# Sound Financial Bites 081 - Types of Life Insurance

*Episode Transcription*

Paul Adams: It works really well for the insurance company because they get more premium flow with no more risk, which if you haven't noticed, that is the name of the game for any insurance company: car insurance, homeowner's insurance, life insurance, disability insurance. More premium, less overall risk for them, they really like that.

Welcome to Sound Financial Bites, where we help you with bite-sized pieces of financial and life knowledge to help you design and build a good life. The knowledge that has been shared from stages at conferences, pages of national business magazines, and clients living across America, our host, Paul Adams, now brings directly to you.

Paul: Welcome. I'm so glad you could be here with us today. I am super-excited because what we get to do today is we are simultaneously recording our podcast, we're recording our YouTube channel, and we're going to have this be like an in-studio experience so all of you can actually see what it is that we do every day. Now, who's we? We are myself, Paul Adams, host of Sound Financial Bites, and Cory Shepherd, President of Sound Financial Group.

> *"A very, very small amount…less than 2% or less than 1% of all term insurance actually results in a claim."*

Now, for those of you that haven't had a chance to meet Cory yet, Cory's, as you're going to clearly see here in a few minutes, the producer of this video, as well as he is the author of Cape Not Required. He is an incredible person who goes out and seeks knowledge rather than just sitting back and waiting what the financial services industry's going to teach him. He spent his entire career in this industry, and for those of you wanting to read a book that's going to talk to you about being able to better build your career or build your personal philosophies about your career, and how to go about living a more effective life overall, Cape Not Required is the book for you. Cory, so glad you could be here around the show for us.

Cory Shepherd: Thanks, Paul. So excited to be here and run in our video series. I just want to say it's been -- what I appreciate about working with Paul for these last five years, I started in a very traditional setting in the financial industry, very common knowledge around solutions for clients that work well for financial institutions, that's for sure. Sometimes, it works really well for client, sometimes maybe not, and in meeting Paul, I discovered someone who almost never accepts anything at face value, always getting to the heart of the matter, the academics behind a strategy, "Does this really work?" digging and pulling apart before we start to implement it with clients, and that's just the attitude of which we run our business. So, I really, really appreciated that for sure.

Paul: Right on. Well, we are talking about something. We're talking about pulling something apart, getting into something, we're talking about something that people do not normally talk about. Here's what people don't talk about: now, generally people don't talk about money, but people definitely don't talk about life insurance. Here's a question for you: how many people, over their lifetime, will ever not have owned life insurance? Nobody.

It is one of those financial tools nearly everybody interacts with, and yet it's incredibly difficult to just find a guide anywhere on the internet -- and I don't mean a guide like a person or a guru, but rather just somebody who would say, "Here's how these different types of policies work on the life insurance front that is reasonable, understandable, applicable, and doesn't have a huge

amount of inherent bias in it," or at a minimum, if they would have bias, it would be nice if they would just tell us, what you can count on from Cory and I today.

We're going to do this as a total of a seven-part series. We're going to break it into different little chunks. You're going to see it we're going to cover the fact that we should understand just what the types of life insurance are, and there's several different types. In fact, what's going to amaze you is how many different types there are of one type that's kind of outstanding.

Then, we're going to get into how much should you own, what's the most effective way to own the life insurance you choose to own, from an efficiency perspective, what kind of company you should buy from, and at the very end, we're going to review this entire series together. It's going to take about seven episodes. We're going to do our best to keep those in control, bite-sized amounts so you don't bleed from your eyes while you're watching. Anything else before?

Cory: Well, I'm so glad that we're doing this because this is something that touches almost everybody's life whether they want it to or not, and yet there's very little education around it. Most of us are forced to own life insurance, whether we know it or not, when we get our first job and are auto-enrolled in all of our employer benefits. So, almost anyone that's listening to this, if they're over the age of 18 and they've worked for a corporation, this touches their life, and yet they may not have had any kind of education about it.

*"You can pay more in premiums than you have in death benefit if it continues beyond the term."*

Paul: Exactly right, and where you're going to notice Cory and I have some fun with each other is when I do what I'm going to do right now, which is reminding Cory he should actually look at you, the audience, while he's talking. His eyes are all over the place, I've got lights in here on him, he's just like a deer.

