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Making S.M.A.R.T. Financial Decisions

Life Insurance

Professor Terrance Odean

When our first daughter, Naomi, was born, I promised my wife, Martha, that I wouldn't ride motorcycles again until our youngest child was at least 21. I had had a couple of close calls on motorcycles, and I didn't consider myself a particularly safe rider. I figured that staying off of motorcycles would improve my chances of being around to watch Naomi grow up. You know, it's been so long now since I've ridden motorcycles, this was the only photograph I could find of myself on one. Since motorcycles aren't the only way people die, I also bought myself a life insurance policy. Raising children is expensive, and I didn't want to leave Martha alone to support a family without any help.

Before we had kids, I didn't have to have life insurance, and I didn't need it. Sure, Martha would have missed me if I had run my motorcycle into a truck, but she would have been able to support herself. Of course, some couples without children may need life insurance, especially if one spouse has been out of work for many years while the other built a career. So to find out whether you need life insurance, the first question you should ask yourself is, does somebody besides me depend on my income? Would anyone be in financial trouble if I died? If the answer is no, you probably don't need it. If the answer is yes, you should take a look into getting some life insurance.

If you do need life insurance, your next step is to ask two more questions. What type, and how much? Let's tackle these one at a time. First up, what type-- you know, there are two types of life insurance. There is term, sometimes called temporary life insurance, and there is cash value, also known as permanent life insurance. Cash value includes whole life, universal life, and variable life insurance. I'm strongly recommending that if you need life insurance, you buy term life insurance. Let me give you a brief description of each of the types of insurance, and then I'll tell you why term is by far the better choice for most people.

Term life insurance looks like this. If you die, your family members or whoever your beneficiary is gets the amount of death benefits specified in the policy you bought. It's called term because you buy a policy for a specific length of time, say, 20 years. If you outlive your policy, it's finished. If you still need life insurance, you'd have to buy another policy, and you don't get your premiums back. Now, cash value, or permanent, life insurance gives you two things-- a payment to your family when you die, just like term life, and a tax-sheltered investment from which you can borrow and pay policy premiums later in life. Now, you're probably sitting there, thinking, whoa, wait a minute. Wouldn't it be better to have a life insurance policy that gives me tax-sheltered investments? The short answer is no. Most people are better off separating their life insurance and their retirement savings. Save for your retirement in your 401(k) or your individual retirement account. You're going to get tax-deferred savings with more control over your investment and lower fees.

So you can think about it this way. If you buy a term policy and you don't die, you won't receive a penny. But the same is true of other types of insurance, isn't it? You know, if you buy homeowner's insurance and your house doesn't burn down, you don't get paid. If you buy auto insurance and you don't have an accident, no check in the mail, but you still have your house. You still have your car. If you buy a term life insurance policy and you don't die, you don't get paid. But you and your dependents still have your income, and you're still alive. So what's the problem? Term life insurance is much cheaper than other forms of life insurance. Term life policies are also much simpler than cash value policies. Insurance companies like to sell complicated products because complexity makes it difficult for you to compare one product with another. One reason term life insurance policies are cheaper is that the commissions paid to the agent selling them tend to be much lower than the commissions paid for other life insurance products. That means more of your money is going to pay for your actual insurance and not to line your insurance agent's pocket. Insurance companies and insurance agents make a lot more money selling cash value policies such as whole life, universal life, and variable life, and that's why many insurance company websites and brochures try to get you to buy cash value instead of term.

There are different kinds of term life insurance you can buy, but the most common is called level term. You pay a fixed annual premium for a fixed number of years-- say 10 years, 15 years, or 20 years. When that term is over, you're no longer insured. Now, you may be able to renew your expiring policy without a health exam, but this will be very expensive. I took a look at my own term policy. I currently have a 10-year term life insurance policy that expires the day before my birthday in 2017. The current annual premiums are $1,785. Now, don't worry. Unless you're as old as me, your premiums are going to be much lower. But if I try to renew my policy after it expires without getting a health exam, the premiums would jump to $44,405 a year. Yeah, you heard me right. I'd be paying almost $43,000 a year more than I currently pay. Why such an astronomical increase? It's because the insurance companies assume that I would only extend this policy if I were very sick. If I were in good health, I might be able to qualify for a new five-year term policy with an annual premium of $6,000 or $7,000. So they figure I'm renewing my existing policy because I'm too sick to qualify for a new one. You know, I don't plan to extend my current policy or buy a new one. By then, I'm going to be 67 years old. My daughters will be self-supporting, and my wife will be eligible for payments from my pension.

