Personal Finance: Another Perspective

Health 2: Life Planning with Life Insurance

Updated 2018/10/11

Objectives

A. Understand the benefits of Life Insurance
B. Understand the five key questions about Life Insurance
C. Understand the different types of term life insurance
D. Understand the different types of permanent life insurance
E. Understand which type of life insurance is best for you and the steps to buying life insurance
F. Understand some life insurance strategies for different stages of your life

A. Benefits of Life Insurance

- What is life insurance?
  - Insurance that provides compensation to your beneficiaries should you die prematurely.
    - This is a low frequency but high severity risk
    - It is essentially contingent financing

Benefits (continued)

- Why have life insurance?
  - It transfers the economic loss of death from an individual to a insurance company by way of a life insurance contract
    - It can help us take care of our own and extended families should we die
    - Death is not an excuse for disobedience (1 Tim. 5:8)

Benefits (continued)

- What are other benefits of Life Insurance
  - 1. *Estate Planning*
    - Pass assets to heirs tax-free
  - 2. *Guaranteed insurability*
    - Gives a sense of control and responsibility to your family and others
  - 3. *Retirement Planning*
    - Some tax advantages for high-income earners as the cash value grows tax-deferred after expenses
  - 4. *Forced Savings*
    - Cash value after expenses can be used for an emergency fund, collateral, and retirement

Benefits (continued)

- Benefit 1: Estate Planning
  - Life insurance products can be helpful in making sure there are sufficient funds for estate tax purposes. This is about 90% of permanent products
- Situation: An widowed owner has a $15.2mn business which she wants to pass to her son when she dies.
  - Application: The owner puts the business in a trust, with the son as trustee, and buys a single-payment $1.6 million life insurance policy, with his trust as beneficiary
    - When she dies, the trust takes the $1.6 million policy tax-free proceeds and pays the estate taxes. The son is the beneficiary of the trust and now owns the business estate-tax free.

Benefits (continued)

- Benefit 2: Guaranteed Insurability
    - Permanent life insurance products cannot be cancelled by the company
  - Situation: Bill has a family history of heart disease but no symptoms and wants to ensure coverage
  - Application: Bill gets a permanent policy when he is young and has no symptoms. Then, regardless of his medical condition later, he cannot be denied insurance, even if he contracts a major disease
    - However, with term policies, once your guarantee/conversion period ends, the policy may or may not be renewed, contingent upon another medical exam

Benefits (continued)

- Benefit 3: Retirement Planning
  - The cash-value portion of permanent life insurance grows tax-free, after mortality costs and fees
- <u>Situation:</u> An investor wants to save for retirement. He has already invested the maximum in his Roth and traditional 401k, Roth IRA, and other vehicles. How can life insurance help?
  - <u>Application:</u> A permanent product provides a death benefit and savings component. The cash value portion, grows tax-deferred after fees and expenses
    - The investor can borrow against the cash value before or during retirement. If the loan is not paid back, the death benefit is reduced by the loan amount

Benefits (continued)

- Benefit 4: Forced Savings
  - For those without the discipline, life insurance can be an expensive type of forced savings (note that there are better and less expensive ways to save)
- Situation: Suzanne is unable to save for retirement, although she is good at paying bills.
  - Application: She purchases a permanent life insurance product with low fees and expenses, and can direct, to a degree, where the assets are invested. This becomes a type of forced savings to aid her in achieving the investor's goals.
    - She can, upon retirement (or even before), then borrow against the cash-value of the account.

B. Five Key Questions about Life Insurance

- There are five key questions that you should ask about life insurance
- 1. Why Life Insurance?
  - Insurance is for emergency planning and control of your life
    - We have been commanded to keep adequate insurance
      - Death is not an excuse for not taking care of our families

Key Questions (continued)

- 2. How does Life Insurance Work?
  - Insurance is an example of risk pooling
    - Individuals transfer or share their risks with others to reduce catastrophic losses from:
      - Health problems
      - Accidents
      - Lawsuits, or
      - Death

Key Questions (continued)

There are two main risks that life insurance can share or transfer: mortality and investment

- *Mortality risk* is the risk that the insured dies outside the contract period and is therefore not covered by insurance

Term ⟷ Permanent

Risky — Mortality Risk — Safe

- *Investment risk* is who takes responsibility for the investment outcome, the insurance company or the insured.