Cory: I just love your beard so much, Paul. It's so glorious.

Paul: It is. It's really something. You should see it in the breeze. So, we're going to get right into it. This is typically a boring topic, unsexy, totally necessary. Totally necessary that you understand it. It is one of those decisions that's hundreds of thousands or millions of dollars of impact on a family, and yet, so often, people take most of what they're doing on a pure price conversation or based upon the first person that offered that they ought to buy it with little or no education, training, or understanding behind it.

Now, let's just get to the very basics of how life insurance works. Historically, what you would do, and this is way back, what would happen is somebody would "pass the hat" when somebody died. So, if we were all coal miners, and if somebody died in the coal mine that day, then what we might do is pass the hat around to all the coal mining families, everybody would throw in a little bit to help the family whose spouse had died.

Now, what you'd hope is that the economy was good when the hat went around to everybody. You'd have to hope that also, "I hope my husband wasn't a huge jerk to all those guys in the coal mine," and you would hope that they were all generous, in return, that your kids had behaved well, all the things that go into whether or not someone would take money out of the hat and put it in the hat.

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Cory: We still see that today. Isn't that what we see when people don't have life insurance? GoFundMe or any of those crowdfunding sites. You know, help this family, and it's still a real thing. I've seen people, friends in the industry have some harsh comments about those sites like, "Get your ish handled first before you have to --" Now, I'm not going to say that to anyone, but it's just offensive enough of an idea like there is an alternative to 1800s technology expressed in a 2017 way.

Paul: Yes, and so what happened? Well, there was actuaries. At some point in the past, hundreds of years ago, somebody said, "Oh, we could own life insurance," so what we're going to do is somebody who's really good with numbers, called an actuary, now we have actuaries also run enormous computers. Back in the day, it was journals with numbers, slide rules, abacus, whatever, and they would do the math and they would say, "Here's what we think it's going to cost to, on average, pay a death claim on this pool of people," and over time, they've gotten better, and better, and better at that science, and really, all the way up, if we look at the history of life insurance, there are really only two kinds of life insurance all the way up to 1970s, which we're going to get into in a moment.

Before we do, there are a few key distinctions I want to make sure everybody understands about life insurance that can be confusing. We're going to touch on them very quickly so that when we say these words, they're not a surprise to you. So, I'm going to pop quiz Cory for him to explain to you one of them. Cory, what is death benefit?

*"The life insurance company needs the term to expire before your life expires."*

Cory: Death benefit, or as I like to call it, cash on death, is the actual proceeds of the policy paid upon the death of the insured. The reason I don't like the word "death benefit" because it's not really a net benefit when someone dies, which we're going to talk about.

Paul: Yeah, exactly right. There is no win upon claim. We're not winning anything. It's not like a lottery ticket because we've lost some valuable economic asset called that income earner, or that spouse. That's part 1. Next, cash value.

Cory: In certain types of policies, there's actually an accumulation of cash in an account inside of the policy. So, you can see the cash on death number and then there's also another number growing that you can actually access while you're still alive.

Paul: Very good, and last but not least, premium.

Cory: Premium is what you pay to the insurance company to keep the policy going.

Paul: Okay, so with those three key things, if you're new to life insurance, haven't been around that much, there's three key definitions we're going to talk about like it's no big deal. In case you didn't have them, you've got them now. So, let's talk about the types of life insurance. In the rest of this episode, we're only going to hit two of them, and the reason we can only hit two of them is because of this wildly complex invention of the life insurance industry where they have tried to make it cool, or sexy, or whatever, and we're going to see that that one takes longer to pick apart and help you understand it.

But, first there was term and whole life. In the beginning, there was term and whole life

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insurance. Okay, let's take term insurance first. It's life insurance, but its only real benefit was the death benefit. It was this very simple idea that if you die in some set period of time, you get the benefit. If you die after that period of time, the coverage terminates, term, terminating insurance. It goes away, there is no more death claim after that period.

Cory: Wasn't that the actual name? "Terminating insurance" at first?

Paul: Yeah, it was either terminating because of the term, or it was termed because it is a term of time like a 30-year term mortgage. So, in those early days, either way, what they realized was they had better just say "term insurance" because it's short and sweet. They weren't the greatest marketing people, but basically having something that means it ends as a life insurance sales tactic, not great. We're going to get to how they got better at marketing post-1970.

