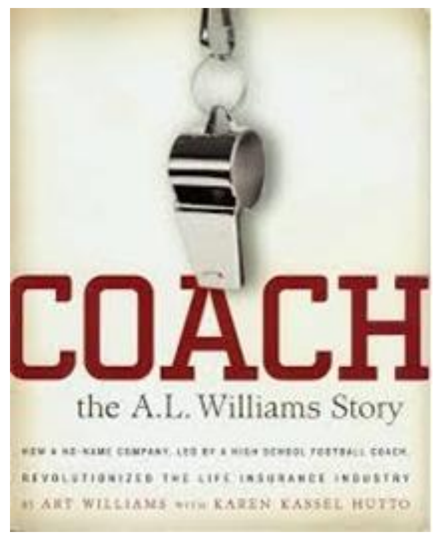
Buy Term, Spend the Difference

by Antoine Rempp

Life insurance is often perceived as a boring and confusing subject, and while some understand the value of it, most people usually try to avoid the topic all together, or if they do decide to buy some, they usually want the cheapest product possible. Over the last few decades, the phrase "buy term and invest the difference" has become more and more popular. The purpose of this article is to discuss where the sentence comes from, what it means, and finally if it still applies in today's economy and society?

Let's go back in time to see where this phase came from. Some of you may have heard of A. L. Williams or Art Williams, he was a very successful football coach, who after facing a tragedy at home with the passing of his dad at a young age, discovered a flaw in the way people were sold insurance policies in the early 80s. He did some research, and a few years later decided to quit coaching football to become an insurance salesman, "to correct an injustice". He started a company from scratch and grew it to over 220,000 insurance sales people in just a few decades. The company that Art built was later purchased by Primerica. Following that acquisition, Art was asked to step aside and retire. His story is very neatly documented in his great book "Coach". What he achieved in these few decades is astounding: he transformed the life insurance industry.



His main focus was the replacement of the "Whole Life" policies with "Term" policies. The whole life policy is a permanent contract, as opposed to the term policy that can be renewed every 10, 20 or 30 years (at a price) but expires when the insured reaches 80 or 85 years old. Nobody who has a Term coverage ends up keeping the coverage as they reach their 60ies, as the premiums (monthly payment for the policy) in those years usually exceed $500/month. In the early years, the premiums are fairly higher with the whole life contracts compared to the term contracts, for a very simple reason. The insurance company knows that they will have to pay out on the permanent contract (guaranteed for life), while they also know that the probability to have to pay out on a temporary contract is lower than 4%. As the saying goes: "there is no free lunch with life insurance".

When Art started his crusade to replace the whole life policies with term, the permanent policies that were sold at the time were designed to favor high commissions for the insurance agents, and low death benefit for the clients. His whole approach was to purchase cheaper Term Insurance, and invest the balance in monthly premiums into mutual funds.

In the 80s, that made huge sense, but is that still true? The entire concept relied on the client being "self-insured" by the time retirement came, or if a tragedy hit before, the Term coverage would provide a death benefit to the family left behind. The Term insurance coverage would therefore last for the 20 or 30 years, leading to that "self-insured" stage, at which time the term coverage would be dropped or cancelled, to be replaced by the significant amount of money held in one's investments. The other assumption in this scenario was that all debt would have been paid off by then, no mortgage left, no car loan, no line of credit...

For this concept to work, the investment portfolio had to perform. In the 80s and up to the dotcom bubble in 2000, a monkey would have made money on the market, as the trend was constantly going up. Kevin Bueter, in his book "The great wall street retirement scam", provides an interesting explanation of that phenomenon. In those years, you couldn't really go wrong investing the difference, as most mutual funds would grow in the double digits every year. The investment would grow to some decent amount, allowing one to literally self-insure. The concept made senses, in those years it did.

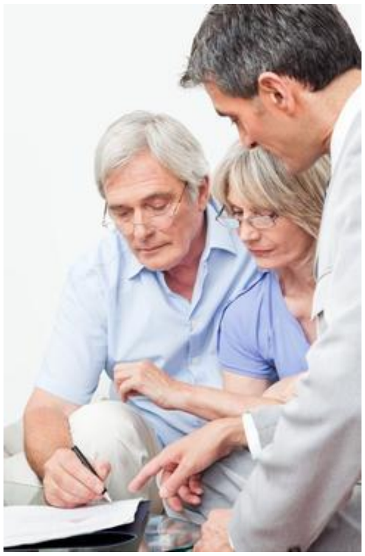
But how has the mutual funds industry performed since 2000? The last decade is called the "lost decade" for a reason: those who invested money 10 years ago on the market are pretty much sitting at the same place 10 years later. If you add the fees, and the erosion caused by inflation, you surely haven't built that self-insurance account that would allow you to replace the term coverage that you dropped because it has become too expensive.

How about the debt situation. In the 80-90ies, a married couple with kids would pay off the house within 20 years (if not sooner), the kids would have left home (along with their expenses), and the credit card industry didn't have such a toll on the household financial stability. The nest egg required in those years to retire was far easier to manage than in our current times. It is not uncommon nowadays for couples in their 50s to purchase a new house with barely any down payment, while their vehicle payments and credit card debt remain a serious concern should something happen to the breadwinner after the term policy is dropped. The boomerang generation doesn't help either, as kids move out, get married, only to end up a few years later back in the basement, bringing an additional financial burden to the couple looking forward retirement. Actually, with our society so marketed into debt by the media, the saying "Buy Term and Invest the Difference" is now more often referred to as "Buy Term and SPEND the Difference". The outcome is quite different.

Another point is the life expectancy in the 80s. In those years, life expectancy was quite shorter than today. With the medical progresses, people live longer, which means they will require more money to last a longer retirement. With the debt burden remaining and the absence of proper returns on the investment side, the need for life insurance changes completely. The challenge with the term coverage is that it expires, usually around age 80 or 85 (regardless of your financial situation or health), but the premiums usually become very expensive as the clients get older, and most often too expensive by the time the clients reach their 50s/60s. Most people do not renew the term coverage as they pass the half century mark.

Last but not least, the whole life policies that were sold in those years were NOT designed properly, to the point that I would have hated having been sold one of those policies on my own life back then. You could easily spend 20, 30 or sometimes even 40 years making significant payments to the insurance company, with very little death benefit for your family at the end. The coverage was permanent, but it also became insignificant very quickly. A whole life insurance policy can be structured 2 complete opposite ways: one favoring the amount of death benefit, the second one favoring the amount of available cash growing inside the policy. One offers higher

commission to the advisor, the other one cuts it by 30 to 40%. Guess which one was promoted (and still is) by the majority of the sales force?
Those whole life policies that are structured for the largest death benefit at the lowest cost are usually only designed to meet estate tax needs or to leave money to heirs or a charity.



The opposite variation would be a policy in which you plan to put a specific annual amount in for a certain number of years for the purpose of cash accumulation. The focus here is not the amount of insurance, rather it is the amount of money that you can get into the policy. Here a policyholder would overfund the policy in the earlier years and plan to stop after 20 years or at age 100.

It is relevant to mention that the first goal of life insurance is to determine the right amount of death benefit need. Assuming that the need is met, we can move on to how the cash value can benefit a client. Our goal in financial planning should not only be to build an accumulation plan, but also to establish a distribution strategy. Most plans, today, have been focused on growth and neglected distribution.

With the proper whole life policy, you could very easily follow the adage buy term and invest the difference, just use part of that difference to fund a whole life policy.

Please don't hesitate to contact us at antoine@remppfinancial.com should you have some questions regarding the information in this article.