

Why

**DAVE
RAMSEY**

Is

WRONG

About Whole Life Insurance

by Robert P. Murphy

Author's Note: This article is adapted from a section in the newly-released Report on whole life insurance for business owners that Carlos Lara and I prepared for Mark Benson of SBO Wealth (mbenson@ameritime.net) and John Moriarty of E3 Consultants Group (jmoriarty@e3wealth.com).

Radio talk show host

Dave Ramsey has made a national name for himself guiding people out of debt. I occasionally listen to his show (Ramsey and I both live in Nashville), and I applaud much of what he tells his listeners. In particular, Ramsey stresses the importance of having a specific budget and communicating with one's spouse about money. Furthermore, as a Christian, I also like that Ramsey ends each show by saying that ultimately, the only path to financial peace is to walk with the Prince of Peace. (Funny tidbit: I discovered months after attending that Ramsey and I actually went to the same church!)

Unfortunately, as many readers of the *Lara-Murphy Report* know all too well, Dave Ramsey really has it out for whole life insurance. It's not merely that he prefers term life. No, Ramsey is quite adamant that anybody buying a whole life policy is a fool, and anybody selling it to him is either a liar or an idiot. In this article I want to explain why Ramsey quite simply doesn't know what he's talking about, when he criticizes whole life.

Ramsey's Case Against Cash Value Insurance, Including Whole Life

To do Mr. Ramsey justice, let's quote extensively from a post from his website entitled, "The Truth About Life Insurance":¹

Myth: Cash value life insurance, like whole life, will help me retire wealthy.

Truth: Cash value life insurance is one of the worst financial products available.

Sadly, over 70% of the life insurance policies sold today are cash value policies. **A cash value policy is an insurance product that packages insurance and savings together.** Do not invest money in life insurance; the returns are horrible. Your insurance person will show you wonderful projections, but none of these policies perform as projected.

Example of Cash Value

If a 30-year-old man has \$100 per month to spend on life insurance and shops the top five cash value companies, he will find he can purchase an average of \$125,000 in insurance for his family. The pitch is to get a policy that will build up savings for retirement, which is what a cash value policy does. However, if this same guy purchases 20-year-level term insurance with coverage of \$125,000, the cost will be **only \$7 per month**, not \$100.

WOW! If he goes with the cash value option, the other \$93 per month should be in savings, right? Well, not really; you see, there are expenses.

Expenses? How much?

All of the \$93 per month disappears in commissions and expenses for the first three years. After that, the return will average 2.6% per year for whole life, 4.2% for universal life, and 7.4% for the new-and-improved variable life policy that includes mutual funds, according to *Consumer Federation of*



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America, *Kiplinger's Personal Finance* and *Fortune* magazines. The same mutual funds outside of the policy average 12%.

The Hidden Catch

Worse yet, with whole life and universal life, the savings you finally build up after being ripped off for years don't go to your family upon your death. **The only benefit paid to your family is the face value of the policy**, the \$125,000 in our example.

The truth is that you would be better off to get the \$7 term policy and...put the extra \$93 in a cookie jar! At least after three years you would have \$3,000, and when you died your family would get your savings.

A Better Plan

If you follow my Total Money Makeover plan, you will begin investing well. Then, when you are 57 years old and the kids are grown and gone, the house is paid for, and you have \$700,000 in mutual funds, **you'll become self-insured**. That means when your 20-year term is up, you shouldn't need life insurance at all—because with no kids to feed, no house payment and \$700,000, your spouse will just have to suffer through if you die without insurance.

Don't do cash value insurance! **Buy term and invest the difference.** [Bold and italics in original.]


To repeat, I am glad that Dave Ramsey is out there on the airwaves, giving his listeners a kick in the pants to get serious about their financial situations, start earning more income, and paying off credit cards. However, I can't beat around the bush when it comes to life insurance: Ramsey's perspective—as illustrated not just in the above excerpt but whenever he discusses the issue on his popular radio show—is based on ignorance. Ramsey's claims that I've quoted above are entirely misleading, and do not even begin to properly compare a whole life policy with other financial vehicles.

The fundamental problem with Ramsey's analysis is that he doesn't treat interest rates properly. When he compares the "return" on permanent life insurance products (such as whole life, universal life, and variable life) with a standard mutual fund that he says will average 12%, he makes two main mistakes. The first problem is that Ramsey grossly exaggerates how real-world mutual funds have behaved. The

second problem is that he doesn't realize the correct way to account for a "rate of return" on an insurance policy. If investors want to see the rate of return in insurance versus other financial instruments, such a calculation can be done; I'll sketch the outline below. But my point is that Dave Ramsey's glib discussion above doesn't even set the comparison up correctly.

Ramsey's First Problem: 12% Returns on Mutual Funds?!

