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INSURANCE

Types of Life Insurance: Which is Right for You?

13 MINUTE READ

If you have a car, you have car insurance. If you have a home, you have homeowner's insurance. If you have a life . . . well, it only makes sense to carry life insurance, right?

Life insurance is one of the most vital pieces of your family's long-term financial plan—and it's the one we want to discuss the least. Its purpose is simple: to replace your income for your family if you die. But with all the choices available, finding a policy that's just right for you could lead to extreme confusion and frustration.

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Fortunately, it doesn't have to be that way. We'll take you through the most common life insurance policies and help you find the one you need.

Term Life Insurance

Term life insurance is the simplest (and usually the most affordable) type of life insurance you can buy. That's because it's insurance that does one thing and one thing only: pays the people you choose—your spouse, children, or other beneficiaries—a fixed amount of money if you die. But a term life policy is not worth a thing unless you die during the course of the term. (We said it wasn't a fun thing to talk about.) The bottom line is, it's a way for you to proactively take care of your loved ones so they don't have to worry when you're gone.

Protect the people who depend on you the most with term life insurance.

Get Started

Think of it like your car insurance. Every six months (or maybe every month), you write a check to your insurance company. They deposit your check. If you have a wreck, they pay the claim. But if you don't have a wreck? You don't expect a refund on your premiums just because you paid them to take on all the risk of that big, family road trip across the country.

With term life, you're paying the insurance company to assume the financial risk of your death during the period (or *term*) of your policy. Typical terms are 10, 15, 20, or 30 years. So, if you buy a 15-year term life policy with $500,000 in coverage, you'll make a monthly payment for 15 years. If you die during that 15 years, the insurance company will write your family a check for $500,000, also known as the death benefit.

If you've listened to Dave Ramsey for more than five minutes, you've probably heard him say term life is the only life insurance policy you should get. We recommend you purchase a term life insurance policy for 10–12 times your annual income. That way, your income will be replaced if something happens to you. This is the cheapest way to protect your family long-term. More on that later.

Permanent Life Insurance

If term life is pretty easy to understand, permanent life insurance is where it gets *really* complicated. That's in part because permanent life insurance is trying to do two things at once. It's trying to provide the benefits of life insurance—paying your beneficiaries in the event of your death—and trying to be an investment account at the same time.

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A permanent life insurance policy includes something called "cash value." Think of cash value as a savings account you're depositing money into every month. It's a pool of money you own and can access or borrow against. The longer you have the policy, the more cash value the policy has.

Another major difference between permanent life and term life policies is that permanent life policies don't expire. They continue until you die or quit paying your premium.

The particulars of how much your family receives, how the cash value grows, and other questions depend a lot on the policy you purchase. Permanent life insurance policies can

include whole life, universal life, or variable universal life.

Whole Life Insurance

When you purchase a whole life policy, you lock in the premium amount for as long as you want the policy. Each month, you pay your premium to the insurance company. A portion of that premium goes into the cash value and grows over the whole life of the policy. Get it? *Whole* life?

The longer you own the policy, the more cash value it has. It really is like a savings account. But remember, your life insurance has one job: to pay your beneficiaries if you die. Because whole life does this *and* grows a cash value, you're usually paying *more* for *less* insurance.

That's why whole life insurance can be a lot more expensive than term life insurance. Worse still, whole life policies don't gain as much cash value as that extra amount you're paying would if it were invested in a good mutual fund. Does it make sense to spend more money for less coverage and a bad long-term investment? Hint: it doesn't.

Universal Life Insurance

Like a whole life policy, universal life insurance has a death benefit and a cash value. But unlike whole life policies, universal life insurance policies offer adjustable premiums—meaning you might be able to access some of the cash value to adjust your yearly payment. Either way, you're not off the hook for the minimum premium payment to maintain the policy. But you *might* be able to eliminate a premium payment depending on how much potential cash value you have. Or, you might choose to leave things alone and possibly rack up some cash value over time.

