A CASE FOR WHOLE LIFE

Variable life has been touted as the best life insurance product to use to build high cash values. However, Miller argues, over the long term, whole life is the better bet, as VL is actually a wolf in sheep's clothing: it's a buy term and invest the difference product, where one hopes that high growth rates in the separate accounts will cover the ever-increasing cost of insurance.

• By Richard L. Miller, CLU, ChFC •

Variable life insurance is probably the hottest life product on the street today. Its sales have skyrocketed in recent years, due to the continued upward growth of the stock market. More and more new and experienced agents are selling the product to clients in lieu of traditional whole life—50 percent and more of many an agent's life sales now come from variable life.

Many agents genuinely believe that variable products are superior to traditional products, but the only problem is that, in reality, the VL products currently on the market are far more expensive than traditional products and can be totally inappropriate for clients.

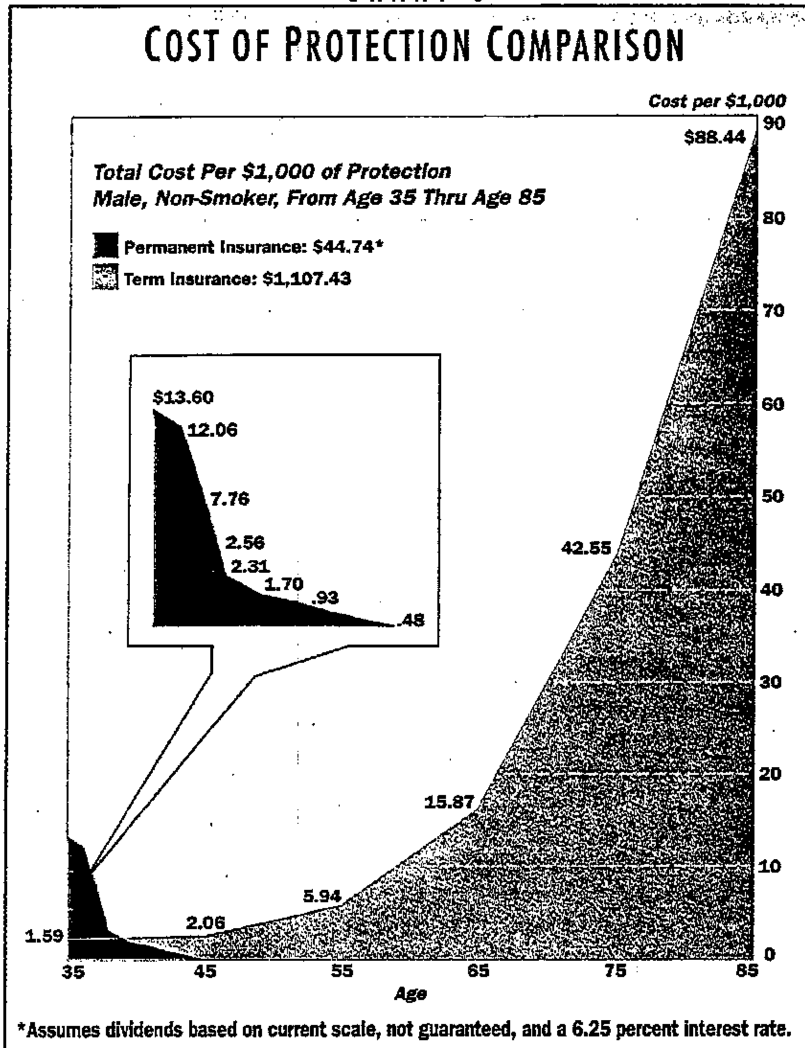
WHY VL LOOKS GOOD

The appeal of VL is easy to understand. If a variable product is illustrated assuming a 12 percent average annual return (the maximum at which it can be illustrated), the growth of future cash values can look phenomenal. The same amount of premium paid into a traditional whole life policy will almost always illustrate much less future cash value and death benefit.

The comparison shown in Chart 1 (see page 58) is for a male, age 35, who buys a $100,000 policy and pays $1,800 a year for 30 years into both products.

Since many growth mutual funds have grown approximately 12 percent each year over the last 10 years, one can certainly argue that a VL contract could perform as illustrated, or even better.

CHART 3



portion of the variable life product is priced like a term policy!

What this means is that the cost per thousand of the term life insurance component's death benefit is very inexpensive for the first 10 years or so after the contract is purchased, but after that, the cost begins to increase rapidly each year. By the client's life expectancy age, the cost of the term insurance component becomes exorbitant. Because the company deducts this high cost from the side fund, the surrender value in this illustration begins to decline at the client's age 69 and is exhausted by age 79.

Contrast this with traditional whole life insurance. The bulk of the insurance cost is deducted during the first four to five years of the policy.

Although the cost of coverage deducted from a traditional policy is high during the first 10 years of the contract, it works out to be far lower, in the aggregate, over the duration of the policy, if it runs out to the client's life expectancy. Chart 3 illustrates the effective cost per 1,000 of coverage, which is effectively deducted from the whole life product's cash values from the client's age 35 to 85, compared to the cost per 1,000 that gets deducted from the variable contract's cash values.