Term — Variable — Whole Life

Risky — Investment Risk — Safe

Key Questions (continued)

- 3. Who needs Life Insurance?
  - Those who need life insurance include:
    - Single or married with dependents or children
    - Married, single income couple where the spouse has insufficient work skills or savings
    - Business owners who wish to transfer their businesses to the next generation
    - Individuals whose estate exceeds the estate tax-free transfer threshold
      - Not everyone needs life insurance.

Key Questions (continued)

4. How much Life Insurance?

- How do you determine your Life Insurance needs?

  From the old LDS Handbook for Families it states:

  - Insure the family's breadwinner first, then others, if desired, as income permits. At a minimum, get enough life insurance to pay for such things as a funeral, taxes, mortgage on the home, car payments, and other debts. The next priority should be to get enough insurance that, supplemented by any government retirement benefits the surviving spouse may be entitled to, there will be sufficient to provide for the family and to make provisions for the children's education and missions. "Handbook for Families: Preparing for Emergencies," *Ensign*, Dec. 1990, 59.

Key Questions (continued)

- There are two different methods of determining how much life insurance.
  - a. The earnings multiple approach
    - The goal is earnings replacement
      - It seeks to replace the annual salary stream of a bread winner for X years, normally 5 – 15 times gross salary is recommended.
        - The lower general interest rates, the higher the multiple needed

Calculating Life Insurance (LT29) may be helpful in determining how much

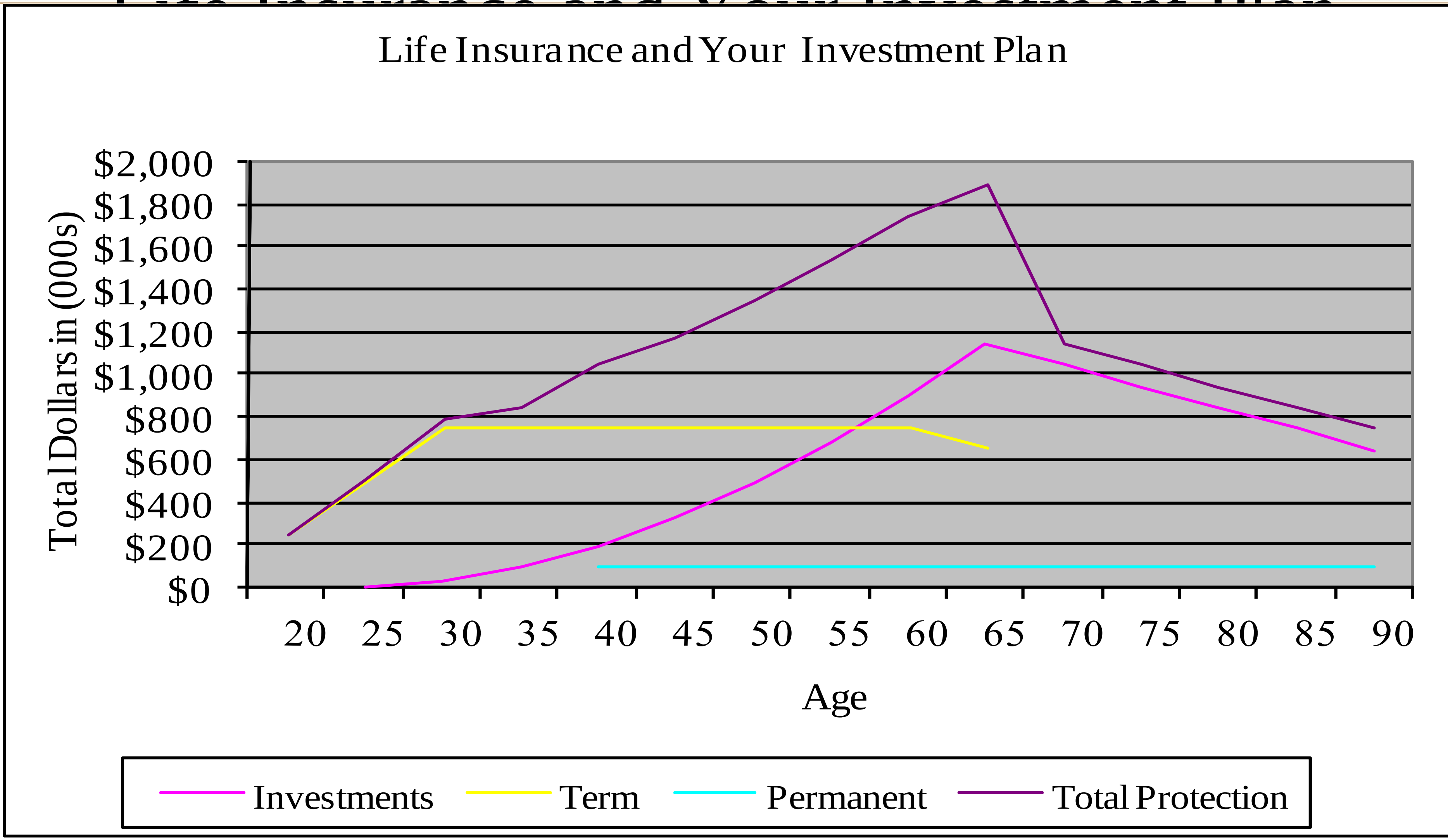
Key Questions (continued)

