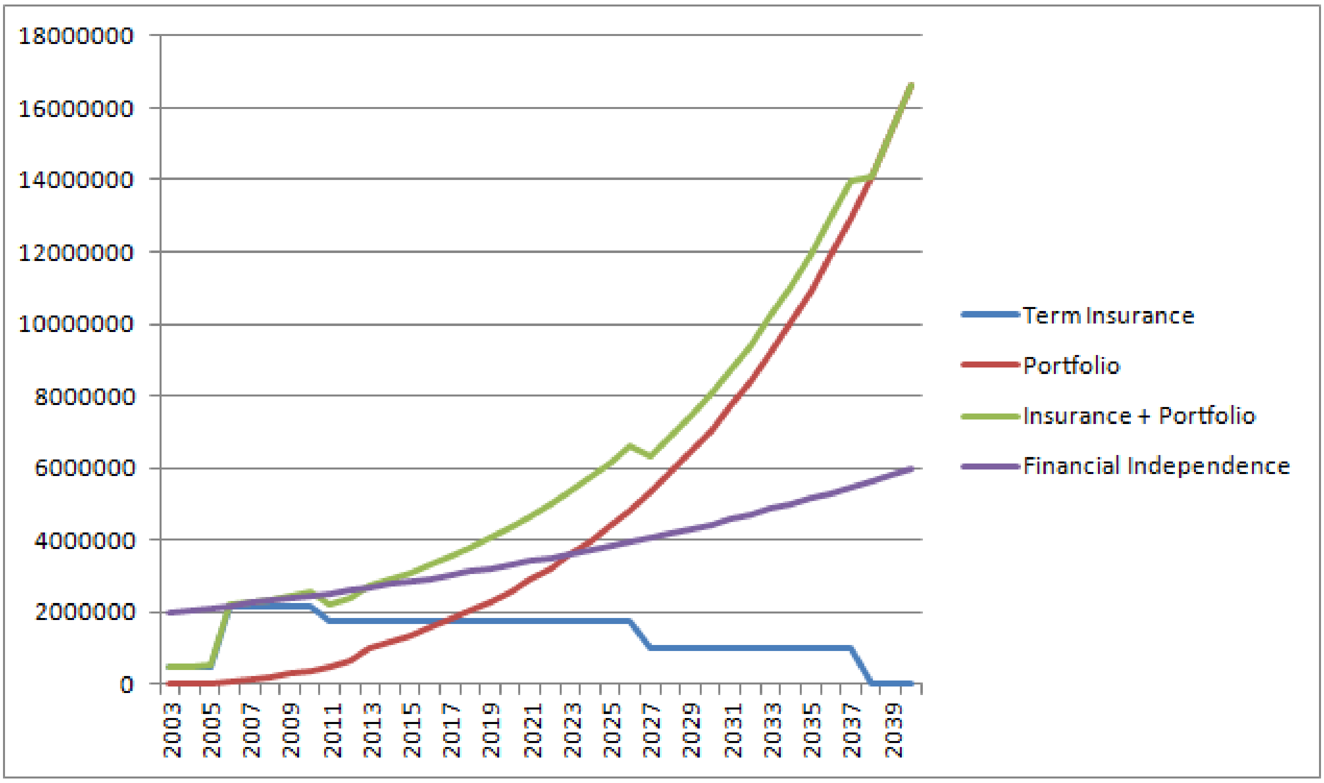
How Buy Term And Invest The Rest Really Works

It seems that a number of readers and especially whole life insurance salesmen don't seem to get how the concept of buying term and investing the rest actually works. I thought I would make a chart, using some of my own data, as well as some projections into the future, that would demonstrate the concept.



In the chart above, there are four lines. The purple line, labeled Financial Independence, is the amount of money I would need to never work again. It is the equivalent of $2 Million in 2003 dollars. Notice that by 2020, that's something like $3.3 Million due to the effects of 3% per year inflation (although from 2003-2014, inflation, measured by the CPI-U, has been well below that.)

The blue line is the amount of term life insurance I have carried and anticipate carrying over the next couple of decades. Note that in the first few years, that line overlaps the green line, NOT the purple line.

The red line is the size of my retirement portfolio (actually net worth, since the vast majority of my calculated net worth is my retirement portfolio.) It uses actual numbers up until 2014, then I apply an 8% nominal growth rate to it and add $100K to it each year for new contributions.

The green line is the sum of the portfolio and the insurance.

Some Observations

There are a few things worth noting here. Notice that there was a period of a few years at the very beginning of the chart where the green line was much less than the purple line. This was when I was underinsured as a resident. That was due to two factors- first, my own ignorance of how much insurance I ought to be carrying, and second, the fact that I couldn't afford to buy as much as I needed (somewhat related to the fact that I was doing a lot of climbing at the time.)

Now, notice the step-offs in the blue insurance line. I'm gradually decreasing the amount of life insurance I'm carrying. When I was in the military, I had three policies, including the 20 year $750K level term with USAA and the 30 year $1M level term with Metlife that I still have. In addition, I had a $400K SGLI policy. When I left the military, I opted not to continue that, since I had a portfolio that was essentially making up for that. I no longer needed that insurance. So I dropped it. In 2026 or so, my 20 year level term will expire. Big deal? Nope. I'll probably drop it before then since the red line will cross the purple line all by itself several years before that. Finally, the 30 year level term policy will expire in 2037. That's the back-up plan. I anticipate dropping that long before 2037.

If I decide to keep working hard and saving hard until I'm 65, well, I'm going to retire pretty darn comfortably on that $17M.

Portfolio + Insurance = Financial Independence

The most important concept here is that when added to your portfolio, your term insurance needs to be enough money that you/your family would be financially independent. Money is fungible and it all spends the same. If your portfolio by itself equals financial independence, you don't need any insurance. Thus the reason that retirees shouldn't need any life insurance and thus the reason that buying a permanent insurance policy means you're buying life insurance for periods of time in your life when you don't need it. It also just so happens that those periods are also the time when the insurance is most expensive!

The most important point on this graph occurs when the red line crosses the purple line in 2022, when I'm 47 years old. That's when I reach financial independence and can retire if I so desire. That doesn't mean I will. Everyone likes a cushion, and perhaps when I'm 47 I'll be thinking I want a cushier retirement than I thought I might need when I was 30. But basically, at that point I can cancel my life and disability insurance and quit work. I don’t need to pay for those insurances for the rest of my life, freeing up about $4K in after-tax income each year.

Now, these numbers may not work for you. You might want more or less in retirement. You might have a smaller or a larger portfolio. You might not be able to save as much each year as I do. But it is probably a worthwhile exercise for you to plot out something similar for your situation, using some reasonable assumptions. You may find that not only do you not need permanent life insurance, you might not even need a 20 year term.

What do you think? When do you expect your portfolio to hit your “number?” At what point will you cancel your term life and disability insurance? Comment below!