Which leads us to the long-term investment "strategy" of this type of policy. Basically, part of the monthly premium of a universal life policy goes toward the death benefit and another part is invested as "savings." The thought is that the investment will grow with time—and maybe even enough to offset the premiums all together.

But in reality, this is a *bad* investment strategy. Why?

Two things:

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1. Fees: Beware of management charges. They're real and they're hefty.
2. Annual Renewal Term: Prepare to have smaller portions of your premium annually "renewed" or applied to the cash value investment part of your policy, and then larger portions annually "renewed" or applied to the insurance portion of your policy.

An annual renewal term might help cover the increased risk of death as you get older, but that will be the only thing increasing—definitely not your savings! You're better off getting a term life policy and investing in a mutual fund for a better return.

Variable Universal Life Insurance

Remember how whole life and universal life policies are trying to do too many things at once? So are variable universal life policies. They just get more complicated! Variable universal life policies are trying to be a life insurance policy, a savings account, and a mutual fund all at one time. And that gets *expensive*.

Variable universal life insurance allows you to decide *how* your cash value is invested. As with a traditional mutual fund, there are dozens of risk levels of stocks and bonds you can choose. You're presented with a host of investment options for your cash value, and you get to pick how risky you are with those investments. That's the "variable" part. However, it's key to remember that insurance is about risk and who assumes the risk.

Because *you* are in control of where your money is invested, *you* bear the risk of your investments—not the insurance company. Variable universal life policies have no guarantees about how much the cash value of those policies will be.

Dave considers variable universal life policies to be one of the *worst* life insurance options on the market because of the high management fees. (Are you seeing a fee trend here?) Again, you would be much better off getting a term life policy and putting your hard-earned money in mutual fund investments.

Other Types of Life Insurance Policies

The two primary types of life insurance—term life and permanent life—are just the tip of

The two primary types of life insurance—term life and permanent life—are just the tip of the iceberg. Insurance companies also offer dozens of other insurance policies, each designed to pay death benefits in different ways. Here's a brief overview of the types of life insurance you may encounter when you're shopping around.

Joint Life (First-to-Die) Insurance

Joint life insurance, also called first-to-die insurance (yikes!), is a cash value policy marketed to couples who want to share a policy between them. Think of joint life insurance policies as the joint checking account of the life insurance world. The policy covers two individuals for one fee. These policies pay a death benefit as soon as the first spouse dies.

And there's the problem: if your finances are like most families, one spouse makes more than the other—and sometimes a lot more. Remember, the job of life insurance is to replace someone's income in the event of their death. Joint life insurance takes a one-size-fits-all approach and pays out the same benefit to either spouse.

That means you could be paying a lot more to insure your spouse's part-time income from the local fabric store than you would if you were to simply buy two term life policies. A joint life policy doesn't make a whole lot of sense when you weigh the costs.

Survivorship (Second-to-Die) Life Insurance

If joint life insurance policies don't make much sense, then survivorship or second-to-die insurance life policies are a complete waste of your money (and doubly hard to talk about). We recommend you avoid survivorship life policies altogether because a survivorship life policy, which is also a type of cash value policy, pays absolutely zero benefit to anyone until *both spouses die*. Then, it pays your kids.

Survivorship policies are primarily geared toward wealthy people wanting to avoid large estate taxes on what they leave behind. They aren't really intended to cover your spouse at all. Plus, your spouse isn't covered when *you* die. So yes, you guessed it. As with all cash value policies, here's the broken-record message: you and your spouse are better off getting a term life policy and then investing in a good mutual fund instead.

Final Expense Insurance

At first glance, final expense insurance (or burial insurance) seems to make sense because

it's relatively cheap. Flashy advertisements will suggest you're sparing your family the burden of paying for your funeral. It's all about "peace of mind" in knowing your funeral expenses are covered before you die, right?

But burial insurance, which is also a type of cash value insurance, is a completely emotional purchase that makes absolutely no sense financially. Your funeral is something you can *plan to pay for* if you simply set aside $50 a month every month starting at age 55.

