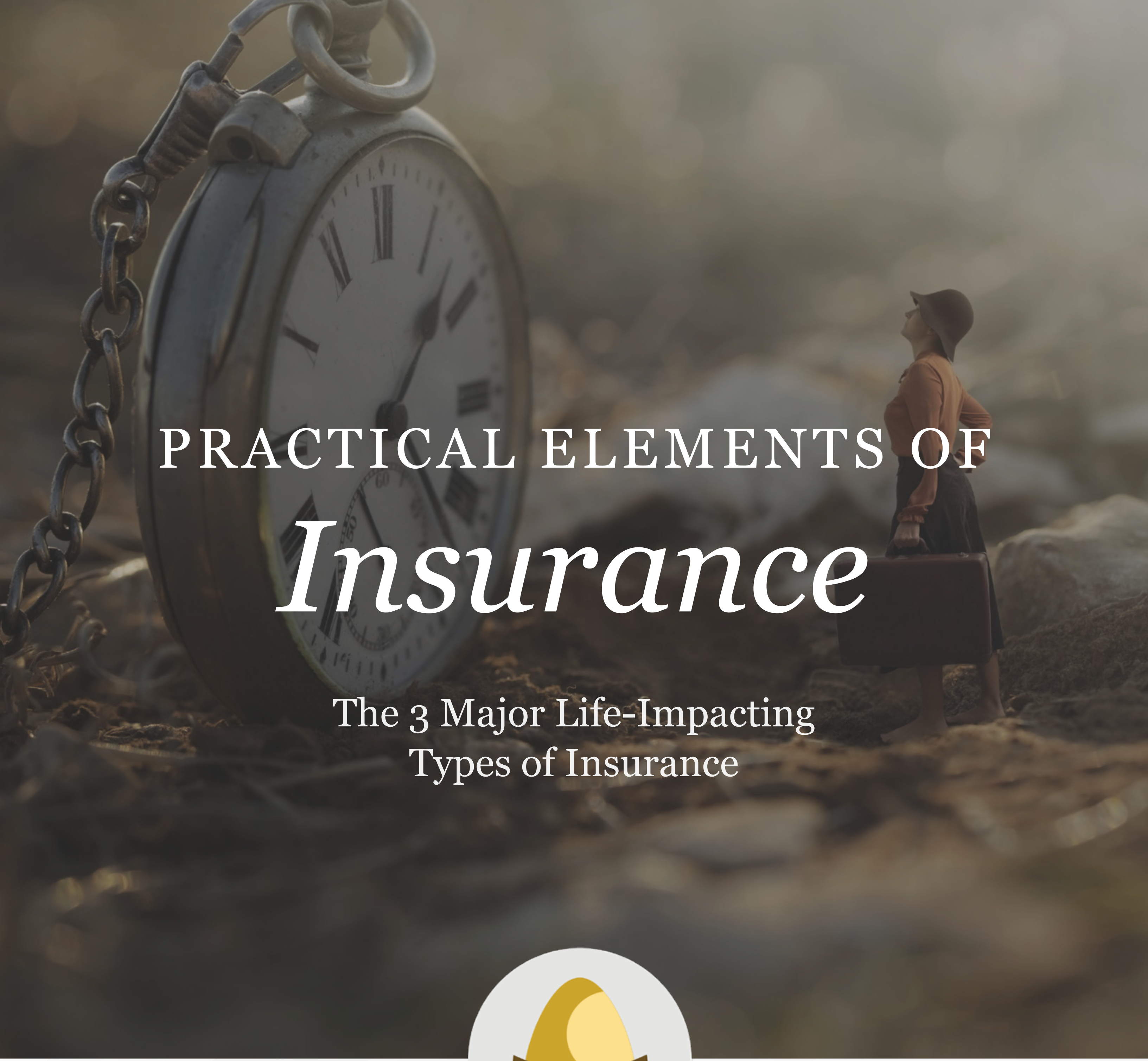

PRACTICAL ELEMENTS OF

Insurance

The 3 Major Life-Impacting
Types of Insurance

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Practical Elements of Insurance

Insurance is the difference between a real plan and a bet.

Probably, the only financial activity more boring than reading a mutual fund prospectus is hearing about and learning about insurance. It's just not enjoyable contemplating all the potentially bad things that can happen to a person, a family, or a business. It's just not.

