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The bare truth – Whole Life vs. Term ***Which is the antidote and which is the poison?***

After completing my Accountancy degree in NTU, I have dedicated the last nine years in the search of the ideal financial planning approach. Having worked with more than four hundred professionals and high net-worth individuals, I am proud to say that at last I have some ideas of the ideal platform. And **“Buying Term and Investing the Difference” (BTID)** is simply not one of them. I recently read in the newspapers that various financial planners preach the BTID concept. Not only has this concept often been unchallenged, the recent articles also illustrated a one-sided and technically-flawed analysis.

The spread of the BTID myth is aided to a large extent by the silence of many advisors (including myself) who are “too busy” to refute it. Do not get me wrong. There ARE merits in buying term policies, but to claim that it is the ONLY path to salvation is fundamentally erroneous. There are SIX key technical mistakes in most BTID analyses. What they essentially do is to point out the health hazards of drinking Brandy and THUS claim that drinking Whisky is a better solution. Let’s explore each mistake:

Mistake One

Term-buying proponents claim that Whole Life Policy (WLP) is illiquid and should not be compared to savings in the bank. This accusation is groundless because a prudent advisor would not ask a client to buy a WLP by comparing it with bank savings. The basis of the purchase is more complex than simply the liquidity issue. Also, there are many WLPs in the market that provide cash bonus. This cash bonus can be withdrawn or redeposit with the insurance companies to generate interest.

Cash bonuses could also be accumulated during good times and used to finance the future premiums during leaner years. Furthermore, WLPs provide loan facilities at about 6-6.5% p.a. This interest rate is lower than most unsecured loans such as credit card rollovers or various forms of personal loans. Besides, Investment-Linked WLPs (ILPs) provide freedom to exercise premium holiday at your discretion, thus eliminating the need to contribute premium for a prolonged period, while maintaining your full insurance cover.

Throughout the nine years of my career, I have witnessed numerous clients who encountered financial difficulties and the only thing that could tide them through was cash values in their WLPs. The nature of WLPs allowed them to faithfully put aside a portion of their income, which they would otherwise have spent. Most Singaporeans (including myself) lack the financial discipline to invest the difference. Working life is so stressful that we often feel a compelling urge to pamper ourselves with luxuries. Of course, there are the rare few who manage to put aside some savings only to wipe it out with a major renovation, a long vacation or a new car. The verdict is, most Singaporeans SAVE TO SPEND.

Mistake Two

Most BTID analyses are done in the United States and may not be a viable option in the local context. Face it, we are in Singapore. The proposition simply “does not hold water” in a small market like Singapore where term policy premiums are artificially jacked up by insurance companies to create a reasonable profit margin. There is no economy of scale to create the low term premium environment for the BTID theory to be practical.

It is worthwhile also to note that the mortality charges expensed in a permanent WLP are different from those in a term policy. Ask any actuary for enlightenment on this. In a permanent WLP, because insurance companies are already sharing some profits from managing your cash value, they can keep the built-in mortality charges lower. On the other hand, the insurance companies have to charge you more in term policies to cover their overheads since they are not earning any income for “investing the difference” for you. This is a technical point that most BTID analyses have failed to address.

Mistake Three

Buy-term proponents claim that buying WLP result in higher cost as you do not need insurance after a certain age. Using the economic life value model of calculating insurance needs, indeed, you do not need any life insurance cover after your retirement. Following this line of argument, buying term policy could also incur unnecessary and extra **premiums**. For example, at age 30, you decide to purchase a **50-year** term policy to cover you till age 80. But when you retire at age 60, you find that you do not need anymore cover since you have already accumulated a tidy nest egg and decide to terminate your term policy. You would then be paying **extra premiums all these years** since the premium for your policy has factored in the mortality charges from age 60 to 80, which are much higher.

On the contrary, if you purchase a **30-year term** policy that expires at age 60, the premiums are lower. However, if at age 59, your health condition deteriorates, you would not have the option of extending your cover beyond 60. In short, we DO NOT know how long we are going to live hence we will never know what is the ideal duration for the term plan. As one of our industry icons states, “If you are going to die right away, I will sell you Term insurance. If you are going to live a long time, I will sell you Endowment insurance. If you don’t know, let’s go straight up the middle with Whole Life insurance.”

Even if most people do not need insurance cover after retirement, they may “want” the cover for various purposes. Some examples are for estate planning or to create extra liquidity in the event of a critical illness. The last thing you need to be thinking about when you are suffering from a critical illness is which of your investments to sell to pay for your medical expenses.

Mistake Four

Another interesting mistake is the assumption that life funds expose you to the same risks as other investments. Nothing is further from the truth. This is because the life fund consists of investment in largely fixed income instruments with exposure to equity, property and even policy loan. It is extremely difficult for an individual investor with limited funds to construct a portfolio with a similar risk return pattern as that of the life fund of an insurance company.

Over the years, life insurance companies have proven to be relatively effective in churning out stable and consistent returns. The only drawback of life funds is that the investments are made mainly in Singapore and provide policyholders limited reduction in systematic investment risks through global diversification.