Regarding the first problem, Ramsey's figure of 12% returns on a mutual fund is an unfair benchmark to hold against a whole life policy. Ramsey doesn't specify exactly what kind of mutual fund he is considering, but for returns that high they must be heavily equity-based. Now Ramsey's discussion of whole versus term insurance was posted at his website in October 25, 2010. At that point, the



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S&P 500 stood at 1198.35. Exactly 20 years earlier, it stood at 312.60. That works out to only *7 percent* annualized growth, not the 12 percent Ramsey cited. Now it's true, looking merely at movements in the level of the S&P doesn't capture dividend earnings, but our calculation also doesn't include a mutual fund's fees or tax considerations. We're just trying to get a rough ballpark of whether the claims of mutual fund performance really hold up, when the gurus tout "buy term and invest the difference" as a no-brainer.

There's another major problem with Ramsey's figure for mutual funds—it ignores the two *crashes* they experienced during the last 20-year window.

This is something that *does not happen* with a whole life policy, where the cash value can *never* go down, per the contract. To see how this is relevant, suppose someone had bought into the stock market only 15 years before Ramsey's post, i.e. in October 1995. The S&P's annualized return over this 15-year period was a hair under 5 percent, a far cry from the 12 percent figure Ramsey cited. And of course, if someone had had the misfortune of "buying term, and investing the difference" in an equity-based mutual fund in the years 1999 or 2000, then his retirement savings would be reeling from the fact that the stock market is currently lower than when he bought in, even though more than a *decade* has passed.

If you look at a graph of the stock market over a 20- or 30-year stretch, you will see that a major reason that the "rate of return" on a typical whole life policy can be relatively lower than returns on other financial products is that whole life is very conservative. In other words, there is less risk in a whole life policy.



The cash value in a whole policy can never go down from one year to the next, and it has a built-in (admittedly very conservative) guaranteed growth rate. Do Dave Ramsey's mutual funds give the same deal, on top of their alleged 12% annual rates of return?

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Ramsey's Second Problem: Ignoring Value of Life Insurance Coverage When Calculating "Internal Rate of Return"

Now let's move on to the subtler problem: Ramsey's handling of the "return" on whole life insurance policies. What he has in mind is the *internal rate of return (IRR) as computed by the surrender cash values in relation to the gross premium payments*. The issue is not so much whether Ramsey's choice of 2.6% is fair or not—many insurance agents can show ways of designing whole life policies with far better results—especially in light of his very generous figure of 12% for mutual funds. Rather, the problem here is that Ramsey's 2.6% figure is *meaningless* when trying to compare a whole life policy to a non-insurance financial product, such as a mutual fund.

First let's see exactly what people (like Ramsey) have in mind when computing the "return" on a whole life policy. They are looking at the surrender cash value available for an insurance policy at various years into the policy, and computing what the average, annualized, compounded interest rate would have to be on the *premium payments* in order to cause a savings account balance to have that same value, that many years into the plan. In other words, when people talk about the "internal rate of return" on whole life, they are asking what the constant percentage return on a savings account would need to be, if instead of paying your premiums on your whole life policy, instead you took that same cash flow and contributed it into your savings account, so that at the end of 3 years, 5 years, 10 years, etc., the savings account balance was exactly the same level as your cash value in your whole life policy. Using this approach typically shows abysmal numbers for whole life early on, but then they get decent several

decades into the policy.

There is a huge problem with this approach: These calculations of internal rate of return (IRR) are virtually meaningless, because *they overlook the insurance dimension of the policy*. Inasmuch as we are talking about a life insurance policy, this seems to be an important omission!

To see why this is important, suppose the policyholder dies in the first year after taking out his whole life policy. Maybe he's put in (say) \$12,000, and within the first year his beneficiary gets a check for (say) \$1 million. That is an annual rate of return of more than 10,000%. Not too many mutual funds offer such returns.

benefit. A huge reason for the higher premium on whole life versus 20-year term is that a whole life policy is *perpetually renewable*. If, say, a 45-year old man buys a whole life policy with a \$1 million death benefit that matures at age 120, then to mimic that Dave Ramsey would need to look up the premium for a 75-year term policy, not a 20-year term policy. Such a thing doesn't even exist, and if it did, there wouldn't be much left of a "difference" between the two premiums to invest in a mutual fund.

To correctly analyze the year-to-year rates of return on the two strategies, we need to correctly assess the "market value" of life insurance coverage. Obviously it would be wrong to say that a 45-year-old man with a \$1 million death benefit whole life policy has "\$1 million worth" of life insurance, if we

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Correctly Calculating Rates of Return on Whole Life Versus Other Financial Products

Now to be fair, Ramsey thought he was comparing apples to apples, by stipulating that someone *buy a term policy with the same death benefit*, rather than buying a whole life policy. Since the term policy's premiums are so much lower, Ramsey was merely recommending "investing the difference"—i.e. the savings because of the cheaper premium—into a mutual fund.

But this still isn't right; it's not true that we're holding "the total insurance component" constant, by having one strategy buy whole life, and the other taking out a 20-year term policy with the same death

are comparing it to holdings of bonds or other financial assets. This is because the 45-year-old probably *won't* die that year, meaning he probably won't see a dime from the insurance company. However, there is a small chance—0.46%, according to the 1980 CSO Mortality Table—that he *will* die that year, in which case his beneficiary receives \$1 million.

