Insurance

The primary goal of insurance

The two main types of life insurance are "term" and "permanent." Term life is a pure insurance product, while permanent insurance, also called "whole life," has a savings component, too. Make term life your opening position, just like you should castle early in the game, since your highest priority is protecting your family. You can use permanent insurance along with the other more sophisticated policies, for differing strategies later on.

Characteristics of term life insurance

- **Low cost** – A term life policy, which is a temporary type of program since it ceases when you stop paying premiums, is cheaper than all other life policies since the only cost is the wager on your date of death. Younger people pay less for the arrangement as they have lower odds of dying than older people do. For example, a healthy forty-year-old man who buys a twenty-year level term policy (which means he locks in the premium amount for twenty years) will pay around $900 per year for a $500,000 death benefit. The same man at age fifty would pay about $2,000 per year, and at age sixty would have to pony up around $7,000 in order to insure his life for $500,000. (Note that these figures are only samples, and the true cost depends on many factors, including where you live, the quality and policies of the underwriting company, your health, and more.) When insurance agents tell you it's a "level premium" policy, you might feel like you are paying a fair amount. In reality, though, you are overpaying in the beginning in order to receive a lower yearly rate at the end. If you were to drop such a twenty-year policy after only ten years, you would have grossly overpaid for that first decade. As best as you can, therefore, try to figure out how long you will actually need coverage.
- **Temporary coverage** – Term policies normally cover periods of one, five, ten, or twenty years and, unless you renew them, they terminate. The benefit is that you get protection for your family for only the specific time that you need, such as when your children are growing up. The disadvantage is that once the policy ends, you have nothing to show for it. You have just filled the coffers of the insurance company. But don't despair – at least you're alive.
- **No cash value** – Since term policies don't accumulate cash as part of a savings plan, you can neither withdraw money nor borrow against this type of coverage.
- **Renewable** – Many term policies allow you to renew them when the initial term expires without having to show proof of insurability. That means that if you get sick during the term of the policy, you can still renew it even if you wouldn't pass the physical exam the second time around. If the policy lacks the "guaranteed renewable" clause, though, you would have to start applying from scratch, which may mean higher premiums or worse – not being able to get insurance if your health has deteriorated.
- **Convertible to permanent** – Though you might wisely choose to start out with term insurance, if your health worsens or if your retirement plans change during the duration of the policy, you might later decide that you want a permanent cash value policy. If your term life policy has a convertibility option, you would be able to switch to a permanent policy without having to undergo another medical exam.

Characteristics of permanent life insurance

- **Permanent protection** – Unlike term policies that end at a certain age, permanent life insurance gives lifetime protection as long as you pay the premiums on time.
- **More expensive to maintain** – You will pay higher monthly premiums with a permanent policy than with term coverage since you are not only paying the cost of insurance, but also the cost of savings.
- **Forced savings** – Since many people neglect to stockpile savings, having a policy that obligates you to make regular deposits can help less disciplined investors.
- **Cash accumulation** – Having cash build up in the policy allows for savings, a safety net in case you can't afford to make a premium payment, and the possibility of taking out a loan against the policy. Don't get too excited, though, because due to the internal costs associated with cash accumulation policies, it takes several years for a sizeable sum to accumulate in your policy. People like cash accumulation policies because they can borrow money from the underwriter. Conveniently, when borrowing against your policies, you have no set schedule for repayment. You can pay a little this month, more the next month, or choose to pay nothing at all. This feature, however, could turn into a disadvantage. For starters, if you don't repay the loan, the company will eventually subtract the amount owed from the policy, which reduces the death benefit. Second, by removing cash value from the policy, you may affect the dividends that you might earn on the account. Third, if you don't make sufficiently high monthly payments, the company's number crunchers will add the interest owed to the base loan, so you'll pay compound interest, meaning that you will pay interest on the interest. Eventually, if you don't pay back the loan and you deplete the cash value of the account, the policy will lapse, and you will have no more coverage at all.
- **The loan feature** – This feature really means that you borrow your own money from the insurance company and pay them interest and possibly fees for the privilege. Why would you want to do that? It's like finally getting your pawn to the back rank of your opponent's turf and, instead of electing to promote it to a queen, you exchange it for another pawn. That useless move, which is not even allowed in chess, is like building up your savings for years and then, when you finally decide to use it, you end up paying interest to borrow your own money. Contrast this to investing the money on your own, and when you need it you simply withdraw the funds from your bank or brokerage account without incurring extra interest payments and expenses.
- **Favorable tax treatment** – Due to the special tax status of insurance companies, the earnings inside the policy are not subject to tax. However, when you start taking withdrawals, you will have to pay regular income tax. If you need to take out money before you reach age 59½, you will have to pay a 10% penalty to Uncle Sam on top of the tax.
- **Level premiums** – Insurance companies design permanent policies to maintain a steady premium. Predictability in financial planning has huge benefits, since you don't want to find yourself unable to afford the rising costs of your policy. Remember what happened to people who had adjustable rate mortgages? When interest rates moved up more than they had originally anticipated, they could no longer afford the monthly payments and had to abandon their homes. The same problem can arise as you get older if you don't have a "level premium" policy to keep your annual payments fixed. Eventually, you may not be able to afford to pay them at all. Having level premiums, though not necessarily the most cost-effective way to buy insurance, affords you the comfort of knowing exactly how much you will have to pay each year over the life of the policy. You may find that predictability is well worth the extra cost.

