Does ‘Buy Term and Invest the Difference’ *really* make sense?

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The happy ending to the American Dream assumes a financially comfortable retirement, and there are many ways to get there. But one of the most important ways to meet this goal is for individuals to protect and build their financial assets.

Working with a financial professional can help identify the proper amount of protection for a family, a business, or an individual. Life insurance can provide valuable protection for individuals, and when looking to protect their loved ones, consumers often consider the two most common types of life insurance — term life (which can provide financial protection if the insured dies during the “term” of the policy), and whole life insurance, which offers financial features that go beyond death benefit protection — providing financial protection for the insured’s whole life. Aside from the difference in the coverage periods, term life insurance generally offers lower premiums than whole life.

When considering their life insurance options, some consumers decide to implement a “buy term and invest the difference” (BTID) strategy to build their nest egg and financially protect their loved ones. Proponents of this strategy believe an individual can receive equal or better returns by investing the “difference” (meaning the money they “save” by purchasing term life insurance) than they would with a whole life policy. But like any financial strategy, BTID has advantages and disadvantages.

More Control, *Theoretically* Higher Returns

In theory, the BTID philosophy can put more control over the investment strategy in the hands of the term life policyholder. Since term life tends to have lower premiums than whole life, term life policyholders can take that difference in premium and invest it however, they like. But while BTID proponents believe

the individual can get a better return by investing themselves, BTID can also turn out to be BTFID (Buy Term and Forget to Invest the Difference) or BTLD (Buy Term and Lose the Difference). The “BTLD” can come into play depending on the investments chosen and the volatility of the stock market. Investing the difference may also require additional out of pocket and lost opportunity costs if the difference is invested in a taxable investment. On the other hand, whole life is *not* tied to the performance of the stock market and the cash value grows tax deferred.

It’s important to keep the following in mind about term life policies:

- They can protect policyholders’ families for a predetermined amount of time.
- They are usually purchased to protect a young family from financial hardship.
- The policy term tends to end as the policyholder nears retirement.
- One hundred percent (100%) of the premiums paid fund the death benefit of the policy. However, once the policy’s term expires, there is no cash value available.

- Historical studies note that fewer than 2% of term life policies pay a death claim.[1]

Discipline Required, Death Benefits Lapse

Whole life offers one major advantage over term life — as long as premiums are paid, the life insurance lasts for the policyholder's whole lifetime.[2] When a term life policy expires, the policyholder may need to buy another policy in order for coverage to continue. They will need to prove insurability and since they will be older, it will likely mean a higher premium.

Whole life policyholders pay a higher premium (than term policyholders do), essentially allowing the insurance company to invest on their behalf. Whole life from a mutual life insurer has another benefit — the cash value of a whole life policy is guaranteed to increase, which can provide the policyholder with a valuable asset over time[3] that can be used for funding a child's education, starting a business, retirement, or anything else the policyholder desires.[4]

To make the BTID strategy work successfully, the term life buyer must be financially disciplined and motivated. Those choosing this strategy must remember to consistently invest the difference between the term life and whole life policy premiums. For many, it's too easy to use that "extra" money in other ways. There's no quarterly or monthly "bill" to remind them to invest it. Conversely, a whole life policy requires a regular payment to stay in force — and, if purchased from a mutual life insurance company, may also offer the opportunity to earn dividends.[5]

The Numbers Can Be Deceiving

Sometimes, the numbers just don't add up for BTID. What one would spend on a 20-year term life policy could equal the annual premium for the first year of a whole life policy. For example, a $1 million, 20-year term premium for a 40-year-old male is about $800 a year. But consider this: After 20 years, the term life insurance policyholder will have spent $16,000, with more than a 95% chance of still being alive, based on actuarial results. At the end of the policy's "term," the policyholder would have nothing to show for the $16,000 spent.

By comparison, a $1 million whole life policy would have an approximate $17,000 annual premium for that same individual. After the second annual premium is paid, there would typically be about $18,000 in cash value. And the increase in cash value each year is nearly equal to the annual premium.

Ultimately, in this example, consumers must ask themselves, do they want to pay $16,000 over 20 years and likely (95+%) outlive the 20-year term of the $1 million death benefit? Or, would they prefer to spend $17,000 annually, but maintain more than a $1 million death benefit for their whole life?

The additional benefits of whole life are many:

- Whole life policies have a tax-deferred cash value component.[6]
- Policy values may be protected from creditors.[7]
- Whole life policies can offer additional protections in the event of disability via a Waiver of Premium rider.[8] If the insured were to become disabled, the insurance company would continue to pay premiums throughout the disability.
- Whole life, particularly its death benefit, can give the policyholder the "permission" to spend down other assets during retirement, knowing they will be replaced upon death.
- Whole life is not directly correlated to the fluctuations of the equity markets.

Consumers who wish to use life insurance as part of a savings strategy must decide whether they have the discipline and knowledge to use the BTID strategy — or if they would instead prefer to benefit from using whole life, with its guaranteed death benefit, as part of a solid savings strategy that is not tied to the performance of the stock and bond markets.

First and foremost, individuals considering the purchase of any type of life insurance should meet with a financial professional to discuss their long-term goals and objectives, and how the policy they ultimately choose can help them meet those goals, while providing the most suitable coverage for those they wish to protect.

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[1] Source: 1993 Penn State University Study of Term Life Insurance, as noted in "Term Life Insurance Death Probability: The Probability of a Death Claim Being Paid Out," Term Life Online <https://www.term-life-online.com/term-life-insurance-death-probability.html>

[2] All whole life insurance policy guarantees are subject to the timely payment of all required premiums and the claims-paying ability of the issuing insurance company. Policy loans and withdrawals affect the guarantees by reducing the policy's death benefit and cash values.

[3] Some whole life polices do not have cash values in the first two years of the policy and don't pay a dividend until the policy's third year. Talk to your financial representative and refer to your individual whole life policy illustration for more information.

[4] Policy benefits are reduced by any outstanding loan or loan interest and/or withdrawals. Dividends, if any, are affected by policy loans and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses, or is surrendered, any outstanding loans considered gain in the policy may be subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first, subject to ordinary income taxes. If the policy owner is under age 59½, any taxable withdrawal may also be subject to a 10% federal tax penalty.

[5] Dividends are not guaranteed. They are declared annually by Guardian's Board of Directors.

[6] Guardian, its subsidiaries, agents, and employees do not provide tax, legal, or accounting advice. Consult your tax, legal, or accounting professional regarding your individual situation.

[7] State creditor protection for life insurance policies varies by state. Contact your state's insurance department or consult your legal advisor regarding your individual situation.

[8] A Waiver of Premium rider waives the obligation for the policyholder to pay further premiums should he or she become totally disabled continuously for at least six months. This rider will incur an additional cost. See policy contract for additional details and requirements.

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