So what about cash value life insurance? Cash value policies combine life insurance with an investment. That might sound better than the death-benefits-only approach you get with term life. However, after you adjust for the cost of equivalent term life insurance, the investment returns of these cash value accounts aren't very good. You're usually far better off keeping your investments separate from your life insurance. Cash value policies are often quite complicated. This can make it difficult to compare the investment returns of different policies. If you've got your heart set on a cash value policy, or if you already own one that you'd like to value, you can get help. In her book, Making the Most of your Money Now, Jane Bryant Quinn recommends an online expert service that will calculate the investment rate of return of your life insurance policies. You can find more information about this on the course website.

If you decide to buy a cash value policy, ask your insurance agent just how much he or she is getting paid in commissions. How big is the first-year commission? What about subsequent years? Now, are you embarrassed to ask? Why? Of course, your insurance agent should get paid to do her job, but this is your money. You know, you should be able to ask how much you're spending on your policy and how much is going to your agent's commission. If you buy a term policy, you should also ask. You're probably going to find out that the commission is more than you expected but not as big as if you had bought a cash value policy.

So how much life insurance do you need? In the course website, there are links to some life insurance calculators. Here are a couple of other things you should know about life insurance. Do you smoke? Maybe you don't take those surgeon general warnings on the cigarette pack seriously, but life insurance companies sure do. To get an idea how much smoking is going to cost you in life insurance premiums, I went to the website of Term4sale.com and looked up some quotes. The first quote was for a $1 million policy, 20 year fixed premium term policy for a soon to be 40-year-old man who is in excellent health and doesn't smoke. The annual estimated premium from an A-plus insurance company was $825. Now, if that same man does smoke and wants the same policy with the same payoff, the annual premium is $2,765, more than three times as much and nearly $40,000 extra over the life of the policy. The smokers among you might be wondering if you can get away with lying about it to your insurance company. Not a good idea, you don't want to do that. Be honest on every question the insurance company asks. And don't let your agent fudge the truth on your behalf because if you do die in what's called the contestability period, two years in most states and one in others, the insurance company may investigate. And if they find out that you lied or withheld information, they can refuse to pay on your policy. Now, after the two-year contestability period ends, they're going to pay up. But if you live beyond the two-year period and the insurance company finds out that you deliberately lied when you applied for your policy, you could be charged with fraud. Cheerful video so far, huh?

You know, nobody likes thinking about dying prematurely and leaving loved ones in the lurch, but hold on because the next point is a bit of a downer. However, knowing about it could help you and your family, so bear with me. If you commit suicide within two years of taking out your life insurance, your insurance company is not going to pay the full policy amount. Instead, they'll refund your premiums. The exclusion period for suicide is going to vary, depending on the policy and the state that you live in. Usually, though, if it's more than two years since you set up your policy, your insurance company is going to pay, even if you die from suicide.

All right, that's over. One final point-- life insurance is a long-term contract-- 10, 20, 30 years, maybe your entire lifetime. Once you've been paying on a policy for a few years, your premiums will probably go up if you need to replace it with a new policy. So you're going to want to buy your policy from an insurance company that's going to be in business for a long, long time, a company with high financial strength ratings. You can find those ratings at the websites of four major insurance rating firms. We put links to those websites in the courseware for this week. Each company uses a different rating system, and we also gave you some information on the rating systems. Remember, these are ratings for the financial strength of the insurance companies. They don't take into account customer friendliness or consumer value. Our youngest daughter is now over 21, but I haven't bought myself a new Harley. And I've been paying term life insurance premiums for many, many years without collecting a dime. I don't feel bad about that. With term life there are two outcomes, this one and this one, and I'm happy with the one I got.