Sound Financial Bites 085- Basics of Life Insurance 5
Episode Transcription

Paul Adams: What we want to do is make sure that, on somebody's balance sheet, they have some non-correlated assets. So, for instance, that third position of cash money market accounts is non-correlated. Fixed income can go up and down, but your money market account is just going to get the interest that it gets, and most of them are designed today to not actually break the buck. They don't go down in value. They just stay and slowly, slowly grow. We want to put another asset on a client's balance sheet, in this case, called whole life insurance.

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: It's so good to be back with all of you. We're now in part 5 of our series on life insurance. Now, in a moment, I'm going to introduce my cohort here, but let me first mention again why in the world are we doing this. Seriously, Paul? You've got wonderful podcast, great guests like Sean Stephenson all the way to John Medina on the brain science of living a good, long life, you've done cool stuff on real estate, college funding. Why are you spending so many episodes talking about life insurance?

"Most people are not going to live beyond the expectancy or beyond the endowment of a whole life policy."

Very simply, it's because life insurance is one of the few decisions that nearly every family makes that's a multi-million-dollar decision, for which there's very little education people can go into, number one. Number two, most people don't seek out any education around it. So, we're just making sure that we put together a series - this is long after we've first started the podcast - to be able to make sure that people have a resource that they can go back to and be able to get some serious value from.

Now, with me today, I've got Cory Shepherd. Cory has not only been an incredible gift here at Sound Financial Group, and more importantly, a gift to many readers since writing his book, Cape Not Required. Cape Not Required is a phenomenal book for people to take stock and look at what they're doing around their own personal and life practices and how that may be affecting the way that they enjoy life, the amount of income that they make, and/or the way they could be progressing in their careers. So, we're just super thankful to have you, Cory. Welcome to the show.

Cory Shepherd: Thank you, Paul. It's good to be back, and I'm really happy to have gotten fully introduced and not have to remind you forcefully to introduce me this time. Watch some of the past videos. You'll notice. There was a little bit of fun that we had to have. We're off and running. That's great.

Paul: Good. Appreciate you giving me a hard time. I'll just remember that for later this video. Okay, so today, part 5, we're talking about life insurance and its uses. We've now talked a little bit about how much life insurance to own, we've talked about how to go to applying for it, we've talked about mutual versus stock companies. Today, we're going to talk about the appropriate ways to own whole life insurance.

Now, why whole life insurance we're choosing as a primary tool on the permanent insurance side? You'll notice, if you do any reading, if you look out on the web, you will see people will generally refer to things as permanent life insurance, and yet permanent life insurance, in that distinction, has two different definitions.

One is universal life, that we just spent an entire episode on. You can go back to episode 3 in the series, and that is, in many ways, not at all permanent, because it has to be funded a certain way, may need to have particular guarantees to be able to pull off that outcome of it remaining permanent, because underneath it, it's just got term insurance.

It's got this term insurance chassis with hope that interests rates will be high enough or the underlying investments would be high enough in rate of return to keep the life insurance in force. So, you just have to manage those products very, very closely if you own them.

But now, we're going to talk about whole life insurance, which is really much simpler than it seems because whole life insurance is designed to be around -- if term is designed to just be around like a period of time, a term, and then it terminates, Cory, how long do you suppose whole life insurance might be around?

"People…pre-1982 were choosing whole life insurance as a place to store capital vs many other places they could put money."

Cory: Let me think. Let me carry the one. Your entire life? Your whole life?

Paul: Your whole life. The people that designed this stuff were not marketing experts, so it's going to be there our whole life, and one of the things to consider when you're looking at whole life insurance, it's the only product out there that is structured to do what's called endowing. So, depending on what you own either at age 100 or age 121, if you own a whole life policy, and you paid your premiums, it endows, meaning the cash value meets the death benefit.

If the cash value meets the death benefit, then they will send you a check, the insurance company, because you lived longer than your mortality, so you can actually have your policy fully endowed and you can take that money. The way I think about is that they ran out of lines in their Excel spreadsheet, or they ran out of lines on their ledger, so they just, at some point, have to give you the money.

Now, most people are not going to live beyond the expectancy or beyond the endowment of a whole life policy, but here is the important thing that we need to understand: because it's designed to endow, it has the appropriate amount of guarantees in place that allow us to look at its cash value as a very dependable asset. Now, when we talk about an asset and asset classes, I just want to turn you to the Investopedia definition of an asset class. Now, do you want to run through that, Cory, with everybody? Can you bring it up on screen?

