Sound Financial Bites 006 - Life Insurance Basics, Part 2

Episode Transcription

"Term and Universal life chassis run the risk of running out of death benefits before we run out of life."

Hello, and welcome to Sound Financial bites. I'm glad you all could join us here for episode six where we're digging into part two of life insurance basics. We're going to be digging into the appropriate type. Last time we covered the appropriate amount of life insurance. Kind of before we get rolling into today's episode I wanted to just take a moment to welcome anybody who's not been in one of our calls before, point you to our website there's all kinds of ways you can engage with us from downloading the first three chapters of my book for free. You can certainly get over to Amazon and download a copy to your Kindle probably that could even be done before you even finish the intro to this talk.

You're always welcome to email us at info@sfgwa.com and be able to ask to be connected to one of our advisors. Our first conversation with clients are always a 30 minute phone call. We want to keep it easy, low key because our mission is to help suitable clients keep money that they're otherwise forfeiting unnecessarily to the IRS or financial institutions. We do that on an educational based model rather than a sales-based model as most firms do. The very reason we have these podcasts and the very reason we do some of our videos is all for the purpose of helping you intellectually engage and learn, which is all we ask of people.

We look forward to being able to engage with you in some way, and last episode we talked about the appropriate amount of life insurance. The appropriate amount of life insurance would be frankly, the most you could acquire, because here's the thing, there's no insurance company who is willing to put your family in a better situation at your death than your family had while you were working, earning, living. That's the same for a single income household or a dual income household.

Now, for me when it comes to amount and type of insurance I'll just kind of tell you what, my wife and I do. I have $13.5,000,000 worth of life insurance and because of the types of conversations that we have, the very same types of conversations that our advisors have with their clients. My wife is crystal clear that even though $13.5,000,000 would drop into her world tax free if something happened to me, she's crystal clear that she is not in as good of a position as she would be if I stuck around. If I don't get hit by the number four bus.

Now, people joke about that all the time, we've even had friends that joke about it and we just go like, no, that's not true. We subtly push back on it. I've actually watched my wife do it, it's very neat to watch her passion around it. She doesn't have a passion around it because she's necessarily as interested in finance as I am, but why she has a passion is she thinks that it's the devaluing of the spouse. It's the devaluing of your spouse that somehow a few million dollars would be a meaningful replacement for that person.

In fact it does something interesting, when you own the appropriate amount of life insurance on yourself, when you own the maximum amount you can from an insurance company it does something interesting internally for you and your spouse, is it allows you to realize even more so the actual value of your spouse. You're kind of putting your money behind that, and your financial decisions behind that.

My wife is a stay-at-home, CEO of household and we have about $6000,000 worth of life insurance on her. Now, both my life insurance and her life insurance are a blend, they're not blended policies they're a mix. Some are whole life policies, some term insurance policies. We put a little over $100,000 a year into the whole life portion of our life insurance and then the remainder is whole term insurance that is convertible to whole life insurance, without having to prove that we're healthy at that time. It's just called the convertible term insurance, and that's because any of our

ability as I alluded to at the beginning of episode one and I promised to get back to it or part one of life insurance here. I promised to get back to the fact that I would talk about that it's important to have the appropriate amount of life insurance. Pay for it the right way but also that's it's not our choice when we get to have life insurance.

We can go to Walmart anytime we want, in fact you can go Walmart at 2:30 in the morning wearing like swim fins, a mask and snorkel on your face, with a toga on and they're perfectly fine with it. You buy something Walmart's going to serve you. There's sort of this ability of get it when I want it, certainly there's what they call the Amazon-ification of the world and how everybody wants things when they want them. Here's the problem, life insurance is not our choice whether or not we can get it, our ability to acquire life insurance can change with something as minuscule as a doctor's note.

"Whole life insurance is designed to stay in place your whole life."

A doctor's not in our medical records could change our ability to acquire life insurance or the cost to acquire life insurance forever. That's why my wife and I, we have a tremendous amount of term insurance to protect ourselves but we also have a tremendous amount of it be convertible term insurance, all of it, because we don't know if we will one day want to convert the whole life insurance. We want to have the option, we want that option on our side of the table not the insurance company's.