The death benefit, itself, is purchased for a period of time. It might be one year at a time, called annual renewable term insurance, five-year, 10-year, 20-year, 30-year terms of time, pure bet on your part where you're saying, "I want to be protected for 10, 20, 30 years with this level death benefit. I don't want it to go up or go away." It can be a great tool - it can - but here's what happens to it when you use it. Over time, when you acquire term life insurance, it does this: we put in a level amount of premium here that's really, really low and we get a death benefit. Let's say this is a 20-year term policy when we pick up this death benefit. Again, enormously small amounts of cash flow required, and yet it only goes for a period of time. What happens after the term?

*"Everybody who cancels their policy in less than X percent of time never sees the benefit of the return of premium."*

Cory: You know, what I love about term insurance, it's always been a little insurance joke of mine is that if you want to make sure there's about a 0% chance that you die in the next 30 years, buy and qualify for a 30-year term insurance policy. Because, there's such a small amount of cash outlay compared to the big benefit that the insurance company has to say, "There's basically no chance that you die during this period," because there are going to be a couple people. So, if you had any chance of dying, it would just blow up their -- you know.

Paul: That's exactly right. They're not giving it to you if they think you're going down soon. Here's what happens at the end of that 20, 30 years: oftentimes, the coverage doesn't fully stop. The premiums just start to go prohibitively expensive. If you ever look, if you have a term insurance policy in your house right now, go look at the page inside the policy that shows all the future rates. Sometimes, it's per thousand, sometimes, it's for your whole contract.

Look at it in the '70s and '80s, and what you're going to find is it gets so wildly expensive that, literally, you would be in a position where you're paying as much in a year as a quarter of your death benefit, and there's another premium next year. Like, you can pay more in premiums than you have in death benefit if it continues beyond the term, hence why the strategy is to own it up until that time it becomes cost-prohibitive.

Said another way, the life insurance company needs the term to expire before your life expires. It needs to be gone before you are, and to Cory's point, a very, very small amount of it, anywhere from, depending on the study, is less than 2% or less than 1% of all term insurance actually results in a claim. Anything else we need to say about term insurance?

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Cory: Well, just that insurance companies sell a lot of it. I mean, they have to to have those few claims pay out, and even with such a small amount, the margins are pretty low. They need to sell a huge amount, which is why that's all you see ads for on TV, the radio is, by and large, term insurance.

Paul: And it's incredibly profitable for the insurance company. The way I always express it is if you had two items for sale in a store, and one cost $10, and every time you sell it, you make 90 cent profit. The other one costs $1, also a 90 cent profit. If you owned the store, which one do you put right by the register, give it the best shelf space, all that? It's the one that's the smaller price point, but same profit margin, or better margin overall, and that's the one that they really press at of why there's so much messaging on it. Not to mention, it certainly appears quite simple. It's a very simple contract, all that.

Now, we're going to talk about one other component of term insurance, and that's convertibility. We're going to go deeper into that and how to buy term life insurance. But, term life insurance, if it's individually acquired, so it's not a part of your group program, it will usually have some kind of conversion. When we get, a couple episodes from now, deeper into how to acquire the life insurance, you're going to learn that you may not want to buy any old term insurance policy totally based on price. It's a very misleading price as the only qualification. You really want to look at some of the contractual provisions. We're going to teach you how to do that.

*"The reason people acquire term is because they need a low entry point from a cash flow perspective."*

Now, let's talk about return of premium term insurance, which is an extra type of term insurance that's out there, that has really caught on, that allows an agent to sell a client a product that is what I would affectionately refer to, and this is going to get bleeped. I don't know if compliance is going to be okay with me saying this.

Cory: Let's see.

Paul: We have attorneys that have to listen everything that we do to make sure that we're not saying wildly out of line.

Cory: I tried to hold him back, folks. I tried.

Paul: But, it's a sucker bet. Here's why it's a sucker bet. What they will say is this: if you go ahead and buy the term insurance, they will let you put in extra premium. So, I'm going to illustrate that extra premium with this pink dotted line, and you might be paying twice as much premium.

Cory: That is twice as much. It looks not very far in our scale. Remember, it is double what you were paying before.

