New life insurance study debunks 'buy term, invest the difference'

Standard advice leaves many Americans underinsured and unprepared for retirement

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By **Mary Beth Franklin**

For decades, the rallying cry of the financial advice industry has been for clients to buy inexpensive term life insurance rather than more expensive whole life insurance and invest the premium savings on their own. The only problem is most clients never execute the second part of the equation, leaving many of them uninsured in later life and unprepared for retirement.

“People don't buy term and invest the difference,” said David F. Babbel, professor at the Wharton School of the University of Pennsylvania and co-author of “**Buy Term and Invest the Difference Revisited**,” published in the May 2015 issue of Journal of Financial Service Professionals.

“They most likely rent the term, lapse it and spend the difference,” he said. And even the minority of those who do invest the difference are prone to the real-world emotional investing when individuals investors tend to buy high and sell low, perennially underperforming market indices, he added.

“Our study sheds light on Wall Street guidance that has been taken as an article of faith, but that clearly underperforms for many who follow it,” said Mr. Babbel.

The study received partial funding from New York Life, but Mr. Babbel noted that all of his previous research and that of other researchers cited in the paper were not subsidized and all have undergone rigorous peer review. *[Editor's note: Ms. Franklin has been paid by New York Life to give Social Security educational presentations to clients, but has no involvement in the company's products.]*

ANALYSIS FALLS SHORT

Typical economic analyses that compare the cost of buying term and whole life policies fail to properly assess the guaranteed cash value growth component of permanent life insurance, Mr. Babbel said. He noted that cash value guarantees always grow, while a more volatile portfolio of stocks and bonds can rise and fall with the market.

Mr. Babbel pointed to whole life insurance policies that he and his wife bought decades ago as examples (neither of which are New York Life policies). The cash value of his wife's $25,000 policy, purchased in 1988, is now worth $61,138 and his $178,000 policy, bought in 1997, has increased to $307,520. The growth, which has significantly outpaced inflation during those respective holding periods, represents both the annual guaranteed increase plus the policy dividends from their “participating” policies that are reinvested to purchase additional coverage.

Finally, traditional buy-term-and-invest-the-difference models, referred to as BTID models, ignore the valuable options of whole life insurance such as the flexibility to borrow against the cash value or to take tax-free distributions, he said.

Although it is common to think about term vs. whole life insurance as an either/or decision, it may be more appropriate to think of both, said Chris Blunt, executive vice president at New York Life and president of the firm's investments group.

(More: Largest independent broker-dealers enjoy double-digit revenue growth)

A typical young client with a family may want to purchase a basic whole life policy with a face value of $50,000 or $100,000 and simultaneously buy a $250,000 term life policy that can be converted to whole life later, Mr. Blunt explained. As their income increases, they can shift more of their premium dollars from term to whole life.

'LOCKING IN YOUR INSURABILITY'

“You're locking in your insurability,” Mr. Blunt said. “No one can take that away from you.”

He also debunked the myth that life insurance needs disappear as parents age and children grow up.

“That assumes the kids will never move back, you won't have health issues, you've maxed out your other retirement savings and you've paid off your mortgage,” Mr. Blunt said. “Behaviorally, those things don't always happen. But even if they do, you can take advantage of other features of the policy such as converting the cash value into guaranteed income or borrowing against it.”

Such tax-free distributions can also be used in retirement to pay for Medicare premiums. Life insurance distributions are not counted in the Modified Adjusted Gross Income calculation that determines monthly Medicare Parts B and D premiums that increase with income.

“Generations of Wall Street professionals have been trained by their firms to trash cash value life insurance so the investment firms could maintain those dollars under management,” said Mr. Blunt, who admits he was a late convert to the values of whole life insurance.

“Finally, a new academic study, using rigorous economic modeling, has debunked Walls Street's heavily marketed, but largely erroneous path to financial security,” he said.