- How is it calculated?
  1. Adjust salary down to compensate for the reduction in household expenses
  2. Choose the appropriate interest rate to match the assumed after-tax and after-inflation earnings on the policy settlement.
  3. Determine the income stream replacement and annuity
  4. Subtract current insurance coverage

Key Questions (continued)

- b. The Needs Approach
  - How is it calculated?
    1. Adjust the salary downward
    2. Add up all funding needs
       - The total needs of the beneficiaries includes: immediate, debt elimination, transitional, dependency, spousal life income, education, and retirement funds
    3. Subtract current insurance coverage and other available assets
       - This is additional coverage necessary
    4. Determine the income stream replacement and calculate the needed annuity

Life Insurance and Your Investment Plan



Permanent: with guaranteed insurability option paid up till age 65. Term: Five-year guaranteed renewable term in $50,000 and $100,000 increments; can add and drop as necessary. Investment: Includes individual and employer sponsored retirement plans

Key Questions (continued)

- 5. What Kind of Life Insurance?
  - What are the different types of life insurance?
    - Term insurance
    - Permanent (also called endowment or cash value) insurance
  - Your choice of life insurance will generally depend on four factors:
    - 1. Priorities and Preferences
    - 2. Amount of insurance needed
    - 3. Ability and willingness to pay premiums
    - 4. Duration of need

Key Questions (continued)

- 1. Priorities and preferences
  - Priorities
    - What are your goals and objectives?
    - What do you want this insurance product to do?
    - Do you want guarantees or just assumptions?
  - Preferences
    - Understand your personal preferences:
      - Do you prefer to "own" or "lease"?
      - What are your insurance "biases?"
      - Who will take the "mortality" and "investment" risks?
      - As you willing to take "assumptions" risk?

Key Questions (continued)

- 2. Amount of Insurance Needed
  - Buy term insurance when there is no way to satisfy the death need without it, and invest the difference
    - The term protection can be converted to another form of protection at a later date, if appropriate (i.e., convertible term).
  - Buy a combination of term and permanent when you can cover the entire death need
    - You are also able and willing to allocate additional dollars to appropriate permanent coverage

Key Questions (continued)

- 3. Ability and willingness to pay premiums
  - Pay on installment basis (term or low outlay whole life) if your mortality risk is higher than average
  - Prepay coverage if you expect to live longer than average (vanishing premium or limited payment whole life) or if you want payments to stop at a specific age
  - Purchase Yearly Renewable Term if you want minimal payments but can afford payments which increase each year and can take the health risk
  - Consider permanent insurance if cash flows are sufficient to cover the higher premiums and you are committed to paying for it for the rest of your life

Key Questions (continued)

- 4. Duration of need, i.e. holding period considerations
  - Buy term if your need is less than 10-20 years
  - Buy term and consider permanent if the need is for 10 - 30 years
  - Buy permanent if the need will last longer than 15 years, or buy a guaranteed renewable term policy with your required duration, i.e., 20 or 30 year term
  - Buy permanent if the coverage will be continued beyond age 55
  - Buy permanent if the policy will be used for estate taxes and charitable giving purposes

