

# The Confession of a Financial Adviser

By Christopher Tan

**"If you buy insurance products like a whole life plan, you're paying to be served a plate of garbage that in fact if you eat, you'll have financial poisoning".**

This is what CNBC personal finance editor and best-selling author Suze Orman told this newspaper 1 year ago. About 7 years ago, I was guilty of serving this plate of poison. But like Ms Orman, I have since repented from my sins and have now become an advocate for the doctrine of buying term and investing the rest. When we establish [www.commissionsfreeinsurance.com](http://www.commissionsfreeinsurance.com), besides doing it to publicly announce our "faith", we did it to contend against the false teachings of buying whole life plans. Let me now confess to you these false teachings that I used to believe in.

Firstly, let me explain what is a traditional whole life plan and what is a term plan. For a traditional whole life, for every dollar you pay to the insurers, they will use a portion to pay for the cost of insuring you (mortality charges) and the remaining portion to invest for you via their life fund. The life fund may invest in asset classes such as cash, equities, properties and bonds and they are subjected to similar risks as any investments. As a policyholder, you will get bonuses from the insurer if the life fund performs and there are surpluses. Once bonuses are declared, they are guaranteed and over the years, these bonuses will increase the cash values of your policy. For a term plan, you pay only the cost of insuring yourself and nothing else. It is not difficult to see why term plans are cheaper than traditional whole life plans.



## Proponents of whole life plans says that:

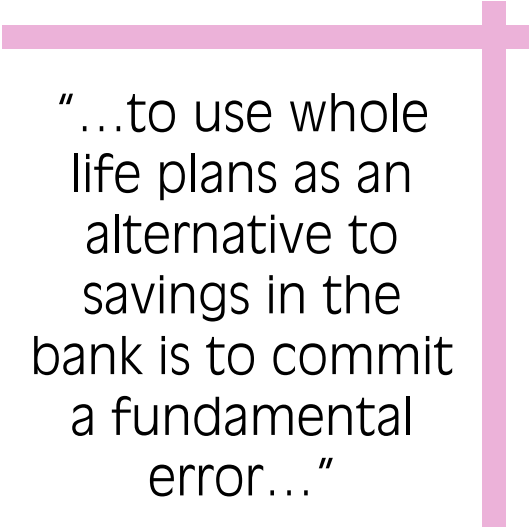
1. Whole life is a systematic and organised way to save, gives you better returns than bank deposits and on top of that, you get protection.
2. Because of the cash values accumulated in a whole life plan, when you cannot pay the premiums, the policy will not lapse.
3. Don't buy term plans because if there are no claims, you get nothing back.
4. Don't buy term plans because it doesn't cover your entire life and you will never know when you will be hit with an unfortunate event.
5. Don't buy term plans because without cash values, it does not hedge against inflation.
6. Buying term and investing the rest will not work for those who are not investment savvy. Using insurance is safer bet.

**Unfortunately, I have to say that all these are false teachings that will disadvantage you if you believe them.**

As a start, to use whole life plans, as an alternative to savings in the bank is to commit a fundamental error. Bank deposits are short-term instruments that give liquidity and flexibility. Insurance, relatively speaking, is a long-term instrument that is not very liquid

and flexible. For example, if you need money suddenly, surrendering your policy usually means losing your capital. Of course, they say you can take a policy loan from the insurer (provided you have accumulated sufficient cash values), but you need to know that it comes with a cost. You need to put back everything you took out plus around 7-8% p.a. interest depending on insurers. This is also true when you intend to use the cash values to pay the premiums. You also do not have the flexibility to "save" less when you cannot afford to. Doing so usually means having your protection lowered. It is wrong to compare the returns of life insurance to bank deposits.

Proponents of whole life plans claimed that buying a term plan is wasting money because if there are no claims, you get nothing back. Buying a whole life is better, because there is a saving component. This is a terrible half-truth! The fact is, all costs relating to protection are an expense. In traditional whole-life, the mortality charges are not invested. They are simply expenses that you have to incur to buy the insurance that you need. So whether you are buying whole life, term or any sort of



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insurances, the cost of insurance, which is built into the premium is an expense and is never invested for you take back later, even if nothing happens to you.

The reason why term plans are effective for protection is not just because you only pay for protection and nothing else, it is also because most people would not need to cover for their entire life. For example, buying a critical illness policy is for income replacement in the event of being diagnosed with a dread disease. When you retire, you should have accumulated a tidy nest egg and you would not need to replace your income then. Thus a term cover for critical illness may be sufficient. Even if you need or want a whole life cover, you can always buy a term cover that covers you for a long period till age 90 or even 99.

It is interesting to note that many financial planners do not advocate term because they claimed that their clients are not investment-savvy enough. As I have mentioned, investing via the life fund exposed you to the same risks as any other investments. Though it is true that there are certain guaranteed values in whole life policies, this guaranteed component is often a small portion of the overall benefit. For those who are not investment savvy, you can simply invest your money using a balanced fund or buy SGS bonds if you are very risk averse. You can easily replicate the whole life plan by buying term plans for protection and investing the rest directly into investments.

A recent study by Provident showed that in fact, it might be better doing just that. We compare the results of a 35 years old male non-smoker buying a \$100,000 whole life (WL) insurance plan (costing about \$3,000 p.a.) with buying a \$100,000 term insurance plan (costing about \$1,300 p.a. covering till age 90) and investing the difference of about \$1,700 p.a.