Paul: Exactly, and then the story goes something like this: as long as you own the term to the end of its period, it's usually how long you have to own it, so 20 years, to get the full return of premium, and then they say, "Well, you are really getting all of this money back at like an 8% or 7% tax-free rate of return because we're going to give it back to you at the end, and we're going to give it back to you in cash, you're not going to pay taxes on it because it's return of premium you already put in."

Now, here's the problem. Number 1, everybody who cancels their policy in less than X percent of time never sees the benefit of the return of premium, number 1. Number 2, almost no company that has a solid mutual company, which you're going to see why that matters in a moment, with a strong, permanent piece of life insurance coverage actually sells the return of premium term. So, in all likelihood, if you've owned return of premium term, you're probably with the company that does not have a participating whole life policy you could even convert to.

Cory: Just for now, mutual company means owned by the policyholders, not owned by outside shareholders. So, there's just a more direct relationship with how the company makes decisions around their policies.

Paul: Yeah, and we'll get deeper into that in episode 3. Here's the thing though, if you die, you're not getting that extra bit. If you die, your family's just getting the extra money. They might give you some of the return on premium, but the problem is you have to hold this strategy for an extended period of time for that to ever work out.

Here's the other part of the problem: had you just taken that extra chunk of money and put it elsewhere on your balance sheet, you actually would have had more money and it would have looked and felt a lot like what the company was going to do to refund to you, except you could have used that money any time in the next 20 years without having to cancel your term insurance to do it.

That's why, largely, the return of premium, we don't use it with our clients, but the return of premium, I think, is part of that creative marketing that's now being done. When I said about things coming out post-1970, they got better at marketing, this is one of those things. It's a really easy-to-market product, and it works really well for the insurance company because they get more premium flow with no more risk, which if you haven't noticed, that is the name of the game for any insurance company: car insurance, homeowner's insurance, life insurance, disability insurance. More premium, less overall risk for them, they really like that.

Cory: There's a concept we're probably going to address at some point called "buy term and invest the difference" that gets thrown there a lot in insurance strategies. If anyone's familiar with that, this sounds like the worst form of "buy term and invest the difference" is return of premium.

Paul: Exactly right, and the idea the reason people acquire term is because they need a low entry point from a cashflow perspective that gets them a lot of coverage, truckloads of our clients acquire term insurance because they have risks that need to be covered. The most important thing which we're going to get to here in episode 3 is that you own the right amount of life insurance, that comes first.

Okay, whole life insurance. If, on one side of the spectrum, we have this term insurance, this temporary terminating goes away, and on the other side of the spectrum, we have another type of life insurance called whole life insurance. Whole life insurance is not -- I would say people complicate it; it doesn't have to be complex.

Let's start with how long does it last? So, if term insurance lasts a period of time, a term, how

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long do you suppose whole life insurance lasts? Wild guess, Cory?

Cory: For my whole life.

Paul: For your whole life, that's exactly right.

Cory: Yes.

Paul: Congratulations, Cory. Good job. So, it lasts for your whole life. Now, it's important that it lasts your whole life and it's not terminating because if you think about how simple the naming is, none of these insurance executives were good marketers back in the day. So, they just called term insurance what it is, they called whole life what it is.

Now, here's how they managed to build whole life insurance in a way that would have all kinds of guarantees. So, it has, one, a guaranteed premium, meaning nobody can ever raise the premium on you, period, end of story. The premium is what the premium is, done, and if you imagine that, there is this guaranteed premium that is going into the contract every year that secures a certain amount of death benefit, and that guaranteed death benefit is level, never increasing the guaranteed death benefit.

Now, there's also the cash value component that grows, and the cash value, think of it like the money that's in the contract that you can access over your lifetime. It also has a guaranteed growth rate. It grows at what's considered a discounted cash flow at 4% depending on when you acquired the life insurance.

It's either based upon the old actuarial table or the new actuarial table. Either one, it either endows, meaning the cash meets the death benefit out here at either age 100 or 121. What it means when it endows is they will pay you the death benefit even if you're still alive. That is key. Because of that contract, that endowment, what that allows is that the guarantee that your policy will indeed be around no matter what.