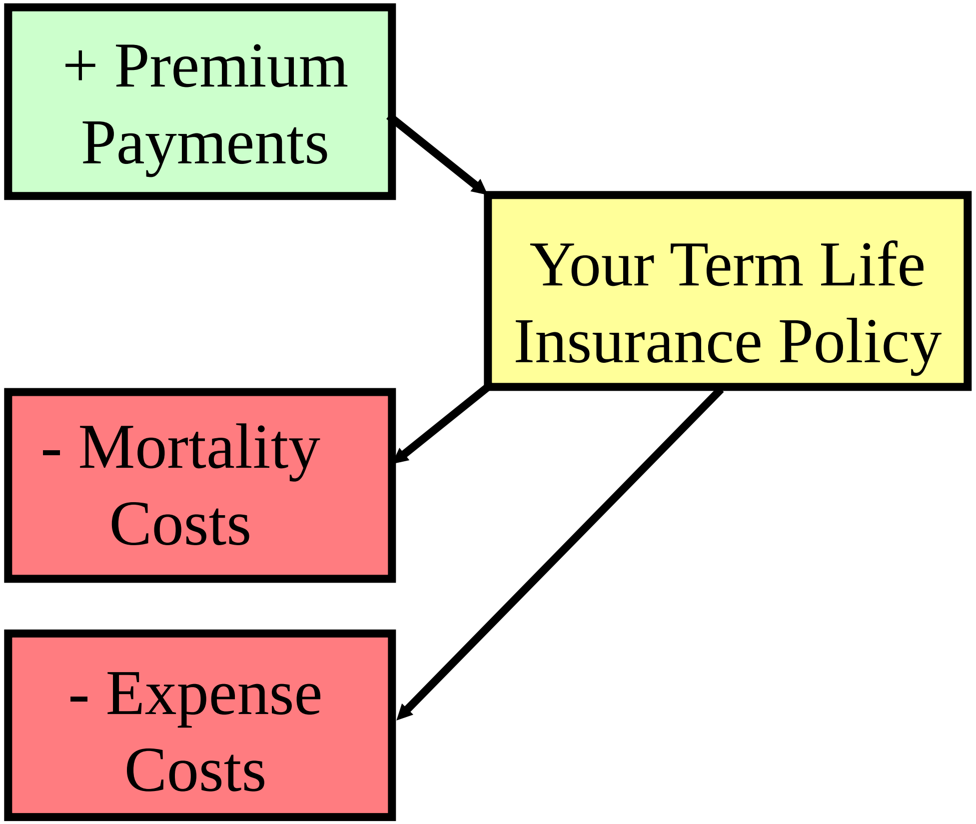
Life Insurance Policy Terms

- Premium
  - The monthly cost of the policy
- Face value
  - The benefit due upon death
- Insured
  - The person whose life is covered by the policy
- Policy owner
  - The individual or business that pays for and owns the policy
- Beneficiary
  - The recipient of the benefit upon the death of the insured

C. Understand the Different Types of Term Life Insurance

- What is Term Insurance?
  - Insurance protection for the insured over a specific term or time period. They may be renewable or non-renewable policies
- What are its advantages?
  - It is the least expensive form of insurance
  - Death benefit coverage is for a specific term
- What are its disadvantages?
  - It is only valid if the insured dies during the term
  - Insurance may not be renewed once your term expires
  - Advancing age increases the cost of insurance

Understanding Term Insurance
The Process



Term Insurance (continued)

- What are the different types of Term Insurance?
  - ✓ Annual term insurance
    - ✓ The face or death benefit amount is constant through the selected term of coverage
    - ✓ Premiums increase each time the contract is renewed, even though the face amount remains the same

Term Insurance (continued)

- Renewable term insurance
  - The policy holder may unconditionally renew the policy for successive terms at higher premiums simply by paying the indicated premiums
    - Premiums increase with each renewal period, and can be renewed for a specific number of years
  - If nonrenewable, the policy holder has no legal right to continue the insurance after the covered period

Term Insurance (continued)

- Convertible term life insurance
  - This is a term policy that can be changed to permanent insurance within a specific number of years without evidence of insurability
  - Typically, it gives a contractual right to convert to some form of permanent insurance, typically whole life, within a certain number of years or before the policy holder reaches a certain age.
  - Conversion allows the policy holder to lock-in the premiums, although at a higher rate, and avoid the ever increasing term premiums

