Common Myths About Cash Value Life Insurance

The necessity of life insurance today is based around the idea of a family with one or both spouses working outside of the home, and that if one of them dies, the other will be left with financial obligations that will not be able to be met. Most advisers agree that life insurance is supposed to fill that gap.

But, this is where the consensus ends (sadly). Most every financial professional recognizes the importance of life insurance. However, "gurus" like Dave Ramsey and Suze Orman have done a good job of painting the picture that cash value insurance is "evil". There is opposition though, and quite a debate over the issue.

The life insurance industry, and all of it's agents, of course love it. For the most part, the investment industry discounts its importance. So, who wins the debate?

It is shocking that the financial industry is responsible for informing and educating the rest of society about saving and investing. I say shocking because many of the advisors that represent the industry seem to be less concerned with the truth, and more concerned about pitching products.

In truth, neither the insurance industry nor the investment industry is doing a very good job of defending their respective positions. Point Blank: Financial "gurus" are leaving out critical information. Either they do not have a very good grasp of how life insurance really works, or they are outright lying. Either scenario is totally unacceptable.

Their reasons for lying can be many. Now, there's nothing wrong with pointing out the shortcomings in a financial product. In the case of life insurance; however, the attacks being made are completely baseless. This is especially disheartening because most, if not all, of these attacks are originating from well known financial "gurus". Here are a few of the lies being spread around:

Lie Number One:

Cash value life insurance is a waste of money. It is the worst type of insurance you can buy. The BEST kind of insurance is term insurance because it's cheap. Insurance companies are shady and always try to take advantage of policyholders and cash value insurance is proof of that.

Fact: Less that 2% of all term policies ever sold ever pay a claim. Which means: there is a 98% chance that your family will never benefit from a term policy. Term insurance may be the best type of insurance if all you are considering is the cost per thousand dollars of insurance. It is generally the worst type of insurance you can buy to insure your life if you are expecting your family to benefit from it (statistically speaking). You need to understand how life insurance companies position their products and how they make money.

You may have heard of the "law of averages". Well, insurance uses something called the Law of Large Numbers. The larger the group of people you are insuring, the more certain you can be about the number of losses.

Let's suppose you were to start an insurance company and you only had one customer - let's call him "Jim". You would be taking on an incredible risk by insuring just Jim. If Jim kicks the bucket, then you're on the hook for a lot of money that you may not have. You would be business very quickly (imagine: Jim gives you $20 for a $500,000 death benefit and then they die the very next day...where do you come up with $500K for Jim's family?). However, if you have thousands of customers just like Jim, then you have the unique ability to better control the risk you take by insuring Jim's life. No one can predict when Jim will die, but if you study a large enough group of people just like Jim, then you can begin to make very, very accurate predictions about the number of people just like Jim that will die in any given year. Given the accuracy of insurance companies in predicting deaths every year, what do their statistics tell us?

They say that that term insurance doesn't pay, since most individuals live until age 65. This is why I say permanent is a better deal. In the long-run, it's cheaper. I know, I know...there are probably a few of you saying "no way, it is always cheaper to buy term insurance". Oh yeah? Watch this:

A male (let's use Jim again), age 25 and in good health with a wife and a child finds that he needs life insurance. Jim is looking for $250,000 in coverage. A typical 30-year term policy - a policy that has level premium payments for 30 years - should cost Jim around $370 per year until he reaches age fifty-five. At that point, the premiums jump up significantly (as all term insurance premiums do) to a tad over $4,700 per year.

By the time he is 65, he will have spent $58,780 on premiums. Keep in mind that the insurance company collected this money but never has to give it back. There's no cash value in term insurance, so the contract only pays when he dies.

What would have happened if he had purchased the same amount of death benefit but used a universal life insurance policy? His annual premiums would have been higher - $1739. By his 65th birthday, Jim has a total premium outlay of $69,560 ($1739 x 40). Wow! But, he will have built up $157,000 of cash value inside the policy.

This money is part of the policy's living benefits, and can be used on a tax-free basis to supplement his retirement or left alone to continue growing. Some life insurance companies also offer an option to spend down up to 100% of the death benefit if you become chronically or terminally ill. If you haven't been able to accumulate a lot of money, this can be very helpful.

Lie number two:

Cash value life insurance is overpriced. You can never tell how much money you are spending on death benefit and how much money is actually going into the cash value of the policy. With term insurance, the costs are clear.

Fact: Whole life insurance carries a stigma in that it is often difficult to determine how much the death benefit is costing you. However, universal life insurance is, in actuality, a term policy with a separate savings account - often called 'the pot of money'. The costs are broken down and the policy is very transparent. Cash value insurance can seem expensive in comparison to term insurance because of the front loaded nature of the contract and the fact that you are forced to save money in a cash account. Sadly, the fees charged by the insurance company are being stressed (I guess they don't know that all financial products carry similar fees).

Be thankful that you pay some of the fees that you do. It makes saving and investing money a lot easier. In regard to life insurance, you have a choice: the contract can be set up to maximize the death benefit (maximizing the cost of the contract), or it can be set up to focus on cash accumulation (minimizing expense charges). All of the expenses associated with permanent life insurance can be made just as efficient and in some cases more efficient than an investment product. But why compare insurance to an investment?

Over the long-term, you should get all of your money back that you put into a cash value policy with interest (note: the exception to this is variable life insurance which doesn't guarantee cash values). If the policy is structured properly, you can also be left with a sizable amount that can be drawn on in retirement.

Lie number three:

If you are smart with the money you have today and you get rid of your mortgage, car loans and credit card debt and put money into retirement plans you don't need insurance 30 years from now to protect your family when you die.

Fact: You might need insurance to protect your children from a big tax burden. Even if you are "smart" with your money, you can't predict the future with absolute certainty. Some people alive today are experiencing a 40% loss in their retirement accounts 5 years before retirement. This is money that was supposed to be there for them and it isn't. If your investments take a hit right before YOU are ready to retire, it doesn't matter how "smart" you were with your money.

Is life insurance is necessary as you get older? You will be shocked at the costs of even a modest funeral these days. What does the average funeral cost in your home town? Ask a funeral director. What is the inflation effect in the funeral industry. If it costs $12,000 today, what will it cost in 10 years? 20 years? 30 years? Ask any beneficiary who has been left any amount of money what they paid in taxes and if it was financially disruptive to them personally.

That cash value life insurance policy that your financial guru told you to ditch could have bypassed probate, provided an income tax free death benefit and, inside of a life insurance trust, completely avoided the estate tax thereby giving your heirs what they deserve.

There are an alarming number of financial professionals that try to draw a connection between life insurance and investing. It's a huge mistake (even supporters of CV insurance make this mistake). Comparing cash value insurance to investing is like asking "how many walkmans does it take to equal an Ipod?". Even if you find an investment strategy that "beats" the insurance product...so what? Cash value insurance is supposed to provide a death benefit with a savings component, not an investment component (despite the mistakes of variable life).

So, should you buy term or cash value life insurance? That depends. What are you really looking for? If you are looking for an investment, then learn how to invest in stocks, bonds, no load mutual funds, options, and other financial derivatives. If you want a savings, then a properly structured permanent life insurance policy can fill that need very well.

About the Author

David Lewis is an independent financial consultant and provides objective financial information about life insurance, and other topics related to retirement & financial planning.