Some of you may ask why $6,000,000 on my wife who's a non-working spouse, let's go back to the 4% distribution. $6,000,000 invested at a 4% distribution rate would peel off about $240,000 a year. I have done all the math I can figure out how to do to justify it and I will tell you right now I don't think it's enough $6,000,000. For everything that my wife does, because it's not just what she does that I would actually have to pay what I think would be three or four people to do everything that she mechanically does in her world. On top of paying for people to do those things there is an amount of economic value that goes into my career that you can't put your finger on that changes when you know you have someone in your life that 100% has your back no matter what. That's part of why she has that amount of life insurance. A good rule thumb is that a non-working spouse the insurance companies will give you half of the primary breadwinners life insurance amount.

On to type, today, when we talk about types of life insurance there's two major different types of life insurance, and every other type of life insurance is on one of these two chassis. There's term life insurance and then there's whole life insurance. Now, term life insurance what I would have you think about is well, many people refer to it today as term insurance because it lasts for a term. Meaning when you acquire term life insurance what it will do is last for a term, a period of time. The easier way to think about it though is think of term as short for terminating insurance, and if term were short for terminating insurance and it lasts for a period of time and then it ends, and it's actually designed to expire before we do. It's not meant to pay claims, it's meant to pay a claim in the extreme circumstances of an early death because they know they do medical exams on people when they buy life insurance. They know it's totally unlikely for someone to die if they own term life insurance.

Let's go to the other end, whole life insurance. Whole life insurance lasts your whole life and it's guaranteed as long premiums are paid it is guaranteed to last your whole life. Many times with the appropriate structure you might be able to have a policy pay it's own premiums at some point in the future or reduce pay up a policy, meaning death benefit drops a little bit but you forever have the coverage. It lasts your whole life.

Now, many people have heard of different types of life insurance. There's a universal life, variable

universal life equity, index universal life, fixed index universal life. All of these universal life type contracts are actually still term insurance at their core. All that's happening is you're funding a term cost meaning it might be a one year term, so one year cost of term insurance each year and along with that one year cost of term insurance each year you have a side account of money. Like an investment it might just pay a fixed interest rate or it might be invested in the market and the job of that side fund is to pay the term insurance cost every year inside the contract, but it's an ever increasing cost of insurance. If we don't get more than enough money inside the life insurance then we're going to not have enough cash there to pay the premiums ultimately and the policy will go away.

"Whole life insurance – whose cost is predictable, understandable, and guaranteed to never go away."

All of those kind of term insurance chassis unfortunately have a decent likelihood that even if they have guarantees to stay enforced for the rest of their lives all of the term in universal life chassis run the risk of running out of death benefit before we run out of life, because even those with guaranteed death benefits have somewhat of a precarious guarantee, like if you missed one premium payment and it fell into the grace period you may loose the death benefit. Whole life insurance on the other hand is designed to same place your whole life. Now, necessarily it is over engineered kind of like, if you looked at the George Washington bridge out in New York, it's meant to be this strong bridge that will sustain far more weight than they ever anticipate of it and far worse weather than they would ever anticipate to happen in that area. It's over engineered so that it's always going to be there.

Whole life insurance is also over engineered. The only difference between whole life insurance and the George Washington Bridge if you're the only car driving across the George Washington Bridge you don't get any real additional benefit to the over engineering. The unique thing is with the whole life insurance policy you do benefit from the over engineering. Typically require some additional cash flow in terms of its premiums but the whole life insurance begins as long as it's owned with a mutual life insurance company will begin to pay dividends and grow cash value.

The cash that grows inside might be best explained if I actually go back to pre 1982 and how life insurance used to be able to work. Life insurance pre 1982 would actually allow you the ability, if you just had a million dollars on your balance sheet you could slide it right into a whole life insurance policy, it would sit there. It would grow, it would grow at 4 to 5% tax free. You could take your money out, it had liquidity. You could just call the insurance company they would send you a cheque. It would never go down in value is guaranteed to sort of go up and not go down in terms of investment performance because this cash value is a vehicle that only goes up and doesn't go down unless you took out.

It was federal tax free, state tax free and for our friends in cities like Manhattan it was also any local or city income tax free, so we had this tremendous tool. Is also creditor protected, today is creditor protected in 42 states, meaning you get sued and they can get about everything except for your whole life insurance cash values and a few types of retirement accounts.