Mistake Five

Buy term proponents claim that since 95% of insurance policies sold are WLPs vs. only 5% of term policies, it is obvious that commission-based advisors are doing it out of their personal interest of earning more money. First, let me get the facts straight. Although only 5% of policies sold are term policies, commission-based advisors do sell a lot of term covers under supplementary benefits and riders attached to a WLP. Based on a sampling of 500 policies, I have found that 80% of the WLPs are issued with at least one rider, which is the equivalent of a term policy. And the medium number of riders attached is 2.1.

Speaking to some actuaries, I was told that the average policy fee imputed in term policy rates is about \$5 per month. For term riders, because the main policy is already absorbing the policy fee, any additional riders added would not carry any additional policy fee. In other words, if you were to buy two term riders versus two term policies, you would save an equivalent of about \$10 per month or \$120 per year or \$3,600 over 30 years. And if you forget or cannot afford to pay your premiums for a period of time, the cost of the term riders would be supported by the cash value of the WLP. In the case of a term policy, if you forget or cannot pay your premium for just one month, you would immediately lose your protection.

Personally, most of the policies I have sold are investment-linked WLPs or Investment-linked policies (ILPs), which are, in the broader sense, BTID policies. You pay a discounted term rate for your insurance cover and the rest is invested to generate returns for you over the years. Despite some initial start-up costs, taking the ILP route is cheaper than the conventional BTID approach.

The reverse question to ask is perhaps whether there is a compelling interest for a fee-based financial advisor to advocate that you buy term and invest the difference. The answer it seems is “yes”. This is because if the “difference” is invested with the fee-based advisor, this would mean an additional income stream for him, as he would be able to charge an annual fee for managing the “difference” for you. And this fee income would grow as the asset under management grows over the year. What the advisor is essentially asking you to do is to let him manage the “difference” instead of the insurance company. On the contrary, if you are to buy a WLP, he would miss out on the additional income stream which could run into thousand of dollars over the years. There is of course nothing wrong in the fee-based advisor proclaiming that he can do a better job than the insurance companies in investing your money, the only concern is that the client is often unaware of the advisor’s inherent bias.

Mistake Six

The return of investment (ROI) used in BTID analysis is often wrong. They should use net ROI, meaning ROI after factoring the “COST” of managing the difference. For example, the annual fee charged by most balanced funds is about 1% per annum. The “1%” excludes the additional fee some financial advisors charge for managing your portfolio under a wrap-account like structure. Currently, the gross investment return assumed in whole life policies ranged from 4.75% p.a. to 5.25% p.a.. Factor in a 1% management fee for investing the “difference” in a life-fund like

instrument, the ROI used should then be between 3.75% and 4.25%. (ROI of 5% or 7% should not have been used in the first place because if you were investing in something different from what a whole life policy is investing in, there would be no basis for comparison.)

BTID analysis often fails to factor in the cost of managing the "difference" and use a different ROI from that assumed in traditional WLPs. We must realise that insurance companies ARE our fund managers and the cost of managing our asset is in-built in WLPs.

An interesting analysis I did recently further strengthens my point. I compared the returns a 30 year-old male non-smoker would enjoy when he purchases a \$500,000 ILP (technically a form of WLP) costing about \$4,000/yr, with the returns he would enjoy when he buys a 30-year \$500,000 term insurance plan costing about \$1,665/yr and investing the difference in a recurring single premium policy (ILP without the insurance component). At the end of 30 years, buying the Whole Life ILP provides an estimated return of between \$127,000 and \$283,000, whereas the BTID option gives him a return of between \$124,000 and \$258,000. Both the lower and upper range of the ILP approach illustrated higher returns. The fund type chosen under each approach is the same so there could not be any dispute over the difference in investment allocation.

	Sum Assured	Annual Premium	Projected return using a gross return of 5% p.a.	Projected return using a gross return of 9% p.a.
30 years Term for \$500,000	\$500,000	\$1,665	0	0
Recurring Single premium Plan	Investment Return	\$2,335	\$124,000	\$258,000
ILP with SA of \$500,000 + Investment Return (WLP)	\$500,000 + Investment Return	\$4,000	\$127,000	\$283,000

Comparisons made against the BTID approach should use an ILP because we can then choose the same type of investment, whereas comparison against a life fund would be futile because it is very difficult to reconstruct one. For example, insurance companies are investing in office space, retail malls and policy loans beside the traditional bonds and equities. Moreover, the term rates charged in an ILP can be used as a close proxy to that assumed in a WLP, thus the comparison would be fair. Despite the result against the BTID approach, I do believe that there is a place for term covers in any financial plan because it is often too costly to buy all the cover we need using permanent insurance. As mentioned earlier, riders attached to permanent plans are in essence low-cost term covers.

Conclusion

The BTID analysis done in "mistake six" has not factored in the additional financial planning fee that most buy-term proponents charge for their pitch to ask you to buy term and invest the difference "with them". If the financial planning fee is factored

into the above analysis, the result would be more convincing against the BTID approach.

Many “buy term proponents” even suggest that you drop your existing life policy to buy a term policy. They could very well be feeding you poison. So buyers, beware.

About the writer

Philip Loh is a Chartered Financial Consultant and a Senior Executive Life Planner with Great Eastern Life. He speaks regularly at investment seminars and writes about financial planning issues and concepts. Armed with ten years of experience in the financial industry, he has a client base of over 500 professionals and high net-worth individuals.