3 Guidelines When Purchasing Life Insurance

Talking about insurance may not be your favorite part of your financial plan. Insurance is just not as inherently exciting as discussing your goals and investments. Here are three guidelines to make it a bit easier for you.

1) Keep insurance and investing separate. The role of investing is to grow your assets so that you meet your financial goals and ultimately gain financial independence. The role of insurance is to protect those assets, including the human capital.

2) Insure only for what you cannot afford to lose, and self-insure for anything else. Keep in mind that insurers must cover costs and make a profit.

For an insurer to make that profit, the premium paid by the client needs to be more than the likelihood of the event multiplied by the expected payout. This means, on average, that a client will lose on insurance — at least on an economic basis.

3) Work with a professional. Because insurance can be such a big-ticket item, comparison shopping often pays. Take the time to figure out what you really need.

We will ask personal health questions, and then match the company that will be most favorable to your situation. If you have a health issue, we will speak with the underwriters directly before even supplying you with a quote.   Many agents will underquote to get your business, when, after underwriting the risk, your price ends up to be much higher than expected.

To think strategically about the insurance that you do need, it helps to divide the task into three basic categories of protection:

- Insure <u>income</u> through life and disability insurance.
- Insure <u>assets</u> through liability insurance, such as auto, home and umbrella policies.
- Insure against <u>unmanageable expenses</u> with health or long-term care insurance.

PROTECTING INCOME

Clients' human capital is their total expected earnings over a career. For example, a 35-year-old making an after-tax income of $100,000, and increasing by 3% annually, would expect human capital of about $4.75 million over the next 30 years.

But you may not need this much life and disability insurance. Rather than use a rule of thumb like 10 years of income, what really matters is protecting your lifestyle. If you are frugal and lives on an annual budget of about $50,000 and the other spouse works, this person may need only $500,000 in life and disability insurance. If the two spouses are financially independent, they may not need this insurance at all.

Additionally, the need to insure income typically decreases over time. In most cases, it makes little sense to keep paying disability insurance when clients are in their early 60s if the benefits are going to stop at age 65.

INSURING ASSETS

As you age, you should be shifting human capital to financial capital. You may have a larger home and portfolio that you want to protect against disasters or lawsuits. If your house burns down or if one of you injures a child in an automobile accident, a lifetime of asset accumulation could be wiped out, so having the right insurance can help to protect assets.

Fortunately, the likelihood is low that catastrophic events will occur, so the cost of insuring for them is typically reasonable.

The principle of self-insuring is still important, however. Higher deductibles are a type of partial self-insurance. If, for example, the client can save $400 annually by raising the deductible by $1,000, then the maximum loss the client would incur is $600 — the $1,000 higher deductible less the $400 savings — and by the third year without a claim, the client has already come out ahead.
Similarly, even if clients have a low deductible, it may not pay for them to make a claim when the payout would be small and reporting the loss would increase future premiums.

Protecting assets from lawsuits is also critical, so consider buying a low-cost umbrella policy.

CONTROLLING EXPENSES

Health insurance is a necessity. For one thing, the costs are sky-high: A heart transplant, for instance, could potentially cost over $1 million. And beyond the expected payout, managed care policies such as PPOs and HMOs also offer lower contracted rates with health-care providers. Thus, even a billionaire could benefit by having health insurance since it’s really a combination of insurance and discounted rates.

Perhaps the most difficult decision is long-term-care insurance: Expenses can clearly be high, and the premiums are anything but certain. When this was a relatively new product, insurance companies underpriced policies; as a result, many consumers are now seeing their premiums increase significantly. And some companies are exiting the business entirely.

Keeping some relatively simple principles in mind will help you choose the right amount of insurance at the best price. It’s always a trade-off between the cost of insurance, the impact of a loss, and the probability of such a loss.

If you have any questions regarding your insurance, please call us.