

BUY THE DIFFERENCE

Comparing the cost of universal life coverage vs. term is relatively simple. Comparing the benefits is not as easy.

BY EDWARD BROWN

Back in the 1960s, a number of insurance salesmen popularized the phrase "buy term and invest the difference." Their theory was that since the typical whole life insurance policy was crediting just 3% to 4% of the premiums toward the cash value, a buyer could accumulate more money by "unbundling" the insurance coverage from the investment. This could be accomplished by purchasing a cheap term insurance policy and investing the difference between its premiums and the whole life policy's in an alternative investment like bank certificates of deposit or mutual funds.

Of course, the insurance industry responded with new universal life insurance products that accomplished the same general goal. In the 1970s, when interest rates were climbing, universal life policies offered competitive earnings in a tax-deferred environment and allowed policyholders to alter the schedule of premium payments—or even skip some years altogether. Despite the popularity of these new products, many advocates of the buy-term-and-invest-the-difference strategy held their ground, arguing that their strategy was superior. The debate, though considerably muted, still goes on today and will probably continue for the foreseeable future. However, upon examining the merits of both sides, the weight of evidence appears to be on the side of advocates for universal life.

To understand why, let's define the terms. When policyholders buy term insurance, they are paying premiums strictly for death protection. The premiums are based on the expected life of the policyholder; the shorter the actuarially determined expected life, the higher the cost of insurance. Typically, a term buyer might pay \$1.30 to \$1.60 per \$1,000 of life

insurance between ages 30 and 40. As the insured passes age 50, and then 60, the premiums increase almost logarithmically. At age 50, the same \$100,000 policy that might have cost a 30-year-old \$130 a year would cost \$300 and would rise to \$700 for a 60-year-old. Rates per \$1,000 usually decrease if the death benefit is \$250,000 or more, and most policies guarantee renewal; however, the cost is clearly going to be very high in the client's later years.

Most term life insurance policies have two sets of rates: the guaranteed rates allowable by law, which must be printed in the policy, and the premiums that the insurance company currently charges and expects to charge throughout the life of the policy. For illustration, let's use the current premiums expected to be charged by the insurance company. Unless certain situations radically change, this is probably a realistic estimate.

Table 1 shows the annual cost of \$250,000 of term insurance for a 41-year-old male nonsmoker. The cost increases more than tenfold over the 20-year period; as a result of the high cost between ages 55 and 60, the total premiums paid amount to \$33,256. In return, for the past 20 years the policyholder has granted his heirs the right to claim \$250,000 upon his death, with no cash value accumulated over that 20-year period.

With a universal life policy, the insured pays a larger premium than the cost of term insurance. In fact, as illustrated in Table 2, the premium each year in years one through five is \$5,000, rather than the \$358 to \$708 shown in Table 1. Some of this pays for \$250,000 of coverage, while some goes toward commissions and administrative fees. For the remaining cash value, an interest rate is applied, and where applicable, the company imposes a surrender charge, which

TABLE 1

TERM LIFE INSURANCE

Male, Age 41, Nonsmoker

Death Benefit: \$250,000

YEAR	PREMIUM
1	\$ 358
2	443
3	528
4	618
5	708
6	800
7	910
8	1,038
9	1,195
10	1,363
11	1,545
12	1,695
13	1,863
14	2,045
15	2,258
16	2,533
17	2,830
18	3,155
19	3,503
20	3,868
TOTAL PREMIUMS	\$33,256

typically vanishes if the policy is not cashed out within 10 or 15 years.

In Table 2, the target premium is close to \$2,500 for 10 years, but the policyholder has elected to double the payments and make only five for the life of the policy. To compare the two policies on equal terms, let's start by obtaining the present value of the total premium payments into the universal life policy. If we use an 8% discount rate, the net present value of the \$25,000 in payments over five years comes to \$21,561. Let's further assume that the term policyholder's investment account will earn 8.5% and that the insurance company's gross interest is 8.5%—that is, before subtracting mortality costs, administrative fees and commissions. Finally, let's assume the insured is in a 30% combined state and federal tax bracket and the cash value that builds up in the universal life policy will continue to build in a tax-free environment as current law provides.

With these assumptions behind us, we can pose a very simple question. Is it best to pay \$21,561 now for a \$250,000 universal life insurance policy? Or would the client be better served to put the money into an investment account and purchase term insurance each year at premiums starting at \$358 in the first year and escalating to \$3,858 by the 20th year?

Table 3 shows the year-by-year results of the buy-term-and-invest-the-

difference strategy. The client starts with an account whose value is equal to the present value of the payments into the universal life account in our earlier example: \$21,561. During each year, the term insurance premium from Table 1 is subtracted from the account, and the balance earns interest at a constant rate of 5.95%–8.5% minus the 30% tax obligation. The final column shows what the account would be worth if the investor were able to get a constant 10% pretax return on his investment, or 7% after tax.

