

Cash Value Life Insurance: A Cautionary Tale from Lake Wobegon

Do you reside in Garrison Keillor's fabled Lake Wobegon? Those who own a cash value life insurance policy probably do – and probably don't even realize it! In Lake Wobegon, "all the women are strong, all the men are good looking, and all the children are above average." And any life insurance policy purchased in Lake Wobegon is no doubt better than average as well!

Cash value policyholders probably didn't "buy" the policy as much as it was "sold" to them. Through luck or through skill, half of all insurance buyers do end up with better-than-average policies. However, a closer look would reveal that almost none of those buyers in the top half came close to maximizing value in their purchase. (Many readers are right now again making the Lake Wobegon mistake, thinking that they are one of the few who did in fact maximize policy value.)

The sad reality is that an average cash value life insurance policy is not a very attractive financial instrument, so saying that a policy is better than average is not saying much. The expected financial difference (in today's dollars) between an optimally designed policy from a premier company and an average policy from an average company is many times more than the level annual premium required to fund the policy. Even the difference between a 99th percentile policy and a 99.9th percentile policy is shockingly large—and well worth the effort and expense to achieve such an improvement.

If you can end up with a cash value policy designed to maximize long-term values, then you will in fact have a financial vehicle worth bragging about—and you can be confident that your policy is not included in the all-cash-value-life-insurance-is-evil mantra that is often repeated among most financial experts and the financial media.

The appallingly low percentage of "permanent" policies that are held until the death of the insured is evidence of the sorry state of affairs within the life insurance industry. Based on industry lapse rates and the types of policies being sold, perhaps only 10-20% of all "permanent" policies being sold today will actually be in force when the insured dies. If consumers were better educated at the time of purchase, then far fewer policies would be surrendered and many more policies would be in force at the death of the insured.

[Interestingly, with certain types of policies with low or no cash values, this could spell financial disaster for insurance companies that are relying on profits from surrendered policies to subsidize the death benefits of those who maintain policies until death—this concept is referred to as lapse-supported pricing within the industry, and products such as long-term care insurance, level term insurance, and no-lapse guarantee universal life insurance rely heavily on this concept. Note that with these products the interests of the



consumer are directly opposed to the interests of the insurance company, whereas with a good cash value policy the interests of the consumer and company are closely aligned.]

Why Is a Fee-Only Insurance Advisor So Valuable?

So why is it so tough to get an optimal policy working exclusively with an insurance agent—and how can working with a fee-only insurance advisor address these concerns?

1. **Company selection** – Agents are either unwilling (due to financial incentives) or unable (due to contractual arrangements) to access the entire universe of available companies. Fee-only insurance advisors have no such constraints, so clients have access to the entire universe of companies either directly or through agents.

2. **Commissions** – Agents obviously have an inherent conflict of interest because they derive compensation from the products they are recommending. Less recognized is the fact that agent compensation can often be reduced 80% or more through the design of the product. The savings from this alone are usually significantly greater than the annual premium for a level pay policy, with the bulk of those savings recognized in the first policy year. Not surprisingly, most agents are not going to willingly give themselves an 80% pay cut.

[Be wary of buying a policy simply because it is characterized as a “low-load” policy. Many of these policies have little or no commission reduction, and even if they do, those commission savings can be overshadowed by other more important policy elements such as insurance company investment and mortality experience.]

3. **Policy type** – Some policy types have an inherent advantage when you are working with cash value products, and agents are often blind to this either because of lack of access or unwillingness to voluntarily accept lower compensation.

4. **Policy design** – Aside from the possibility of greatly reducing commissions, there are other design considerations in certain situations that can greatly improve long-term performance. These designs further lower agent compensation, which creates yet another potential conflict of interest.

A recent case we completed resulted in present value savings of more than \$25,000, with \$18,000 of that being realized within the first year. The original proposal that the client brought to us (which was illustrated by the client’s original agent) was from a premier company and showed an annual premium of \$20,000 and a first-year cash value of **zero**.

At the conclusion of the engagement, our client ended up with a policy from the same company that instead had a first-year cash value of **\$18,000**. The original agent first claimed that this design was “not allowed” by the insurance company; he then incorrectly



claimed that his design was “safer” than the design with reduced compensation; and ultimately the agent acknowledged that he had no interest in placing the policy if the commission was going to be so minimal. We placed the policy using an agent who had no qualms about maximizing policyholder value. Note that the savings in this case would have been substantially greater had the starting point been a policy from anything other than a premier company.

Confusion and complexity are two of the most useful tools for the insurance industry. Once a product becomes so complex and confusing that the consumer is left with no alternative but to “trust” the agent selling the policy, then the consumer is completely at the mercy of someone who has an inherent conflict of interest. Another interesting byproduct of the complexity of cash value insurance is that many buyers will never figure out whether or not they have a policy that is performing well or performing poorly. We cannot think of another consumer industry where mediocrity can be so richly rewarded and can often go undetected for a lifetime.

Without the insight and oversight of an objective and unbiased expert, you may be on your way to establishing a second residence in Lake Wobegon!

