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Is Permanent Life Insurance a Good Way to Save for Retirement?

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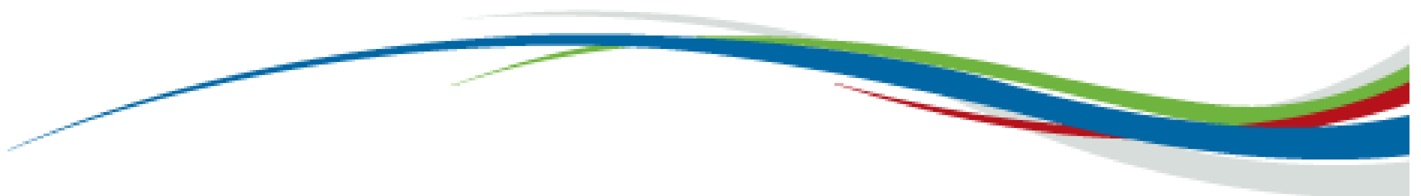
Is permanent life insurance a good way to save for retirement? Not really. That's my conclusion, based on research we conducted in the last year after several new clients came in wanting to know what to do with the variety of policies they had purchased over the years, or who were being actively solicited to purchase a new policy.

A few basics are in order. As the name implies, permanent insurance (e.g., whole life, universal life) is insurance that stays with you for life. In contrast, term life insurance is only in force for a set amount of time. With permanent insurance, the insurance company knows you are going to die, and so it needs to collect from you over time the sum total of what it is going to pay out by the time it expects you to die, plus a profit margin. The way it does this is to set up a cash value account for the money that you give it annually, which it invests. At any given time, the cash value represents the amount that you could receive by surrendering the policy before death or by taking withdrawals or loans; hence, permanent life insurance can be used as an alternative way to save for retirement.

Indeed, the insurance industry likes to position permanent life insurance as a retirement savings vehicle because almost everyone needs to save for retirement, but far fewer actually need permanent life insurance. These cash value accounts do have some attractive features such as tax-deferred earnings growth. However, like many other retirement savings vehicles, withdrawals in excess of the amount you have paid in (since the premiums themselves were paid with after-tax dollars) are taxed at ordinary income tax rates.

So how is the insurance company investing your money? By law, insurance companies have to be pretty conservative, and so they typically purchase mostly long-term bonds, laddered to mature as their policyholders die. As such, they pay the policyholder an annual dividend based on what they are earning from their bond portfolio, less the cost of the underlying insurance they are providing and their selling and administrative costs.

The issue from an investor's perspective is that anyone can buy and own a bond portfolio, and most bond managers charge less than 0.3% annually to manage one. Alternatively, you can buy a very low cost bond mutual fund or ETF. In short, you don't need the assistance of an insurance company to do it—and which is also charging you for insurance you very likely also don't need. With insurance products, you are also taking on what's called company risk. If the company fails, you are likely to lose some of your money, whereas with a properly-constructed bond or fund, a single bankruptcy will have much less impact.



Advocates in favor of using permanent life insurance as a savings vehicle will argue that tax-deferred earnings growth is valuable. I agree, to a point. But there are several cheaper alternatives to achieve this objective, such as no-load deferred annuities that don't come with an insurance wrapper. Advocates will also argue that because the ultimate death benefit is tax-free, you might never pay taxes on the investment. This is an attractive feature, but most of us are going to need to tap into our savings during retirement, and so will either have to surrender the policy or start taking out withdrawals or loans from the cash value account. Such withdrawals are tax-free, but any withdrawal in excess of basis (i.e., the aggregate amount of premium paid in) must be received in the form of a policy loan from the insurer. And current rates for policy loans are not cheap – most policy loan rates we looked at last year were running at 7% per annum.

Investors can get themselves into trouble fast in the withdrawal phase. Withdrawals and loan interest can build to such an extent that the investor is forced to make more premium payments or let the policy lapse. If they lapse, they will likely be left with a big tax bill since all investment gains in the policy are taxed at ordinary income rates.

Bottom line:

There are very legitimate reasons for owning permanent life insurance, but all involve the need for the insurance all the way until death. For example, if your estate is illiquid and you don't want your heirs to have to sell to divide up the proceeds, or you have a disabled dependent and want to ensure there are sufficient funds for his or her care after you die. If you don't have these types of insurance need, my conclusion is that you can typically do better and have much more flexibility by directly investing in a bond portfolio.

But don't sweat it if you do already own some permanent life insurance. If the company is high quality, you are likely getting a reasonable bond-like rate of return already. The way to check is to ask your insurance company for the cost you are paying for the insurance and administrative expenses, as well as what the historical performance has been on the invested assets in your cash value account.

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