After five years, the account balance in Table 3 is \$25,681, which compares favorably to the \$24,442 cash value of the universal life policy in Table 2. This is evidence in favor of the buy-term strategy—or is it? In the 10th year, the term account value is only \$28,052, whereas the universal life policy's cash value exceeds \$39,000. Starting in the 13th year, the term premium becomes more substantial than the amount earned on the investment account, so the account balance begins to decrease. At the end of 20 years, the term insurance/investment strategy results in an account value of \$19,021, compared with more than \$75,000 in the universal life account.

Even if the investor using the term strategy were to earn 7% after taxes, the universal life option would still prove more beneficial. Once again, somewhere between years five and 10 the universal life policy account begins to surpass the investment side account, and the result is essentially the same after 20 years. If the policies were kept in force for longer periods of time, then the difference would be even greater; however, beyond that point of the client's life, insurance coverage may not be necessary. How do the two strategies compare if, after 10, 15 or 20 years, the investor decides to forgo insurance coverage for the remainder of his life? This would involve taking the cash value out of the universal life policy and paying taxes where applicable, or taking no more term insurance payments out of the side account established for the buy-term-and-invest-the-difference option.

Under current tax laws, each premium payment into the universal life policy increases the taxpayer's basis. After five years, the policyholder would have a basis of \$25,000. After 10 years, the

TABLE 2

UNIVERSAL LIFE INSURANCE

Male, Age 41, Nonsmoker

Death Benefit: \$250,000

YEAR	PREMIUM	CASH VALUE	EFFECTIVE TAX-FREE INTEREST RATE ON DISCOUNTED PREMIUMS
1	\$5,000	\$ 971	
2	5,000	5,959	
3	5,000	11,567	
4	5,000	17,659	
5	5,000	24,442	
10	—	39,019	6.11%
15	—	54,090	6.32%
20	—	75,091	6.44%
\$25,000 TOTAL			

TABLE 3

TERM INSURANCE — INVESTING THE DIFFERENCE

VALUE	PREMIUM	NET INTEREST	END OF YEAR	ACCOUNT BALANCE	7% NET INTEREST
\$21,561	<358> =	\$21,203 × 1.0595	1	\$22,465	\$22,687
22,465	<443> =	22,022 × 1.0595	2	23,332	23,801
23,332	<528> =	22,804 × 1.0595	3	24,161	24,902
24,161	<615> =	23,546 × 1.0595	4	24,947	25,988
24,947	<708> =	24,239 × 1.0595	5	25,681	27,049
25,681	<800> =	24,881 × 1.0595	6	26,362	28,087
26,362	<910> =	25,452 × 1.0595	7	26,966	29,079
26,966	<1,038> =	25,928 × 1.0595	8	27,471	30,004
27,471	<1,195> =	26,276 × 1.0595	9	27,839	30,825
27,839	<1,363> =	26,476 × 1.0595	10	28,052	31,525
28,052	<1,545> =	26,507 × 1.0595	11	28,084	32,078
28,084	<1,695> =	26,389 × 1.0595	12	29,580	32,510
29,580	<1,863> =	27,717 × 1.0595	13	29,366	32,792
29,366	<2,045> =	27,321 × 1.0595	14	28,947	32,900
28,947	<2,258> =	26,689 × 1.0595	15	28,277	32,787
28,277	<2,533> =	25,744 × 1.0595	16	27,276	32,371
27,276	<2,830> =	24,446 × 1.0595	17	25,900	31,609
25,900	<3,155> =	22,745 × 1.0595	18	24,098	30,446
24,098	<3,503> =	20,595 × 1.0595	19	21,821	28,829
21,821	<3,868> =	17,953 × 1.0595	20	19,021	26,709

universal life cash account is worth \$39,019, the gain is \$14,019 and the tax obligation (30% of the gain) is \$4,206. If we subtract the taxes from the cash value, the policyholder's after-tax account is worth \$34,813, which compares favorably with the \$28,052 (at 8.5%) or \$31,525 (at 10%) that has accumulated in the term strategy's side account. If the universal life policyholder were to cancel his policy after 15 years, the tax obligation would be \$8,727, and the after-tax value would be \$45,363—well above the term account balances of \$28,277 or \$32,787. After 20 years, the universal life policy would have an after-tax value of \$60,064, compared with \$19,021 or \$26,709.

It is important to put these results into proper perspective. Despite universal life's obvious long-term advantages—a tax-free buildup and vanishing premiums—term insurance serves an important purpose in today's market. If

a young client cannot afford to pay universal life's relatively high premiums or plans to maintain insurance coverage for less than seven years, then term insurance should be considered. However, policyholders tend to be reluctant to cancel their life insurance coverage even in later years, which means that planners should carefully consider the client's temperament and enforce discipline if the term option is chosen.

For most other situations, universal life has apparently answered the market's desire for an unbundled product without giving up the idea of permanent insurance. Although tax laws may alter the economics of life insurance in the future, planners should test the year-by-year benefits of term and universal life insurance using their own assumptions. Their goal is to help their clients take a long-term perspective on the costs and benefits of today's complex array of risk management vehicles. □