Term Insurance (continued)

- Why are premiums for term much less than permanent insurance?
  - You are only paying for insurance for a specific period, i.e. risk is priced one period at a time
    - 98% of term policies lapse without payment
  - It is generally for a shorter period, i.e. 1-10 years.
    - The longer the period, the more insurance companies must charge higher fees in the early years to offset the more expensive mortality charges and fees in the later years
  - Term is generally easier and cheaper to administer
    - Fees and sales charges are less complex

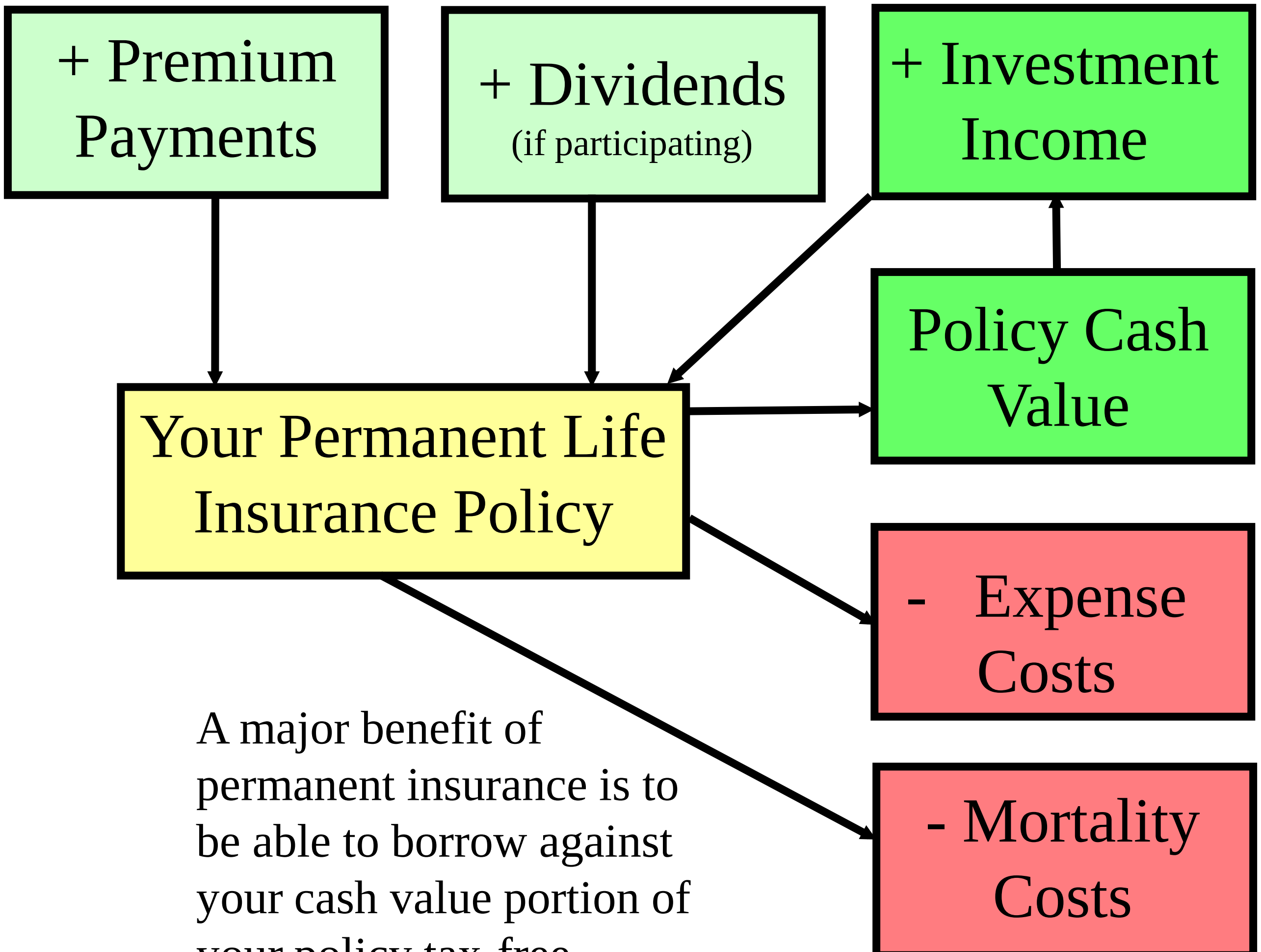
Term Insurance (continued)

- Key questions when purchasing term insurance:
  - How long can I keep this policy?
  - What are the renewal terms of the contract?
  - When will my premiums increase?
  - Can I convert my term policy to a permanent policy? What are the details?
  - How strong is the insurance company financially?

