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Honestly, What's the Best Policy?

Insurance Agents Are Pushing Pricey 'Permanent Life' Aggressively. Here's What You Need to Know

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Insurance agents have a story they can sell even harder than usual. But that doesn't mean you should buy it.

The recent market meltdown breathed new life into a much-maligned financial product: permanent life insurance. Part insurance policy and part savings account, permanent life's main benefit -- safety -- has suddenly become a big part of the pitch.

While sales of "term life" -- the bare-bones, low-cost insurance that young families have favored for decades -- declined by 12% in 2010, its third consecutive drop, permanent life is heating up. One variety, "whole life," saw sales rise by 2% in 2010, according to industry-funded research firm Limra, while sales of the other type, "universal life," surged 21%.

While insurance agents are quick to tout permanent life's virtues -- in part because it carries high commissions -- the factors driving the decision of which insurance to buy haven't changed because of the financial crisis. For most people, term life still offers the best combination of coverage and cost. But for some wealthier folks looking to build tax-deferred savings, permanent life can be a good option.

Term life provides a death benefit for a specific period, such as 10 to 20 years, and premiums are generally set at a flat rate; only a small percentage of policies sold to people in their 30s and 40s ever pay out. Permanent life is meant to be in place your entire life, paying out upon your death, whenever it is.

Until recently, permanent life was widely considered stodgy, needlessly complicated and a bad bargain to boot, what with its hefty agent commissions and other costs and the slow buildup of value in the savings account. The accumulation is so slow in part because commissions typically eat up the entire first-year premium, and then run about 5% a year for the next few years before dropping off.

All those caveats generally still apply, but sales have jumped as life insurers have done a good job promoting permanent life's safety benefits and playing on consumers' fears about the stock market.

Under the hottest-selling types of permanent life, the savings component is invested in bonds -- which generally held up well during the market meltdown. Big sellers of permanent life such as Guardian Life Insurance Co. of America, Massachusetts Mutual Life Insurance Co., New York Life Insurance Co., Northwestern Mutual Life Insurance Co. and TIAA-CREF continued paying healthy dividends or interest to their policyholders, a feat some have noted in recent marketing campaigns.

But it isn't fair to compare the stock-market crash with the performance of an investment based largely on bonds. An investor could have bought cheaper term insurance, plunked the rest into Treasury bonds, and done well during the financial crisis. The old argument for buying term insurance and investing the rest still applies, advisers say.

In short, term life remains the best choice for most people, says James Hunt, an actuary with the Consumer Federation of America, a nonprofit advocacy group based in Washington. It is the lowest-cost way to get the most coverage for a shorter period, and it is easy to walk away from a policy if you find a better deal or your needs change, he says.

Permanent-life policies, in contrast, generally need to be held for at least two decades for the savings component to beat a bond-based buy-term-and-invest-the-difference strategy. That's because the savings account expands so slowly in many of the policies pitched to consumers -- thanks largely to big upfront commissions.

Many buyers underestimate how difficult it can be to keep up with the high premiums, and end up walking away from a policy early. According to the Society of Actuaries, which studied data from the early 2000s, 26% of whole-life policies are terminated in the first three policy years and 45% in the first 10 years.

So why bother with permanent life at all? The real appeal is that the savings account builds up on a tax-deferred basis -- no small thing to upper-income families who fear rising taxes to pay for the nation's huge budget deficits. The tax breaks are especially attractive to those families who have maxed out on 401(k) accounts and other tax-advantaged savings vehicles, advisers say. Much of the money can be pulled out without triggering any taxes whatsoever, assuming the policyholder is careful about following the rules.

In considering a permanent-life purchase, you need to think through how long you need the coverage to be in force and "make a judicious decision that your cash flow -- through good times and bad -- will be enough to pay the required target premium," says Victor Muro, who runs Financial Integrity Strategies Inc., a New York insurance and investment-advisory firm.

Permanent Life

Pros

Earnings build up tax-deferred. The higher the tax bracket, the more valuable the policy.

Most policies are bond-based, which can help protect your portfolio from a stock-market tumble.

Cons

Commissions can be steep, and the buildup of your savings can be slow.

If you walk away from a policy in the first decade, you may lose thousands of dollars.

Term Life

Pros

It's the cheapest way to buy the most death benefit for your dollar.

It's easy to cancel without taking a financial hit.

Cons

If you still need insurance after the term expires, you may have to pay a much higher rate.

Very few policies pay out on young people, so after the term is over, you may have nothing to show for the money spent.

Stark Difference

The difference in premiums can be stark. A 37-year-old man recently could get a $1 million, 20-year level-term life policy for as little as $495 a year, according to Term4Sale.com, a comparison website. By contrast, a low-cost universal-life policy from TIAA-CREF could cost the same man $4,933 a year in premiums -- though at the end of 20 years, this consumer would have about $150,000 in the cash account, based on the insurer's current 5% interest rate.

The Consumer Federation's Mr. Hunt often recommends TIAA-CREF to shoppers who are good candidates for permanent life because, he says, its costs are some of the lowest around and its current interest rate is competitive. Most publicly traded insurers have offerings with much steeper costs, and they pay lower interest. TIAA-CREF is a financial-services firm known for a focus on serving educators and nonprofit groups, but it also sells to the general public through staff, and analysts say it has some of the lowest sales costs in the industry.