From the outset, I will admit complete defeat, realizing there is very few ways to get you or anyone else truly interested in insurance. Though I promise I have no intention of trying to convert you to someone who likes insurance, I hope to help you gain an understanding of the basic tenets of insurance and the solid financial reasons why prudent folks choose to spend money on reasonable types of insurance. They may not like it, but they do it; and, when the bad times arrive, they are glad they did. And if the bad times never arrive, they do not begrudge the fact that they were protected all along.

First and foremost, know this about insurance: insurance is the difference between a real plan and a bet. Without it, you are betting nothing bad is ever going to happen - but I am quite sure your life experience tells you otherwise. If something bad does happen - or rather, when something bad happens - insurance is the only financial instrument that guarantees a predictable and manageable financial outcome.

The 3 Major Life-Impacting Insurances

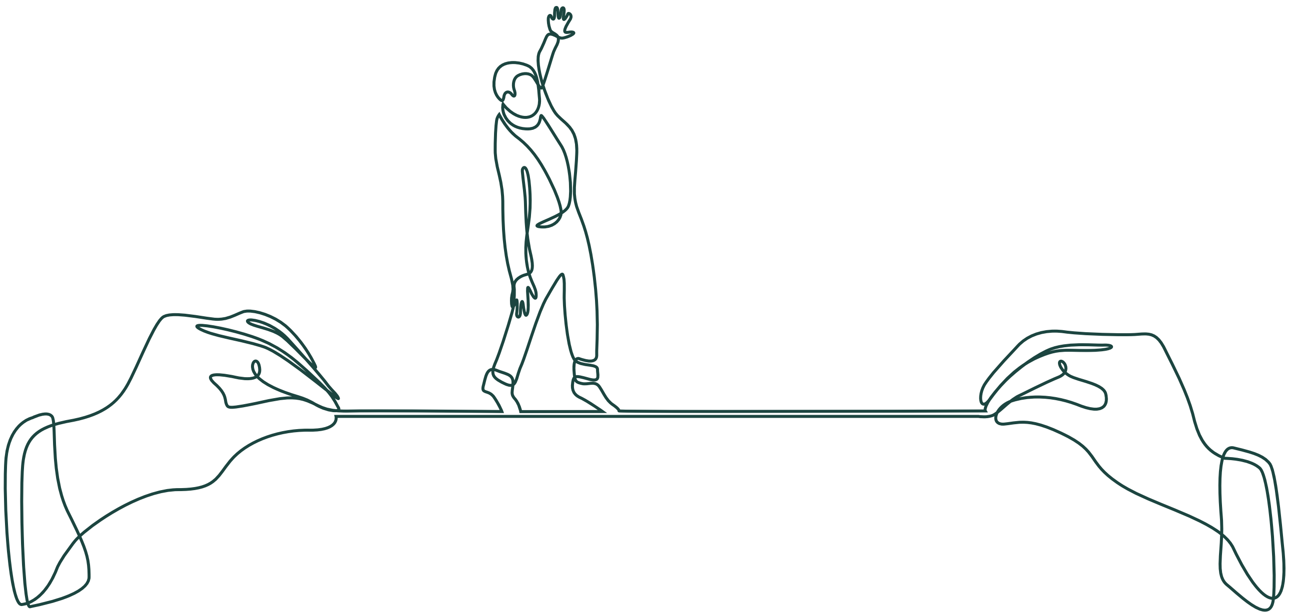
In my planning practice, I have made a conscious effort not to spend too much time on the involuntary types of insurance you have to own like homeowners and auto.

Not that you should avoid them - because you should not. You must have homeowner's insurance because no lender in their right mind would give you a mortgage without a protecting their investment in you. And the state in which you reside likely requires you to buy auto coverage if you want operate a vehicle legally.

Like many financial products and services, this is an area that requires special knowledge and experience. There are many companies that offer these types of coverage (generically called "property" and "casualty") and they have well qualified folks who can walk you through all the different policies. As you frequently have to renew these policies, you can make changes as necessary. So, find a company that provides good service and someone with whom you can talk to on a regular basis, and you will be well served.

As for medical coverage, this is a highly specialized area unto itself. It is a complicated web of employer sponsored plans, Affordable Care Act requirements, state specific Medicaid options and a government-run Medicare system for those over 65, intersected by your ever-changing medical conditions and history. Whenever I encounter a serious situation where a review needs to be undertaken, we refer this out to true experts in the field.

Having begged off on the above set of personal coverages, that leaves only life, disability, and long-term care insurance to discuss in detail. In no particular order of importance, allow me to present the three major types of insurance that will most impact your life and that you will need to consider in greater detail.