Let's say you live to the ripe age of 78 years old (the average lifespan in America).(1) That's 23 years of socking away $50 a month or more than *$13,000*—and that's assuming you don't invest the money! If you invest it with your other savings and earn just 10% a year, you'll have saved almost *$53,000*! Since the median cost of a funeral is around $7,000,(2) why not just save up the money to pay for your own funeral and tell the insurance company to take a hike?

No Medical Exam Insurance

Both term and whole life policies typically require applicants to undergo a medical screening. But no medical exam policies allow you to, you guessed it, skip the medical exam. You just have to pay more. In fact, these polices are usually pretty expensive—we're talking many times more than a traditional term life or whole life policy, but with a lower face value. That's because the insurance company has to assume far more risk by not requiring a medical exam. So you can expect the price to be a lot higher.

These policies cost far more and pay out a lot less. You should really just go ahead and get the medical exam. You'll be glad for the money you've saved!

Decreasing Term Life: Mortgage Life and Credit Life Insurance

Decreasing term life insurance was designed to provide a death benefit that decreases in proportion with a decrease in your liabilities. Specific examples of this type of insurance include mortgage life and credit life insurance. In these examples, the death benefit is designed to follow the amortization schedule of a mortgage or other personal loan.

The policies are advertised as a way to settle debts or pay off your mortgage if you die. So really, it's just making payments on your debts—and your beneficiaries don't get the full benefits of life insurance. In other words, they potentially inherit nothing more than a

benefits of life insurance. In other words, they potentially inherit nothing more than a paid-off or paid-down debt, but no cash in their pocket. Like term life insurance, there is no cash value. Therefore, the final value is ZERO at the end of the term.

So, let's go back and take a look at that $500,000 term life policy example we mentioned above and apply it to real life. If you had a decreasing term life policy and died in the last month of the term, your family would get zero dollars.

So, here's the question: if life insurance is about protecting your family's long-term financial plan, how on earth can you *plan* for something you don't know the value of? That's the problem with decreasing term life policies. You never know how much they're going to be worth when you die, so they provide your family very little financial security.

Accidental Death and Dismemberment Insurance

An accidental death and dismemberment policy, or AD&D, is one of those policies almost everyone has encountered at some point. The insurance agent tries to sell you an inexpensive policy that pays out in the event of your accidental death or dismemberment. If you lose an arm and can't work, it pays a portion of the benefit. If you die in an accident, it pays the full death benefit.

These policies are cheap—usually just a few bucks a paycheck—but you get what you pay for. Many AD&D policies will not pay a death benefit if you die from a medical procedure, a health-related issue, or a drug overdose. So as you get older, your chances of dying by accident are significantly reduced. That is why an AD&D policy is no substitute for—wait for it—a term life policy.

Determine How Much Life Insurance You Need

So, how much life insurance should you carry?

We recommend carrying a term life insurance policy that covers 10 to 12 times your annual, pre-tax income. If you make $40,000, you should carry at least $400,000 in coverage. Why this much?

If your surviving spouse invests that $400,000 in a good mutual fund with an average 10–12% return, they could peel off $40,000 a year from that investment to replace your income without ever cutting into the original investment amount.

Keeping It Simple: Term Life Insurance Makes Sense

Life insurance *should* be simple. That's why we recommend only purchasing a term life insurance policy. It's straightforward, inexpensive, and designed to do one thing over the long-term: **support your loved ones if you die**. And as an added bonus, the death benefits of a term life insurance policy are almost always *tax-free*.

No one wants to talk about it, but we have to. You *need* life insurance. When you're gone, those you love will be grieving. This is unavoidable. Leaving them penniless, however, *is* avoidable. Make sure they'll be financially secure no matter what.

Whether you're in the market for a new life insurance policy or just wondering if you're carrying the right kind of life insurance, ***contact our friends at Zander****. Their insurance professionals will walk you through the process of securing a term life policy that fits your family's needs.*

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