Cory: Yeah. So, an asset class is a group of securities that exhibit similar characteristics, behaves similarly in the marketplace, and is subject to the same laws and regulations. You see here on the screen, the three main asset classes that Investopedia talks about are equities or stocks, fixed income or bonds, and cash equivalents, or also called money market instruments.

Paul: What I want you to think about, when you think about asset classes is think about technology companies. So, technology companies, their large U.S. technology companies will all

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be in one bucket. Why? Because, they're similar regulators and they may move up and down at similar time. That's called correlated because they're together in asset classes.

What we want to do is make sure that, on somebody's balance sheet, they have some non-correlated assets. So, for instance, that third position of cash money market accounts is non-correlated. Fixed income can go up and down, but your money market account is just going to get the interest that it gets, and most of them are designed today to not actually break the buck. They don't go down in value; they just stay and slowly, slowly grow.

We want to put another asset on a client's balance sheet, in this case, called whole life insurance. Now, why is that important? I'm going to back off here a little bit and take some time to explain whole life insurance not in the way it works today, because that actually makes it more complicated to understand. I'm going to start by explaining whole life insurance and how it worked back pre-1982, because it was actually a little bit simpler, there was less regulation on it.

But, first and foremost, what the regulation, which we're going to talk about in a moment, was levied by the IRS. Now, I want you to think about this for a moment. The IRS is not known as a really great consumer advocacy organization. They don't like review cars and say, "This is an unsafe car, and a safe car. This is a good investment or a bad investment." What they tend to regulate are the things that give individuals an unfair advantage against the tax code in paying taxes. What they did many years ago is they had to change some regulations around the tax code to make that real in a way that they would be happy with.

"A set of legislations whose acronyms were TEFRA & TAMRA made up some new rules around life insurance."

Let's think this through, and we'll just do it in the way of a drawing. Pre-1982, here's what you could literally do. You could take, if you had a million dollars on your balance sheet, and let's say it was just sitting in some other investment, you could move that money all at once into a whole life insurance policy, and once in that whole life insurance policy, again, whenever we're talking about whole life insurance, we're going to be talking about a mutual company that's going to pay the dividends back to its policyholders. So, you put in the million dollars, and it would grow over time.

For the sake of this example, we're just going to use it growing between 4% and 5% per year, that cash value, the million dollars that you put in. Well, here's the other attributes of it. It would grow between 4% and 5%, and it would be tax-free, federal tax-free, state income tax-free, and if you live in a city that has income tax, one like New York City, you would also not have to pay any of that city income tax on your gains inside the policy. It also is creditor-protected in 42 states in the country right now, and it's totally liquid. You could take your money out whenever you wanted, and last but not least, it's guaranteed to never actually decrease in value. Did I miss any of those attributes?

Cory: No, I don't think so.

Paul: We've got all of these main components. So, I want you to think about this for a moment. Let's say what you could do is you had a choice -- this is not available anymore. Again, this is an example of how it used to work, so it's easier to understand how it works today.

Think for a moment, if you could still do this today, if you could take $1 million, move it into a

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whole life policy, and it had all of these attributes, would you put much money in the bank beyond, maybe, your emergency funds? Like, would you have money in the bank at half a percent, if instead, it could be guaranteed inside of a life insurance contract gaining 4% to 5% a year with no taxes. That's pretty easy. We wouldn't put it in the bank. Would you put it in CDs, a five-year CD getting you 2% taxable in today's environment? Once again, the answer will be no.

Cory: Probably not.

Paul: Would you take money and put it into municipal bonds at 3%, and still take interest rate risk versus having a book value asset called this "whole life insurance" that's totally liquid, take the money when you want? No, people, again and again, pre-1982, were choosing whole life insurance as a place to store capital versus many other places they could put money. So, what happened? Somebody said, "There ought to be a rule." I think that's the downfall of -- many well-intended things start with, "There ought to be a rule against that."

“There are billions and billions of dollars in corporate America…that would love to own more whole life insurance.”

Cory: It's kind of like the lifeguards who didn't specifically tell you you couldn't play chicken. Now, it's like one person gets hurt, and it's like, "Everybody out of the pool, done for the season."

Paul: That's what happened here, so let's talk about what happened between 1982 and 1987. Largely, a set of legislations whose acronyms were TEFRA and TAMRA made up some new rules around life insurance.

Now, here's why they made it. How in the world did they let people have this vehicle called whole life insurance? Well, what they would do on top of that cash lying you see growing, they would put a little tiny layer, represented by the blue line, called death benefit. So, they might let you put in a million dollars, but the death benefit would only be $1,050,000. So, they're taking very, very little risk at the insurance company level while you put in all this money.