Now, it can perform better than that guarantee. This goes to more of what we're going to talk about here in a few minutes about owning it from a mutual life insurance because it shares its profits back with you. But, when you get profits back from the company from which you acquired the life insurance, it changes these curves. The cash value can outperform that projected amount because there is almost no likelihood that these mutual life insurance companies are going to perform the guarantees.

It's incredibly rare that a company pays only its guarantees, and alongside that, the death benefit has to grow because there still needs to be money at risk, which we're going to talk about in a few episodes that the death benefit itself needs to grow also if there's not money at risk for the insurance company, it's not considered life insurance. It loses a great deal of its benefits.

What are those benefits? Well, one that you need to know, whole life insurance will typically require 10 times the amount of cash flow as an equal amount of term insurance. That's like a 20-year or a 30-year term. So, you're driving more cash flow to it, but then what we'd have to do, we're going to be scientific about it, think about it, we would have to say, "Why in the world

would it cost 10 times the amount?"

Cory: Or take 10 times the premium is, perhaps, the thing we want to highlight, because cost, actual cost, is a tough thing to tell from the start. So, premium in, cash flow in is 10 times higher.

Paul: Right, and think about just our natural proclivity, like just think about consumer products. If somebody told you and you saw two cars side-by-side and somebody said, "Well, this car costs me -- like its cost, its retail value, whatever it is is $50,000, and this other car, I bought for $500."

Now, the first thing you would do, if somebody said, "Hey it's same-same, buy the cheaper one," the first thing you'd have to ask, just having some kind of scientific mind, "Wait, I don't think those are the same," because how, otherwise, would the free market allow, one, to charge $50,000, and somebody else to charge $500? That's impossible; why would that be? So, you'd have to say, "Well, wait, what's the difference between the two?" and we're going to hit on a few of those differences before we get to real uses of it.

Cory: Like, one's a luxury car and the other is a Ford Pinto with no engine it.

Paul: Yeah, your special exploding gas tank in the back just turned out not to be true, but that is the thing you would instantly start to look for the differences. For some reason, we've actually been programmed by the dominant financial conversation --

Cory: I'm going to switch to my camera for a second.

Paul: Just let me loosen my lips up?

Cory: Yeah, shake it out.

Paul: So, the dominant financial conversation would be you go for the cheapest term insurance you can. That may not make sense. You should pause long enough to go, "What is the difference between the two?" Some of the differences are is you've got this fixed cost and mortality that can't increase in the whole life insurance. Whole life has other features: the cash value, which can never go down in value unless you choose to take it out or use it to pay premium.

Cory: Fixed cost of mortality, another way I think of that is term insurance, you're either paying for your cost based on your age every single year or that year that you first got it until the term expires, whereas whole life, you're only ever paying the cost as the age when you started.

Paul: And they're levelizing that across, versus like a 20-year term is doing that, but not for your lifetime, just for 20 years.

Cory: Then, you have to reup 20 years later.

Paul: Yeah, exactly right, and the premiums can't be raised by the insurance company. You can stop them early. There's a few different strategies to stop it early, things like reduced paid-up insurance, or you can let the insurance policy carry itself for a period of time. That stuff, you want to work out individually with an advisor. You can even reduce the death benefit, and own that

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death benefit, the reduced amount, plus the cash value forever. That is that reduced paid-up that I talked about.

Cory: Downsizing a house when you go from a big house to a smaller one if your life changes.

Paul: Yep, exactly right. The biggest problem, actually, with whole life insurance is not whole life insurance and what it does. It's quite simple. It has its cash. You could cash out, take the cash, you could take money out via loan, get it back in the tax-exempt environment. All that stuff is possible. The problem with whole life insurance, more than anything else, is the simple fact that it's often misunderstood and misexplained. Now, we're going to go deeper into that, but what it gets collapsed with is something called universal life insurance, and we're going to pick up on that in our next episode.

But, if you've had any interesting a-ha's, and you're thinking, "Oh my gosh, what should I be doing here?" One, listen to the rest of these videos and see if they're triggering new thinking for you, two, check out Sound Financial Bites. You can get it on iTunes, you can get it on Stitcher, whatever podcasting service that you use. You can go to SoundFinancialBites.com and get it, and we'd love for you to be able to get more knowledge and be able to equip you better to design and build a good life, and even equip you better to talk to your existing advisor, if that needs to happen.

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