Different policies suit different people depending on their situations in life, their tolerance for risk, their ability to watch their portfolios, and more. Though some individuals may like the forced savings and tax-deferred growth inherent in permanent life policies (sometimes called "cash-value" policies), others note that IRAs and 401(k) retirement plans force you to save, too, and the money accumulates on a tax-deferred basis. Also, permanent life policies tend to have high fees, and the insurance component may often be more expensive than that in a comparable term life policy. Above that, there are marketing and sales commissions, surrender charges if you drop the policy in the first ten years, annual investment fees (which are often complicated to determine), and a fee called the "mortality and expense" ("M&E") charge that compensates the company for various risks it assumes. Though the fees may not stop you from reaching your goals, they can certainly slow you down.

Should you buy term or whole life?

Focus on maximizing the effectiveness of each of your money moves. Just as a chess player moves two pieces at once when castling, maneuver your investments so that each, in its unique way, moves you toward your goal as quickly as possible. Specifically, go for the efficient route and handle insurance needs with a term policy and investments with a brokerage or bank account. While one-stop shopping may seem efficient, it can be more costly in the long term.

Illustrations

In tournament chess, players write down the moves. This allows them to study the progression of the game and compare one series of moves with another. Likewise, ask your insurance agent to supply you with a written policy illustration to see what the premium pattern looks like and compare apples-to-apples against other similar policies.

Riders

Riders in insurance policies are long shots. Policies almost never pay out for these extras, such as accidental death (which might double the death benefit) and waiver of premium (which takes over your monthly payments should you become disabled). Paying the extra cost to buy the rider, which can become a hefty sum when calculated over the years, is akin to a chess master advancing a specific pawn each and every move in the beginning stage of the game. He might get to the other side and capture an important piece, but the odds of that are slim. Instead of wasting time marching forward with this one piece, he could develop a much more potent strategy during those moves. Though some riders might make sense in your case, don't blindly buy them all. These add-ons complicate the core point of buying insurance, which is to protect you against a specific (though improbable) risk that you cannot afford to handle on your own.

When castling, not only do players swap their kings and rooks, but they also build a solid defense around the king using pawns, bishops, and knights. If the defensive players fail in their protection duty, or wander off to some other part of the board, the king is left by itself and all the effort of castling is for naught. Likewise, if you pay premiums to a second-rate company for years and if it subsequently fails or experiences significant fraud, you may be left defenseless. You can confirm the soundness of your insurer by checking with a rating company such as AM Best (www.ambest.com) that evaluates and analyzes the stability of companies. Though their review offers no guarantee, at least you get a sense of the stature of the company upon which you are relying to protect you and your family. In any event, though, most states have a "guaranty fund" designed to deal with insurance bankruptcies. Though there are limits to these funds, they normally offer enough coverage for the average consumer's claim.

Just as a grandmaster works multiple strategies simultaneously, insurance planning must also cover many possible eventualities. Spend time reviewing your life and disability programs, and also checking and updating your health, home, mortgage, car, and other coverages, too.