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Life Insurance and Why You *Should* Believe in it

My favorite saying when it comes to life insurance is: 'Wives don't believe in life insurance; widows sure do.'

At some point in almost every interview I conduct with a husband and wife, one of them will make a statement that sounds something like: "I don't believe in life insurance." What the respondent really means is that they do not enjoy paying for life insurance. It's as if they are embarrassed to admit they do not want to pay for something they know they really need. Instead of telling the truth, they make a statement about faith, or in this case, a lack thereof: "I don't believe in life insurance."

Well, let's just state the obvious here: you will die.

Given then that the odds are one to one that you will have the opportunity to collect on your life insurance policy, why would you not have one?
In the case of auto insurance and homeowner's insurance, the odds of actually collecting on either of those is significantly less than "one in one," yet virtually everyone owns these types of insurance.

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The Simplest Way to Begin Thinking About Life Insurance

The simplest way to begin thinking about life insurance is to attempt to answer this question: If you died yesterday, what would you need your insurance to do for your family today?

More specifically, who is going to need money right away? For what purpose will they need it? Who will pay next month's mortgage? How will your spouse educate your children? Will your business survive without your economic contributions? Should your business partner buy out your spouse? The questions are endless, and your answers to them are very important.

Whenever you are evaluating life insurance, the most important aspect to define is how much insurance you need. Crude as this may sound, if your friends are huddled over your casket at your viewing, I guarantee not one of them is saying: "I wonder what kind of life insurance he had. I wonder what company it was with." Trust me, they are not asking that question. They're asking this question: How much insurance did he have?

I have just tried to bluntly hit you over the head with a large two by four. In case I missed, let me reiterate. How much insurance coverage you have is far more important than what kind you have. Once that is determined, the other details are easily worked out. What kind? How long should the coverage last? What company? These are the essential elements of any productive discussion about insurance with your financial advisor.

Most people fail to recognize the true economic value of their own worth.

After some discussion, most people will concur that we should determine how much insurance they should have. I get very little push-back on this point. But when we actually do the calculations, most people are floored to find out how much insurance they really should have. They fail to recognize the true economic value of their own worth.

Are You Underestimating Your Worth?

People underestimate their true economic value when it comes to life insurance.

For example, assume you are 40 years old and you make $80,000 a year. Assume you get run over by a bus tomorrow. If you would have worked to age 65, you would have brought home $2,000,000 in earnings during your remaining 25 years of work. That's even with assuming you never got a raise! In truth, your remaining lifetime earnings would likely have reached over $4M. How many 40-year-olds do you know who have insured themselves for $4 million? Not many.

"I feel fine. Who needs life insurance?"

People underestimate their true economic value when it comes to life insurance. I suppose it has to do with not wanting to contemplate what it costs to buy $4M of life insurance (which is actually a lot less than you might think for a healthy 40-year-old). But I also think that most people don't feel like contemplating their own demise. "I feel fine. Who needs life insurance?"

The only flaw in that thinking is this: if you are in perfect health now, can you get better or worse? Will your health improve or go downhill from today? When are you most likely to get insurance at the best rate? When you are at your peak of health and fitness, is your health going to continue upward or might it be on the downslide? The irony is that people are less likely to buy insurance when they are in fact at the absolute best place and time in their lives to buy it.

Unfortunately, Insurance is a Lot Like a Parachute.

Once you realize you will need it, it's too late to get it. If you are already out of the plane and free falling, there's no chance to reach up into the overhead bin and grab a parachute.

You either have it on or you don't. My point is this: buy the insurance when you know you need it and buy it when you are best able to purchase it at a favorable price.

I will not go into a lengthy discussion on the different kinds of life insurance. In general, life insurance comes in two basic flavors: term or permanent. Term insurance is like renting. You have the least cost of ownership and no commitment to equity. You pay for it as you need it, and it ends at a particular time (the term). Use-it-or-lose-it is the basic format.

Permanent insurance is more expensive initially, but it provides additional benefits that may include tax favored accumulation, investment management, flexible premium payments, unlimited death benefit and tax-free growth of equity that may continue to purchase the protection even after you stop paying. Regardless of whether it is term or permanent, almost all insurance proceeds are paid income tax-free.

Disability Insurance: The Most Misunderstood

Over the years I have found that the most misunderstood type of personal insurance is disability coverage.