With the assumption that the ROI is 5%, the total "sum assured" and "surrender value" of the term plan is generally close, but most of the time, better

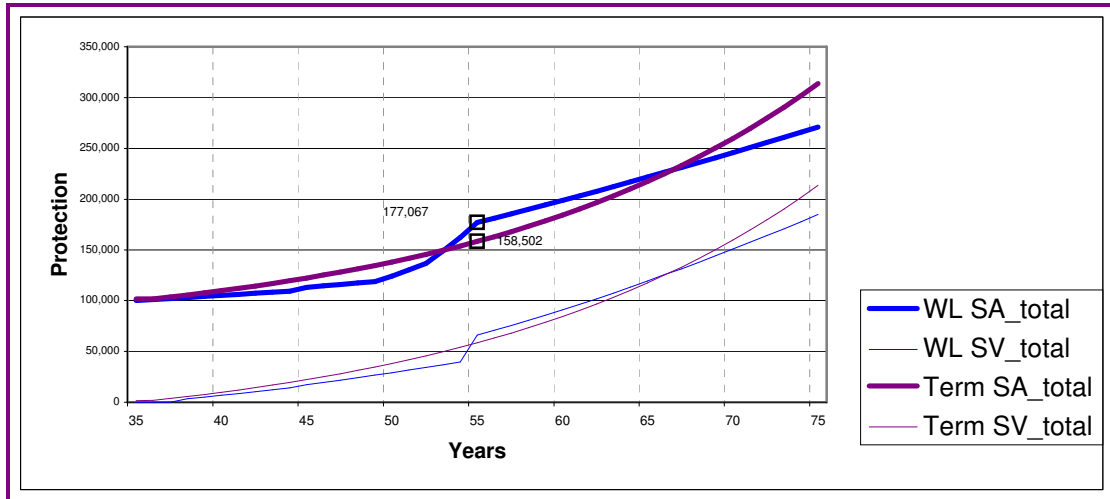
than that of whole life (WL) insurance plans (see graph 1). If we assume a higher ROI of 7%, the total "sum assured" and "surrender value" beat whole life (WL) insurance

throughout (see graph 2). Our study for the older ages such as age 45 and 55 showed similar results. For term plans, total sum assured is the value of the investments plus the \$100,000 cover. The surrender value is the value of the investments at the point of selling the investments.

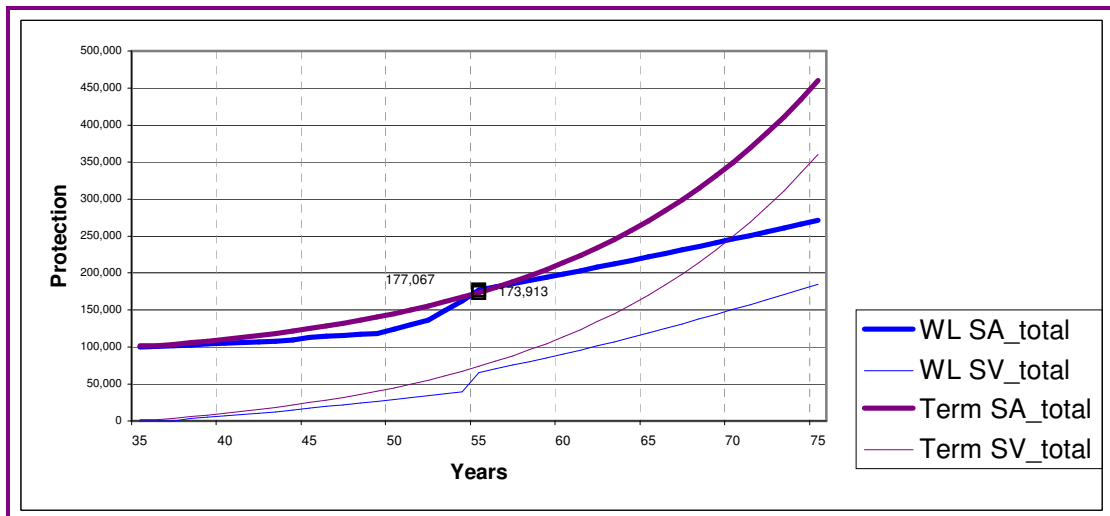
By buying a term plan and investing the rest, not only are you better off in terms of protection and investments, your protection is also hedged against inflation. And because of lower premiums, you can now fully cover all your insurance needs. On top of that, if you faced financial difficulties, you have full flexibility to stop

investing without affecting your cover. If you really cannot afford the insurance, you can dip into your investments to temporarily pay the premiums without the need to pay interest later on. Furthermore, by having full flexibility to choose the fund managers that are specialist in their area of work, you have a better chance of getting the returns that you need. Sceptics will question the ability of investors to achieve a return of 5%, let alone 7%. By simply investing in a 15-year SGS Bond, you'll already get about 3.5% p.a. guaranteed by our government. If you invest in a portfolio with equities, and with constant monitoring and rebalancing, you should be able to get 5-7% p.a. comfortably.

GRAPH 1



GRAPH 2



It's funny how things turn around and how money can cause perspectives to be different. Years ago, when Ms Genevieve Cua wrote in the BT advocating term plans. I disliked her writings then. Commissions for term plans are a lot lower than whole life plans and thus her writings were a threat to my trade. But it is now my turn to be advocating a truth that has caused many in the industry to be upset. I can only say that I am now a new person. By removing commissions from advice, I can really be free from temptations that may hurt my clients. I am thankful that I realised it early and that I have the courage to be honest with myself. So, to consumers out there, beware what you eat, and to us advisers, let's be careful what we serve.

This is an original article written by Christopher Tan. The edited copy appeared on the Business Times, in November 2004. Chris is the Chief Executive Officer (CEO) of Providend. He is a Certified Financial Planner licensee and a member of the Financial Planning Association of Singapore (FPAS). Chris holds a Bachelor of Financial Services Degree with honours from the National University of Ireland and a Master of Business Administration Degree from University of Warwick. He can be contacted at [Chris.Tan@Providend.com](mailto:Chris.Tan@Providend.com)