The IRS said, "We're just not going to allow that to be called life insurance. We're going to say that life insurance requires that the insurance company be at risk for some amount of risk beyond just the cash that somebody put in." So, these pieces of legislation came in, and the easiest way to understand it is the part of TEFRA, TAMRA that talks about a 7-pay test, meaning you cannot have this policy totally paid for in less than seven years.

Going back to our example, instead of us putting in $1 million all at once, what this rule now requires is that we put in all of the million dollars over seven years, and if we get all the money in over seven years, then we still get to retain all these attributes: 4% to 5% rate of return, it's federal, state, local tax free, it's still creditor protected in all these states, it's guaranteed not to go down in value, and it's totally liquid, and you can get your hands on your money when you need to.

But, think about this. Why is it most people don't do this today? Well, how many people do you know, maybe even yourself at one point in the past that was never going to make a decision that would require two, three, four, five years worth of foresight? Well, most people don't, and because they don't, the IRS, by simply making this seven pay test rule, created this corridor that had to be in place where there was money at risk for the insurance company.

We'll call that the TEFRA-TAMRA corridor. As long as there's money at risk for the insurance company, it can remain tax free as long as it doesn't penetrate this TEFRA-TAMRA corridor. So, the more death benefit we own, the bigger the window to put money into this environment. As long as the money is in there, it's exempt from taxes, and as long as you could distribute it properly, it could be distributed tax-free. How did we do on that, Cory? Any points of clarity you'd want to give our audience?

Cory: I think that the one thing we could acknowledge. The government identified life insurance as doing a social good. They didn't want to just do away with some of the tax benefits that were inherent to life insurance, because starting back 100 years ago, they gave the tax preference to life insurance so that people would be incentivized to own it, and then if someone died with life insurance, that puts lets pressure on welfare, social programs, the tax base, etcetera.

They just didn't want people to just buy the life insurance company's bond portfolio for no other reason, which is what it amounted to pre-TEFRA-TAMRA. People rich, wealthy, smart people said, "These life insurance bodies are managing their long-term low-risk holdings better than any other company I'm seeing. I want to buy into that portfolio. Now, you just have to want life insurance as well, at least not be too annoyed by having it.

"Before the TEFRA/TAMRA legislation you could put cash into a whole life policy and have 100% access to it right away."

Paul: Think about, even today, there are billions and billions of dollars in corporate America, and including banks, that would love to own more whole life insurance, and the reason they can't own any more of it is you have to have an insurable interest on an insurable life. This is why corporate America owns so many life insurance policies on executives, and why you see the same thing in banks.

In fact, if you want to look it up on your own, you can Google COLI's, C-O-L-I for corporate-owned life insurance, or BOLI for bank-owned life insurance. It's so widely popular in those places that there are acronyms for it that, and if you Google it, you'll see that companies own truckloads of it, because for them, if you're depositing money at the bank, let's say, and you're getting half a percent, they may well be turning around and storing some of that money in a whole life insurance policy that's getting them a better rate of return.

What are the other ways we could use it and what would the advantage be? Well, another major advantage that occurs for whole life insurance, if you own it, is that if you are the primary breadwinner or any breadwinner of your household, you have earnings, should you be permanently disabled, you can add to the contract that has to be done when you acquire the contract, that you can add to the contract, a waiver of premium that if you would be permanently disabled, what they would do is take care of the premiums for you. So, it might be the only part of your actual financial and savings programs that will self-complete, should you become disabled. That's one small piece I didn't want to miss.

Now, let's shift to where you might deploy whole life insurance somewhere in your life. We don't use it on every single client. We talk with people about whether it's appropriate, and it always has to get tested. So, if somebody's going through a design-build process, this is not a prescription that you should always do whole life insurance. It just can be a handy tool in somebody's toolbox.

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But, here's one way people do use it. I want you to imagine, for a moment, that you just, because of your earnings level, you're making $300,000 a year, it's totally appropriate to keep one year's worth of savings on the books. Now, here's the problem. If we look at a simple calculator of $300,000 sitting in cash, and that $300,000 -- now, if your number is $100,000 in cash, or you're a business owner watching this, and you keep $3 million in cash all the time, it doesn't matter. The math remains the same. Just, you do it to whatever multiple makes sense for you. So, $300,000 savings in cash for a total of, say, you're 35 now, and we're going to analyze this to age 65. If you're getting a half a percent rate of return on the $300,000 it doesn't amount to very much money.

