The Insurance Decisions Guide

> Insurance is sold, not bought, which is why so much of it is the wrong kind. Here is how to see through the pitch on life insurance and health accounts.

Insurance is one of the most oversold products in personal finance, because commissions reward selling the expensive kind. The good news is that the right choices are usually the simpler, cheaper ones. This guide covers two decisions that trip people up, term versus whole life and HSA versus FSA.

Buy term and invest the difference

Whole life insurance costs far more than term because part of the premium builds a cash value, wrapped in fees. The classic counterargument is buy term and invest the rest. Buy cheap term coverage for the years your family needs it, then invest the money you would have spent on the pricier whole life premium.

An example shows why it usually wins. Term coverage might cost 500 dollars a year against 5,000 for whole life, a 4,500 dollar difference. Invest that difference, about 375 dollars a month, at a 7 percent return for 30 years and it grows to about 457,489 dollars. A whole life policy might illustrate a cash value of 250,000 over the same period. Buying term and investing the difference comes out roughly 207,000 dollars ahead, and that money is fully yours. The Term vs Whole Life calculator runs this comparison on your own numbers.

When whole life actually fits

Whole life is not a scam, it is just wrong for most people. It fits a minority with specific needs, such as those who want guaranteed lifelong coverage, a forced savings habit they will not otherwise keep, or particular estate-planning and tax goals where leaving a set sum regardless of when they die is the point.

For the ordinary goal of protecting your family during your working years, term does that job for a fraction of the cost. If someone is steering you toward whole life, ask what specific problem it solves that term plus investing does not. If there is not a clear answer, term is almost certainly the better buy.

HSA vs FSA: the tax-free growth gap

Health savings accounts and flexible spending accounts both let you set aside pre-tax money for medical costs, so both cut this year tax bill. The difference shows up over time. An FSA is largely use-it-or-lose-it, so unspent money is gone at year end. An HSA rolls over, can be invested, and grows completely tax-free.

An example. Put 4,000 dollars a year into either, in the 22 percent bracket, and you save 880 dollars in taxes each year either way. But with an HSA, if you pay medical bills out of pocket and leave the account invested at 7 percent for 20 years, your 80,000 dollars of contributions grow to about 173,642, roughly 93,642 dollars of tax-free growth an FSA can never build. The catch is that an HSA requires a high-deductible health plan. The HSA vs FSA calculator shows the growth edge for your situation.

The coverage people actually skip

While whole life gets oversold, two genuinely important coverages get skipped. Disability insurance replaces part of your income if illness or injury stops you working, and your ability to earn is usually your largest asset. A common target replaces about 60 percent of gross income, which after tax often covers most of your take-home pay.

Term life insurance sized to your real needs is the other. The DIME method adds up debt, income to replace, mortgage, and education, then subtracts what you have, to size a policy. The Disability Insurance and Life Insurance calculators size both. Getting these two right matters far more than the whole life decision most sales pitches focus on.

Key takeaway. Buy term, invest the difference, and use an HSA if you can. Then make sure you actually have disability and term life coverage, the protections that get skipped.

Assumptions

- The buy term and invest the difference comparison invests the premium gap at a return the user supplies and compares it to a whole life cash value.
- The HSA growth advantage assumes you pay medical costs out of pocket and leave the account invested. An HSA requires a high-deductible health plan.

Sources

- Consumer Financial Protection Bureau, insurance
- IRS, health savings accounts and other tax-favored health plans (Pub. 969)