The sensible way to appraise the death coverage is to multiply the two values, i.e. take the \$1 million death benefit times the likelihood of death, which yields a value of \$4,600. *That* is the actuarially fair market value of our hypothetical man's \$1 million life insurance coverage (whether whole life or term), during his 45th year. (In reality it's actually less than that, since the 1980 CSO Mortality Table is pessi-

mistic. But I'm just making a theoretical point here, about how you'd go about correctly calculating the rate of return on someone's total wealth, who holds a life insurance policy.)

Insurance Company Keeps the Cash Value When I Die?!

Before continuing, there is one wrinkle: As Ramsey pointed out, a whole life policy's cash value is wrapped into the death benefit. In other words, if the insured dies, the insurance company just sends a check for the death benefit. This makes perfect sense, if we return to the home mortgage analogy: When making monthly mortgage payments, the homeowner gains equity by knocking down the remaining principal on the loan. When the mortgage is finally cleared, the homeowner receives the deed free and clear from the bank. He wouldn't expect the bank to then give him "all of my equity in the house" *on top* of the deed! That would obviously be misconstruing what "equity in the house" means.

The same holds for the cash value on an insurance policy. It reflects the present discounted mar-

ket value of the expected death benefit and future premium payments. As time passes, this calculated value increases. But if the insured should suddenly die, then those projections are collapsed into the immediate payment of \$1 million. The rising cash value was merely the (actuarially discounted) *anticipation* of the eventual \$1 million payment, offset by the necessary premium outflows to keep the policy in force. The cash value isn't something laid *on top* of the death benefit.

So although there is nothing sinister or duplicitous in the insurance company's behavior, Ramsey is correct that with the strategy of "buy term and invest the difference," in the case of death the \$1 million benefit check *supplements* the mutual fund's value at that point. The way we can handle this complication is to reduce the effective market value of the whole life policy's death coverage. Specifically, we can say that in any given year, rather than the whole life policy offering coverage of \$1 million, it *really* only offers \$1 million minus the policy's cash value at that time. In other words, the term policy—while it's in force—offers the full \$1 million in pure coverage, whereas the whole life policy only offers



The insurance company will only send his beneficiary a check for \$1 million, making him "lose" the \$50,000 in accumulated cash value.

the Net Amount at Risk in coverage in any given year, on top of the cash value at that point.

For a specific example, suppose Hank is a 45-year old with a \$1 million whole life policy with a cash value of \$50,000, while his twin brother Tim has a \$1 million term policy with \$50,000 in a mutual fund. If we wanted to value the death coverage itself, we could say that Tim holds assets of $(\$1 \text{ million} \times 0.46\%) + \$50,000 = \$4,600 + \$50,000 = \$54,600$. But Hank, with his whole life policy, using this approach would only have $(\$950,000 \times 0.46\%) +$

A particularly interesting feature is that in year 21 of the two strategies, the correctly calculated “total rate of return” for the man using term insurance will be very low (possibly even *negative*), because his life insurance coverage will drop from (say) \$1 million down to \$0. Multiplied through by his probability of death that year, the “fair market value” of this coverage could be significant, more than offsetting the appreciation in his mutual fund versus the gain in the cash value in his rival’s whole life policy that year.

The reason it’s dangerous to think in terms of “rates of return”—and to compare the internal rate of return on a standard whole life illustration with projections for an equity-based mutual fund—is that an insurance contract is a complicated animal.

$\$50,000 = \$4,370 + \$50,000 = \$54,370$. Hank gets “dinged” by \$230 because if he happens to die that year, the insurance company will only send his beneficiary a check for \$1 million, making him “lose” the \$50,000 in accumulated cash value. In contrast, Tim’s beneficiary will get the full \$1 million death benefit, plus the \$50,000 mutual fund balance.

A knowledgeable financial advisor should be able to construct a proper accounting of “rates of returns” broken down by year, for a man using whole life versus an identical man “buying term and investing the difference.” Depending on the particular insurance quotes used, the results will make the two approaches far more comparable than the usual tables show—in which whole life gets blown out of the water.

Conclusion

Nelson Nash often tells his audience that using whole life for banking purposes “isn’t about interest rates.” Sometimes critics think that Nelson is implicitly admitting that whole life is “a bad deal.”

On the contrary, the reason it’s dangerous to think in terms of “rates of return”—and to compare the internal rate of return on a standard whole life illustration with projections for an equity-based mutual fund—is that an insurance contract is a complicated animal. Just properly *setting up the apples to apples comparison* involves a deep understanding of permanent life insurance, of the kind that most analysts—including Dave Ramsey—don’t begin to appreciate.



Bibliography

1. See Dave Ramsey’s “The Truth About Life Insurance,” October 25, 2010, available at: <http://www.daveramsey.com/article/the-truth-about-life-insurance/>