What if, instead, we looked at that pool of money, that most of the time, goes untouched? In fact, your ideal life would be you wouldn't want to be in a position where you had to penetrate your emergency savings at all, if you could help it between now and age 65. It means something really bad happened. But, what if, instead, we simply dripped $30,000 a year from that policy or from that account over to a whole life insurance policy, so at the end of the decade, we've transitioned the money all to a whole life insurance?

Now, if you did that, what you're going to first notice is that you end up with only, only very slightly more money, sometimes a little less than you would have had had you built it up in cash. Some people say, "What's the big deal? That was kind of a waste of money. All I got was a little bit of death benefit, but I still have the same amount of money I would have had in cash," which is true, but this is where things are different. If we look at the first 10 years of that life insurance contract, we're going to see why Cory calls this the checkmark asset. Could you talk just slightly about why it is that illustration, Cory, kind of dips and then starts to head back up?

Cory: Sure. So, back before the TEFRA-TAMRA legislation, you could put cash into a whole life policy and have 100% access to it basically right away, and the government made that change to put that time limit factor on access into cash, so it just means that you have to have a little bit more long-term of a view to actually use a product like that.

When you put money into whole life, what Paul was talking about, transferring over into a cash account, you're actually going to go backward on access to that cash. So, that's the downward level of the checkmark, but then once you get past that hump and the policy equalizes the level of cash and then starts growing, you've got a contractual guarantee that the whole life cannot go backwards from the level where it was at unless you choose to take the money out. So, that's where we see that continued upward line from there. So, it's a nice balance to the volatility and constant ups and downs of the stock market to have that one asset that goes only one direction after a certain point.

Paul: Yeah, and what a unique way of thinking about it is that it is going to go down a little bit. If you were moving $300,000 of cash over, your total available cash is going to go down a little bit at the very beginning, and then start rising, which is not the same as all the other assets that we might own. Some of them could go down and be down for three years. The real estate wheel might go down for several years and then go back. Our equities, our portfolio of investments may go down and then come back up. This one, it does go down, but we know it's going to come back up.

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Cory: I think there's a lot of dialogue and opinion-based dialogue out there in the marketplace, so much so that people could have a very charged reaction to a word like whole life. But, if we just said, "Here's a mutual fund that's a little different than other mutual funds, I promise you that your money will actually go down for a couple of years at the beginning, but then after that point, it goes only upward from there. Would you like to have a little bit of that mutual fund?" I think a lot of people would.

Paul: I'm not at all meaning to stack life insurance against 401(k)'s, but look how readily we accept putting money into 401(k) with no thought, when in fact, we're being told there is no way we can touch our money until age 59 1/2 without significant taxes and penalties, and in some cases, while we're working for an employer, we may have no access unless we resign.

Talk about restriction to your money, but here's the difference between the two. When I get my statement on whole life insurance, it says my money's down. I get my statement on my 401(k), it says I have all that money, even the money that I don't have. If you have $100,000 in a 401(k) right now, you don't have $100,000. You might, depending on the state you're in, only have $65,000 depending on your income tax rate, and if you took it right now and you paid the 10% penalty, you have less than $60,000, but you feel great because it shows $100,000 on your statement. By the way, the financial institution feels great. They get to manage the $100,000 all the time, regardless of how much money is yours.

Cory: You know, another funny one is I built a spreadsheet once - maybe we bring it into one of these videos - where I took real data from stock market returns over a 10-year period, and there's lots of 10-year periods over the last 80 years where you would have had much more money in a whole life policy same same going in because of the volatility in the market.

Now, there are different assets meant to do different things. It's not saying one is better than the other, but it's just funny that people can sometimes say, "Oh, the cash goes backwards in the whole life," but never that the market can bring your cash backwards over the short term too. It's just very dissimilar movements, and that's a good thing.

Paul: Yeah, it's a good reason to have all. Like, it's not either/or. It's not even either/or or both; it's either/or is where everybody else is on this topic, and where we all are is all of it. It should all be on the table, we should be talking about all of it, and we should integrate into some of these financial pictures whatever assets are going to be most appropriate for their aims, for what they're after in their life.