The odd part of disability insurance is that it is the only type of insurance that actually pays you! Think about all other kinds of insurance and who they pay. It's always someone else. Life insurance pays your beneficiaries, medical insurance pays your doctors and the hospital, and long-term care insurance pays the care givers and the facility. Only disability insurance pays the insured directly.

One of the often-overlooked effects of America's ever-increasing life expectancy is that all the major killers of the last generation are now the major disablers of this generation. Although medicine has not eliminated the vast majority of diseases and afflictions, it has gotten much better at treating them so people can continue to live. The result is that many, many more people now live with the conditions that once killed them. But this longevity comes at an economic price.

Living a long time is wonderful if you have assets and income. Living a long time without assets or income can be a nightmare. What provisions have you made for personal protection? Specifically, what is your plan to protect your family during a prolonged period of income loss due to permanent illness or injury?

This may not be the kind of question that gets your attention, especially if you are the sort of person who doesn't like to contemplate bad things happening to good people. If so, think of it this way: if you had a goose that laid golden eggs, would you insure the eggs or the goose? I hope you said the goose. In this case, you (or your spouse, or both of you) are the goose. You are a money machine, and disability insurance is the service contract on you.

To put it bluntly, how will your income be replaced if you could not work in the event of injury or illness?

Isn't it true that there would be little - or at least a lot less - money available for mortgages, car payment, investments, vacations, etc.? Your income will be dropping just at a time when your expenses are increasing. Your assets will be draining, and it is very unlikely that someone will want to let you borrow money, especially if your future earning capacity is severely constrained.

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The Risk of Not Having an Income

I know what you are thinking. My family can stick it out. My husband or wife will pick up the slack. But honestly, can your spouse be a full-time employee, spouse, parent, and nurse? Is this a chance you really want to take?

To answer this question as rationally as we tried to answer the life insurance question, we return to the fundamental issue: how much coverage do you need? Specifically, how long do you want to drain your own resources before an insurance company steps in and begins to pay you? For some people, the answer may be that they have enough resources to self-insure. If so, fine. They do not need disability insurance. But I suspect the older you are, the more income you make and the more quickly you would like to get to retirement, then the more likely you are to see the wisdom in a well-crafted disability insurance program.

Disability insurance reduces your risk of a temporary or permanent loss of income.

Integrating disability coverage into your plans reduces the risk that a temporary or permanent loss of income due to illness or injury will derail your financial plan. Is it worth taking 1-2% of your income to pay for the right kind of disability insurance to assure that your family won't have to pay the devastating price if you become disabled? Does that make sense? I hope it does because the cost of having coverage is far less than the cost of not having an income.

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Long Term Care Insurance (LTCI)

Our current generation of seniors will live noticeably longer than their parents did. And we know that the things that used to kill us now may just disable us.

While the benefits of longer life are commonly understood, this phenomenon of longevity creates a risk. As we live longer, we increase the odds of using up all our funds for medical and personal care. But, where there is risk, there is insurance. That specific kind of insurance in this case is Long Term Care Insurance (LTCI).

LTCI is essentially an agreement between you and an insurance company for a pool of money they will pay out in the event you need long term medical care. In insurance terms, there is a very specific definition of when LTCI is triggered. There are six recognized "activities of daily living (ADL)" that we take for granted:

1. **Bathing**
2. **Continence**
3. **Dressing**
4. **Feeding ourselves**
5. **Using the bathroom**
6. **Transferring**
   (from a bed to a chair, for example)

An LTCI contract usually begins paying the benefit when the insured has lost any two of the six ADLs mentioned above.

No matter where you are when it happens - at home, in assisted living, nursing home, etc. - when you lose two of the six ADLs, the policy is triggered. By "triggered," I mean that the policy comes into active use.

Typically, however, the policy does not start actual payments until you satisfy the "elimination period" (EP). The EP is basically identical to the deductible on your auto insurance. You pay the initial cost of a claim up to the deductible amount on your car. Then, if the claim is above and beyond that amount, the insurance company starts kicking in its share. The same applies with LTCI.

What to Do with Your Cash Benefits

When you satisfy the deductible or "elimination period," you begin to collect actual cash benefits.

This can mean two things: either you have to set aside enough money to pay for your care during the elimination period, or you have to hope that the initial cost of your medical care is covered by your health insurance or Medicare. For example, Medicare covers the first 100 days of nursing home care that results from any Medicare covered illness or injury. Therefore, most people choose a policy with an EP of 90 or 100 days. This approach allows the LTCI benefits to begin roughly when the Medicare or insurance coverage ends. But, it never hurts to have a good cushion of savings set aside in case Medicare does not cover your initial expenses.

