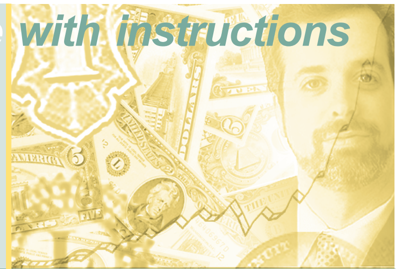
because money doesn't come with instructions

Inside Personal Finance

with RIC EDELMAN®



Beware Investing Mortgage Proceeds in Life Insurance

Q My wife and I own a home worth $1.5 million+. We have a first mortgage of $200,000. We are considering refinancing. We have always had fixed-interest mortgages. One person suggested we take a variable-interest loan for $600,000 that is fixed at 1.25% for five years. He suggested we invest $300,000 in whole life insurance and get a guaranteed rate of return. After five years we could apply the money made in the whole life policy to the principal. This option is supposedly attractive as we would not have to pay tax on the earnings as it would be washed in the equity. This sounds good, as my wife and I plan to retire in about five years, but I have never heard of such a plan. What is your opinion?

Ric: I'm very upset to hear about the sales pitch you received. Here are the problems with the pitch:

1. The "fixed" rate of 1.25% refers only to the payment calculation; the actual interest rate you'll be paying for this loan is really 6.75%.
2. Because you'll be making payments based on a 1.25% rate when the actual rate is 6.75%, this means you are not paying as much as the loan costs. The shortfall, therefore, will be added to your mortgage balance. This means you will owe the bank more in five years than the $600,000 originally borrowed.
3. Refinancing to cash out $400,000 for investment purposes presents a big tax problem. Interest is tax-deductible only on the first $100,000. This dramatically reduces the effectiveness of the strategy, and I bet the person who pitched this idea didn't tell you this.
4. The whole life insurance policy indeed offers a "guaranteed" rate of return, but the guarantee is probably significantly lower than the 6.75%, which is what you'll pay to borrow the money. As a result, the future value of the account will be less than the amount you pay in interest — making the strategy a failure.
5. The "guarantee" usually applies only if the money is left in the policy for perhaps 15 years, maybe longer. If you take money from the insurance contract in the fifth year, you are likely to incur substantial penalties that will dramatically reduce the proceeds.
6. There is no assurance that you will be permitted to withdraw the money from the policy in five years without incurring a tax liability. This is a function of tax law, which could change. Keep in mind that, over the next five years, we're going to have at least one new president and two more Congresses.
7. Assuming a tax-free withdrawal is indeed permitted, it is simply because the withdrawal is considered a loan; it must be repaid. If it is not repaid, the money you had placed into the contract will be lost. The death benefit will also be lost.
8. The cost of the policy (underwriting expenses, mortality charges, commissions, policy fees and so on) will prevent the policy from accumulating as much value as investments in mutual funds would produce.
9. The commission on this product is as much as *one hundred times more* than the commissions for investing in mutual funds. Could this be why that person wants you to do this?
10. Securities regulators caution stockbrokers and investment advisors from encouraging consumers to invest mortgage proceeds without substantial disclosure and suitability determinations. But life insurance is outside the jurisdiction of the regulators, giving insurance agents free rein to pitch anything they want, without explaining to consumers the regulatory issues involved.

Not only would I strongly recommend that you decline this investment strategy, I suggest you find another advisor — a genuine, independent, objective financial advisor and not an insurance agent masquerading as one.

Ric Edelman is the best-selling author of five books including *Ordinary People, Extraordinary Wealth* and the personal finance classic *The Truth About Money*. He hosts *The Ric Edelman Show* on the ABC Radio Networks, and writes a syndicated newspaper advice column for United Media. His firm, Edelman Financial Services LLC, manages over $3.5 billion for consumers nationwide, and is winner of more than sixty awards. For station listings, and more of Ric's common-sense financial advice, visit him online at RicEdelman.com.