D. Understand the Different Types of Permanent Insurance

- What is permanent insurance?
  - It is an insurance contract that is purchased for your entire life with premiums divided between death protection and savings.
- What are its advantages?
  - Provides insurance that cannot be cancelled
  - May be used for estate retirement, and savings
- What are its disadvantages?
  - It is complex and expensive
  - Unless premiums are paid, it can expire worthless
  - Certain permanent products are not permanent, i.e. they can lose money

Permanent Insurance: the Process



A major benefit of permanent insurance is to be able to borrow against your cash value portion of your policy tax-free

Permanent Insurance (continued)

- Policy Loans (against a policy's cash value)
  - You are taking a loan from the insurance company with the policy's cash value as collateral
  - There is a nominal interest charge, which is paid to the insurance company
  - If you fail to pay back the loan, the face value of your policy is decreased by the value of the loan at payment to your beneficiaries

Permanent Insurance (continued)

- Differences in life insurance products relate to:
  - Mortality Risk: The risk that the insured dies outside the contract period and is not covered by insurance
  - Investment Risk/Control: The risk of who takes control and responsibility for the investment returns (permanent only)
  - Policy Cost: The cost of the policy compared to other policies
  - Investment Choice: The types of investment vehicles the non-mortality portion of the permanent premiums are invested in, i.e., bonds, stock, cash, etc. (permanent only)
  - Policy Flexibility: The ability to change the types of investments, monthly premium amounts, or the face value amount during the life of the contract (permanent only)
  - Payouts Based On: The basis for determining the payouts and costs of the products: guarantees (all term and whole life) or assumptions (all other permanent policies except whole life)

Term Insurance

Term Insurance					
Type of Policy	**Description**	**Mortality Risk**	**Policy Cost**	**Payouts Based on**	**Biggest Risks**
Annual Renewable Term*	Lowest cost term policy with premiums increasing each year; however you must reapply each year to re-qualify.	Must be renewed each year so high	Lowest cost term insurance	Payouts based on guarantees	Insured is unable to qualify for renewal and cannot get new insurance
Level Term Option*	Lower cost term policy with option for a level price each year of the period.	May be renewed for multiple years at the same price so lower risk	Lower cost insurance	Payouts based on guarantees	Insured is unable to qualify for renewal and cannot get new insurance
*** Convertible Rider** (included with both policies above)	Insured can convert to a permanent if within a certain number of years or before a certain age	As term, higher risk; but as permanent, risk is lowest as cannot be declined	Higher cost term insurance to compensate for the ability to convert	Payouts based on guarantees	Insured does not convert within the conversion period and cannot get new insurance
Column Descriptions:	Key points of the policy most relevant to consumers	The risk that the insured dies outside the contract period and is not covered by the policy	The cost of the policy in relation to other life policies, both term and permanent	What the payout amounts are based on. If assumptions, the insured's risk is greater	The insured's key risks of the chosen insurance policy