Let's go to this idea of moving the cash and putting it in a better place to be positioned over time. Look at what happens now from year 10 to age 65, and look at how far apart the cash is in the whole life insurance policy, the cash value versus the cash if we left it in a bank growing, or being a little bit nice here, we're not assuming we have to pay any money to keep it there, which is sometimes the case, but let's say just half a percent after tax rate of return, and we see that these two numbers get very, very far apart, and at age 65, not only do we have far more cash than the whole life policy. We also have this little bit pesky younger brother just tagging around with all the cash value called death benefit. Perfectly usable to us as clients, but so often, we ignore it, or in fact, we disregard the asset because it has life insurance attached to it. But, we can see clearly that, compared to cash, this is the better place.

This is what we call the "Stillwater Strategy". Whether on your business balance sheet or on your personal balance sheet, think of all of this like a lake up in the mountain somewhere, and every lake out there has something feeding it - let's just call that a stream - and then water leaves that lake also often via stream.

Though, if it's a deep, deep lake, there's also still water that doesn't turn over that often. Much of the water just flows in and out on top. That's much like your personal financial picture. Somebody might leave $20,000 or $30,000 in their checking account and have $300,000 that's on the side that's their emergency fund.

That money that's on the side, that emergency fund, that's the still water. That's the money we don't turn over that often. If you're a business owner, that might be $3 million inside your business coffers. That's the money we want to reposition, make sure we still have access to it. Absolutely, we need to still have access to it, because the reason we had it originally was just in case of an emergency or opportunity, and if we can, instead of getting half a percent, slowly move the still water over to achieving closer to 4% tax-free, then we're much better overall positioned from a purely mathematical perspective not counting the value of the death benefit, which we're going to cover in our next video.

Lastly, we've talked about ways to use whole life insurance. Once again, we're talking about orchestrating everything. So often, if you get a chance to go to like a classical concert, then you're going to hear everybody tuning up, and the violins doing whatever they're doing, and somebody's hitting the drums, and then somebody else is playing the cello, and there's some horn going off, and it's a bit of a god-awful sound as everybody's checking their tuning.

Then, what happens? A conductor steps up to the podium, and he just taps, and when he does that, everybody comes into unison, and then they're orchestrated. That's what we're doing with our financial assets. So, one orchestration that can be done is, let's say, you have an investment portfolio of $1 million. Well, what's prudent to do is to keep a fixed income portion of that portfolio.

That's what Cory talked about earlier of being equal to bonds, and that's meant to be the safe harbor in your portfolio so that when stocks go really, really well, and now they make up 90% of your portfolio, we're taking part of those chips off of the table, if you will, and moving them to the safer assets. That way, when stocks go the other way, we're going to be taking money to safe stocks that not only make 70% of the portfolio, we're taking money out of cash and pushing it back into the market. We're at a fixed income pushing back in the market.

Well, we can do something similar to reduce risk on somebody's portfolio simply because they have whole life insurance. I cannot tell you how often I've met somebody, or Cory has met somebody where they go through the process with one of our advisors and they already have whole life insurance, but no advisor they've worked with have actually treated the whole life insurance as an asset class. So, they have bonds in their portfolio, they have their cash in the bank, and then there's like this thing that's like the ugly stepsister in a closet somewhere that's just sitting on a shelf, this thing called a whole life policy.

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What I want you to consider is that needs to be integrated. So, something very simple: you've got $100,000 of cash value in life insurance, that can act as a bond substituting a portfolio. So, if you were normally going to have 30% in bonds in your portfolio, if you had an amount that equaled 10% of your portfolio in cash value, you could then have a portfolio that would do 80-20, meaning 80% stocks, 20% bonds, and still have the same risk profile you originally intended. In fact, if people build up a lot of cash and don't pay attention to this, a lot of cash value and they're not paying attention to their overall portfolio, they could unknowingly be taking a much more conservative stance than they would have intended.

So, that's it on life insurance, other uses than having it inside your financial life. If it's used properly, it will get you a great rate of return compared to other safe vehicles. It remains liquid, it does have to be built over time. In the first few years, you are running from behind, but you'll see, from this conversation, you actually end up getting ahead, and way ahead ultimately.

Lastly, we can use it as a substitute for cash in our lives. If somebody sues us, in most states, it's totally creditor protected, and it puts us and our families in the positions where there's actually death benefit on the table, permanently, the entire time, protecting us via waiver of premium. Meaning, if we got permanently disabled, they will continue to self-fund the program for you so that you end up with that completing on your balance sheet.

Next, we're going to talk about whether or not there's benefit to having that permanent death benefit in your life so that you'll have that well on into retirement. Have a great rest of your week, so glad you could join us, and watch back here in the coming week for the next video. We're going to talk about spending your death benefit while you're alive.

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