It's this tremendous tool and people are putting tonnes and tonnes of money into it, but it was the IRS that made a new regulation and said you can't put that much into a life insurance policy that quickly. What they said was the insurance company needs to be at risk, the way they did it back in 1982, to give you such this amazing account you could put a $1000,000 in. You might put a million dollars but maybe they only give you $50,000 of death benefit on top of the $1000,000 of cash.

They weren't really taking much risk, there wasn't much death benefit, so the IRS said what we're going to do is not regulate it by a flat amount like a 401(k) as a flat amount of money because

different people require different amounts of life insurance, rather what we're going to do is we're going to say the insurance company needs to be at risk. We're going to measure it on something called the 7-pay test. If you put money in faster than this 7-pay test then we're going to no longer call it life insurance, and it's going to lose a ton of it's tax benefits.

If you wanted to that risk corridor you can think of it all the legislation passed after was TEFRA, TAMRA would like those two major sets of legislation that changed that. We call that the TEFRA, TAMRA corridor, that's the gap between the cash and the death benefit that the IRS wants to see the insurance company is still at risk. What that means for you and I is to go back to that pre-1982 example we could still get the $1,000,000 and we just have to do it over a seven year period to simplify how that rule works.

Whole life insurance today can still if properly constructed utilized get a say 4 or 5% rate of return depending on age and mortality, health at the time of acquisition. They could still be totally liquid because you can actually call the insurance company and get your cash out. You still have guarantees where it goes up like a one-way economic route sheet that goes up but cannot click back down and it's creditor protected in 42 states. If you think and look at your balance sheet that if I got in a car accident or a professional liability situation of some sort what would happen?

Lastly, that whole life insurance can actually put you in a position where you can have your premiums paid on your behalf should you become disabled. It's one of the few financial tools we can use that will self complete or has the ability to self complete if we're unable to work through the sickness or injury.

Our major types of life insurance just about everything out there is either going to fall into what's effectively this term insurance policy chassis which would include all of the universal life contracts, because term insurance, terminating, or ever increasing cost falls into all the universal life policies and on the other side is whole insurance. Life insurance whose cost is predictable understandable and guaranteed to never go away.

In one of our future podcasts it won't be the next one, but later on in our episodes I will talk about how you can actually utilize that life insurance tool and not it's cash but rather it's death benefit and retirement. Now, if you guys wanted to see something interesting you can Google it. You can Google life insurance as an asset class, I think there's still a website out there called lifeinsuranceasanassetclass.com. You can go out there and look at some of the resources where you can actually utilize that whole life insurance as a bond substitute inside your portfolio. It's not meant to be an investment life insurance but it does make a good financial tool. It make a nice supplement to what it would otherwise be our cash savings and it's one of the ways that life insurance properly landing in your life and utilized can actually enhance the use of other tools.

I'll give one more example and then we're going to end for today. If what you did as a part of your financial strategies is you simply took, and we're throwing say $50 or $100,000 a year into your life insurance policy. Now, over time of course that builds up, so once your life insurance policy had let's say $400,000 of cash value and elsewhere in your life you had a $1000,000 portfolio that you would normally like to have about 40% in some kind of fixed income. I'm not recommending an allocation there I'm just giving an example. What you could now do if you've got $400,000 in fixed income in your portfolio but you've got $400,000 of cash value we can actually change the allocation of your investment portfolio to include the fact that you have $400,000 of a bond like asset that's non-correlated. It's what's called book value, meaning it's not going to drop in value on you like a bond can. You could say what I'm going to do is allocate my portfolio differently knowing that

elsewhere in my life I have this other thing that acts like a bond, and maybe have $300,000 more than you would have otherwise at work in the stock market because your life insurance is acting as a part of that bond substitute. Still keeping your total fixed income component of your portfolio at 40% and yet $300,000 more is at work.

In fact if you have a large investment portfolio, this will be the subject of a future episode, a large investment portfolio on what you did is just took a little bit out of it every year to build this separate bond substitute in life insurance. It's quite conceivable you could acquire a great deal of life insurance without any household budget out of pocket cost because if you look at your balance sheer like a pair of pants all you're doing is moving money from the right pocket to the left pocket but it's still in your pants. You still own the capital, you're just moving it from one account on a balance sheet to another part of your balance sheet.

I'm glad you all could join us today. I hope as you listen these as you're driving back and forth to work or you're out on a run that these are helping you contribute to the way that you think about designing and building a good life for your family for the rest of your lives.

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