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How would a buy-term-and-invest-the-difference strategy fare versus a permanent-life policy? The term-life buyer would take $4,438 -- the difference between the term-life and permanent-life premiums -- and invest it steadily. Depending on his returns and tax rates, he could lag behind or come out ahead.

For example, if he invested the money in bonds and earned a 5% annual return, after 20 years he would end up with $126,306 after taxes, assuming he was in the 35% tax bracket, according to financial planner Allan Roth of Wealth Logic LLC in Colorado Springs, Colo. If he invested in a stock portfolio that earned 8% annually, he would come out with $180,812 after taxes, assuming a 15% long-term capital-gains rate -- but would have taken more risk. And if he bought the permanent-life policy and cashed it in after 20 years, he would net $134,686 after taxes.

A couple of points to bear in mind: If the permanent-life holder cancels and pulls out all the cash value, taxes would apply to any gains at ordinary-income rates. On the other hand, if income or capital-gains tax rates were to rise, that could tip the balance toward permanent life.

Richard and Misty Knight would seem ideal candidates for term life. Mr. Knight is 40 years old and Ms. Knight is 37, and they have two daughters, eight and six. But the couple, both professors of Human Communication Studies at Pennsylvania's Shippensburg University, bucked convention last fall and bought two $225,000 whole-life policies.

How do they justify their decision? They have stable jobs and benefits that include full pensions. They have a 15-year home mortgage and little other debt, so they feel confident they can afford the higher premiums of their two MassMutual whole-life policies -- a total of about $7,000 a year -- and will benefit from the tax-advantaged build-up of the savings account.

They also have exposure to stocks through their 403(b) and individual retirement accounts. After the financial crisis, bond-based whole-life was "more appealing," Mr. Knight says.

For the time being, the Knights are still holding on to two $150,000 term policies they own through their employer, since they are relatively inexpensive. But as the policies need to be renewed and the premiums rise, they say they may drop some of this coverage.

Here's a guide to helping you shop for life insurance, once you decide which kind of policy is best for you.

Buying Term Life

Term policies are typically sold to cover periods between five and 30 years, though at least one insurer, Primerica Inc., now offers 35-year policies. "Guaranteed level-term" policies, in which premiums stay the same for the designated coverage period, are popular because they allow buyers to lock in a price for the entire term.

There usually is a gamble involved: A 10-year policy will have a lower annual cost than a 20-year one, but if you become ill and still need insurance at the end of the 10 years, buying a new policy can prove costly -- if you can get one at all.

If you are in excellent health, you may want to shun the convenience of "rapid issue" and "simplified issue" policies, something insurers are pushing these days as a way to speed up the sales process, advisers say. With these approaches, insurers forgo the customary blood work and urine samples. The best prices usually require giving a blood sample, actuaries say. And you will generally pay less if you choose to make one larger annual premium instead of monthly or quarterly payments. The monthly-to-annual price difference is 12% at Primerica, for example.

It is easy to compare term-life policies, thanks to websites such as Term4Sale.com. Unlike some other quote-service sites, Term4Sale.com doesn't require shoppers to disclose contact information, so you won't be setting yourself up to receive annoying calls from agents.

Buying Permanent Life

Permanent-life policies vary widely across the industry and are hugely difficult for ordinary consumers to understand, much less compare. You want a policy in which the savings account starts building in value quickly -- and many agents aren't likely to steer you in this direction, because it will cut into their commission.

Your best bet may be to hire a fee-only insurance adviser who can help you cut costs using a strategy known as "blending." This involves structuring a policy to include significant amounts of term-life coverage and "paid-up additions," a low-commission form of permanent-life coverage that supplants the term coverage over time.

The strategy helps for this reason: A policy's savings component is funded by a portion of each annual premium, after adjusting for sales-related costs, the cost of providing the death benefit and the insurer's administrative expenses. Under many policies pitched by agents, premiums from the first year or two are mostly eaten up by these costs, leaving little for the savings component. The costs mean it can take seven or more years before your savings equal what you have paid in premiums, less the cost of the death benefit.

You can pay $85 for the Consumer Federation of America to compare a policy you are thinking of purchasing with a buy-term-and-invest-the-difference approach. (You can learn more about this service at EvaluateLifeInsurance.org.)

In addition to recommending offerings from TIAA-CREF, Mr. Hunt often favors "mutuals," which are insurers owned by their policyholders. That means they don't have to split profits with publicly traded shareholders. Among the biggest are Guardian, MassMutual, New York Life and Northwestern Mutual, all carrying strong claims-paying-ability ratings.

Some well-to-do buyers pay more than the required premium amount, stuffing as much into the policies as they can under complicated tax-code rules, aiming to withdraw some of it later for retirement income or other purposes. Consumers should consult with a trusted adviser or tax attorney in such withdrawals.

Splitting the Difference

Still undecided? You can buy a term-life policy that converts into a permanent one, without medical qualification. In practice, that means you have the option to buy a pre-approved universal-life policy before your term ends. You should look for a conversion feature that allows the purchase of any permanent-life policy sold by the insurer, at the latest possible date.

One plus of convertible term-life policies: Professional investors in the "life settlement" market, who ordinarily wouldn't buy term policies, are willing to buy convertible ones. If you sell to such investors, they take over responsibility for premiums in return for receiving the future death benefit. A sale would help you recover some of the money spent on premiums, but it is only for those who can stomach a stranger having a financial stake in their demise.

—Jason Zweig contributed to this article.