LTCI normally pays in monthly checks based on the amount of coverage you contracted for - e. g., $4,500 per month for three years or $3,000 per month for the lifetime of the insured. The benefit is a monthly amount, payable over a particular number of years, and may or may not have inflation-protected increases built in. Obviously, the cost of the insurance is predicated on the benefits you may receive; the higher the benefit (and thus the higher the risk to the insurance company), the higher the premium cost to buy it.

Now, notice that I said, "benefits you *may* receive."

Like any insurance, you may pay the premium while hoping you never need to use the coverage. Although most senior clients know one or more of their peers who required long term care, many of them don't fully appreciate the risk of needing long term care themselves.

Statistics from the Administration on Aging as of November 2017 indicate that 37% of individuals age 65 or older will require long term care at some point in their lives. If we only consider individuals age 75 or older, the likelihood of needing long term care jumps to 70%. More specifically for the 65 and older crowd, current statistics suggest that out of every 100 seniors, 63 of them will never need any kind of nursing care. Of the 37 who do, 13 of the original 100 will need less than one year's care.

Typically, these folks can self-insure the risk. Of the remaining 24 who need more than one year of care, roughly 16 will need more than three years of care. Thus, only 1/6 of seniors are likely to get their money's worth in terms of collecting benefits from LTCI over a long period of time.

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The Single-Biggest Risk to Your Financial Well-Being in Your 70's-90's

It is very unlikely that you will need to use LTCI if you are a purchaser. The principal question is: can you afford to be the one in six seniors who may need chronic long-term care if it costs $90,000-$110,000 per year?

Can you weather that storm? Can your spouse continue to live well if you are the one in the nursing home? Do you want to plan for that contingency, or not?

Before you answer, realize that the single biggest risk to your financial well-being in your 70's, 80's, and 90's will be health care costs. These costs will also be the single biggest risk to your being able to leave an inheritance.

To go about answering the question of how to plan for LTCI expenses, think about your financial situation and ponder these larger questions. Once you have a strong sense of what's really important to you, the smaller question of whether to buy insurance should be easier to answer.

Here's where to start: if either you or your spouse ever needed long term medical care, could your current income handle the cost? Funny as it may sound, I have several clients who actually would be saving money if one of them went into a nursing home since they spend more money as a healthy couple than they would if one of them were in a nursing home. If you are not one of those lucky couples, then think about this.

If one of you needed to enter a nursing home or receive home health care, which assets would you liquidate first? How long could you afford to continue to liquidate those assets?

Folks who have few, if any, assets at retirement are not really candidates for LTCI.

As a general rule of thumb, folks who have few, if any, assets at retirement - say $200,000 or less - are not really candidates for LTCI. Ostensibly, people who need to liquidate assets in large quantity do so because their income from Social Security and pension are relatively small. When coupled with few assets, these folks quickly "spend down" to the Medicaid limit and therefore qualify for state welfare benefits.

In the End, LCTI is Really for the People in the Middle Range of Wealth

Wealthier folks who have sufficient assets and income can self-insure while the folks at the bottom of the economic ladder have Medicaid to fall back on.

Where will you end up? It's always the people in the middle who have assets to protect and who fear being driven into poverty that really need to consider buying the insurance. Does this apply to you?

While the need for LTCI has been steadily rising, insurance companies have, in my opinion, done a poor job in creating and maintaining good insurance offerings. There are numerous news stories of how insurers have underpriced their products (either purposefully or unwittingly) to initially entice policyholders to buy coverage and offer policies to younger ages, only to later return to policyholders requesting higher premiums or reducing the benefits when those insured are most likely to start needing the coverage. With good reason, consumers have become very wary of buying a policy where monthly payments can go up unexpectedly and monthly benefits can go down.

Addressing Consumer Concerns with Insurance Products

In response to this lack of consumer confidence, new providers have entered the market and begun offering more robust products that do a better job at addressing consumer concerns.

Specifically, people want to know that the price can't be changed later, that there is some value returned to them if they don't use the policy and that if they should die while owning the policy, any remaining value could be passed on to other family members.

Essentially, these products are a hybrid insurance product combining aspects of life insurance, annuities and LTCI.

The specific details are for another time, but the concept is very appealing. When appropriate, this can be an excellent instrument; but it may also be overkill. So, consider your needs and goals before deciding whether they are a good choice or not.