The coverage cost of the term insurance deducted from the variable product is easy to figure out, because

Investment performance and dividend scales can fluctuate for life insurance companies.

term rates are published by almost all companies. In our example, the coverage cost at age 35 is only $1.59 per year per thousand. By age 85, however, this cost has risen to a whopping $88.44 per year per thousand. So the total cost per thousand of coverage over the first 50 years of the contract comes to $1,107.43! The client will actually pay more than the face value of the contract in order to purchase the coverage, if he or she lives long enough.

CALCULATING THE TRUE COSTS

It is much harder to calculate how much is actually deducted for the cost of insurance inside a traditional whole life contract, since published term insurance rates are not what are used to calculate values. All we know, really, is how much cash value there is at the end of each year, and how much was paid in premiums.

Here's a way to calculate the cost of coverage for a whole life contract. In the first year, the client is paying $1,800 for a $100,000 policy. In both cases, before any costs are taken out, there would be $1,912.50, because of the 6.25 percent growth rate assumed. However, the whole life policy will have $516 of total cash value at the end of the first year. So the effective first year cost of coverage can be determined to be $1,396.50 ($1,912.50 minus $516), for a net death benefit of $102,701 at the end of year one ($103,217 face amount less $516 cash value). Dividing the $1,396.50 annual cost by 102.701 thousands will yield an effective cost per thousand of coverage in year one of $13.60.

ments, and 10 to 20 percent in high risk investments. Most people should never invest 100 percent of their assets at the top of the pyramid, even though this level may very well pay a higher return over time. More secure investments are necessary because they provide stability to your portfolio, which is essential during periods of market decline.

The Wall Street Journal publishes a report each quarter which shows the asset allocation recommendations of the top 12 brokerage firms. When the percentages are averaged, it always turns out that the recommendations are for approximately 60 percent of a well-balanced portfolio to be in stocks or growth accounts (the top two levels) and approximately 40 percent in bonds and cash (the bottom two levels).

VL DOESN'T REALLY GROW FASTER

Traditional whole life cash value properly belongs as part of the security base allocation in the pyramid, because it involves no market risk. A variable life product, on the other hand, properly belongs at the third or fourth level, depending on the risk level of the separate accounts used.

An investor who accumulates a large amount in a variable life growth account must allocate other assets to bonds and cash in order to maintain a balanced portfolio. Conversely, an investor with a large amount in whole life cash values will need to allocate more to outside growth accounts to achieve the recommended percentage in equities. As long as each investor maintains the same percentage of his or her total portfolio in stocks, bonds, and cash (i.e., 60/30/10), the total return will be the same, assuming other portfolio characteristics are also similar.

If the owner of a variable life contract and the owner of a traditional whole life contract allocate their entire portfolios correctly, the VL owner will not end up with more assets in the aggregate than will the whole life policy owner. Yet, most agents selling VL continue to use the same type of myopic, simple-minded comparison showed in Chart 1, which assumes variable life values grow at 10 to 12 percent compared to a whole life contract which has no similar upside.

VL'S PROPER ROLE

It is clear that traditional whole life is far superior to variable life as an insurance product when the true cost of insurance is analyzed. In addition to the points already mentioned, there is no danger of losing your whole life contract because of a stock market correction. Although variable life should not be purchased to provide life insurance protection, it can be appropriate to buy it as an alternative to a growth mutual fund if it is structured properly.

Variable life enjoys the same tax advantages as traditional whole life. Cash values accumulate tax-deferred and can be withdrawn using a tax-free policy loan which never has to be repaid (the policy loan is deducted from the tax-free death benefit upon the death of the policyowner). This makes the gross before-tax cash value of life insurance properly comparable to the after-tax value of any other investment. If the VL contract is structured to provide the least amount of insurance coverage possible for the amount of premium, the VL cash value may actually exceed the after-tax value of a comparable growth mutual fund (which provides no insurance protection at all). For this reason, VL can be a good investment product even though it is a poor insurance product for long-term coverage needs.

Most consumers have one or more problems for which a life insurance product can be the ideal solution. These problems may include the need to provide adequate survivor income, to maximize company pension income at retirement, or to pay federal estate taxes at death. As long as these needs have been covered by an adequate amount of traditional whole life, it can be appropriate to purchase VL as a third-level investment in Chart 4's asset allocation pyramid. This is true, however, only if it is structured with the lowest possible death benefit and if this death benefit is not required to cover the client's basic insurance needs.

A traditional whole life policy from a competitive company is probably the best choice for long-term insurance needs for almost all consumers. Even those who have no current need for protection should consider whole life to help fund the security base portion of an investment program.

Although dividend scales are not guaranteed, the current long-term rate of return projected by the top companies and favorable tax treatment make traditional whole life an excellent product for accumulating future capital, as well as, creating an immediate estate. Buying term insurance and investing the difference, whether inside or outside a VL contract, is ultimately much more expensive and does not work nearly as well as traditional whole life over the long run. ◆

I/R Code: 4400.00 Life Insurance

Richard L. Miller, CLU, ChFC, is president of T&M Financial Inc., Topeka Kansas. He has qualified for the Million Dollar Round Table every year since 1977, and in 1999, qualified for the Court of the Table. He can be reached by mail at 3706 SW Topeka, Suite 400, Topeka, KS 66609, by phone at (785) 266-8333, and by fax at (785) 266-7819.