Permanent Insurance

Permanent Insurance *								
Type of Policy	Description	Mortality Risk	Policy Cost	Payouts Based on	Biggest Risks	Policy Flexibility (for Permanent Insurance Only): Investment	Premium	Face Amount
Whole Life	Lowest cost permanent policy with payouts based on guarantees	Low as the policy will remain in force as long as premiums are paid	Lowest cost permanent, but significantly higher than term	Payouts based on guarantees	Expensive and conservative returns on guaranteed insurance instruments	No ability to change, only in Insurance company bonds	No ability to change premiums	No ability to change contract face value
Universal Life	Lower cost permanent policy with cash value invested in short-term and money market investments	Low as the policy will remain in force as long as premiums are paid	Lower cost permanent, but more expensive than Whole Life	Payouts based on assumptions ONLY	Expensive and risk remains that conservative money market returns may require additional contributions	No ability to change, only in money market investments	Maximum ability to change premiums	Maximum ability to change the contract face value
Variable Universal Life	Higher cost permanent policy with cash value invested in stocks, bonds, money market, etc.	Low as the policy will remain in force as long as premiums are paid	Higher costs as there is more flexibility in investments	Payouts based on assumptions ONLY	Expensive and risk remains that low subaccount returns may require additional contributions	Maximum ability to change, between stocks, bonds, money market etc.	Maximum ability to change premiums	Maximum ability to change the contract face value
Equity Indexed Universal Life	Highest cost permanent policy with cash value appreciation tied to a stock market index with no downside on returns but capped upside	Low as the policy will remain in force as long as premiums are paid	Highest costs and expenses which gives limited upside	Payouts based on assumptions ONLY	Very expensive and low stock market ceilings and high fees offer limited market upside	No ability to change, as only in index options	Maximum ability to change premiums	Maximum ability to change the contract face value
Column Descriptions:	Key points of the policy most relevant to consumers	The risk that the insured dies outside the contract period and is not covered by the policy	The cost of the policy in relation to other life policies, both term and permanent	What the payout amounts are based on. If assumptions, the insured's risk is greater	The insured's key risks of the chosen insurance policy	The insured's ability to change the investments during the life of the contract	The insured's ability to modify the premium payments for certain periods and ranges	The insured's ability to change the face amount of the policy within the contract period
Note: * With all permanent products, a key risk is that if insurance company profits are not sufficient, they can change the contract unilaterally in their favor to increase profits								

Permanent Insurance (continued)

- The key is to understand why you want permanent life insurance
  - Understand your needs
  - Understand the individual polices of competing life insurance companies, i.e., the charges and deductions of the insurance company, and fees and expenses of the mutual funds/assets invested in
  - Select the policy that gives you maximum benefit at the lowest possible cost to you

Permanent Insurance (continued)

- Why are permanent premiums higher than term?
  - It is priced for your entire life
    - Earlier premiums must be priced higher to take into account that mortality costs increase as you age. There is a cost to eliminate mortality risk
  - It includes a savings component
    - These savings must be funded
  - It cannot be terminated by the insurance company
    - 95% of all permanent policies are paid
  - It is more costly to administer and sell
    - There are more and substantially higher up-front, operating, sales and other charges and fees

Permanent Insurance (continued)

- Watch your expenses carefully
  - Expenses on a typical Variable Universal Life policy at the account level include:

	Minimum	Average	Maximum	Compared to a No Load Fund
• Sales Charges *	0.0%	8.0%	10.0%	0%
• State Premium Taxes	0.75%	2.0%	5.0%	0%
• DAC Tax *	0.0%	1.5%	2.0%	0%
• First-year Expense *	$200	$350	$700	0%
• Administration Fees/month *	$4	$6	$15	0%
• Mortality and Expense	0.4%	0.7%	1.3%	

Source: Ben G. Baldwin, "The New Life Insurance Investment Advisor," 2nd ed., McGraw Hill, New York, 2002, p.106.

* These expenses will vary among competing insurance policies from different companies, so compare them carefully

Permanent Insurance (continued)

- Expenses at the sub-account level (i.e. the individual investment level) include:
- Asset Charges

	Minimum	Average	Maximum	Compared to a No-load Fund
• Investment Management *	0.4%	.8%	2.8%	.10-.75%
• 12-b1 Fees *	0.0%	0.0%	0.5%	0%
• Overall Expense Ratio *	1.0%	1.5%	4.4%	.10-.75%
• Policy Loans as % Contract Surrender Value *, Interest spread	75%,4%	90%,2%	100%,0%	
• Surrender Charges *		can be significant		0%

Source: Baldwin, p.106

* These expenses will vary depending on the mutual funds or assets chosen for the sub-accounts. Mutual fund expenses can be reduced through research on comparable funds and comparison shopping.

Permanent Insurance (continued)

- It is not uncommon for the deductions and fees to range between 5% and 15% of every dollar you put into some types of permanent insurance.
  - As such, the cash-value portion of this life insurance grows slower than a term policy with the remainder invested without these fees
- Permanent insurance is not for everyone, but it may be for some
  - Key is to understand your needs and the needs permanent insurance can fill
    - Estate planning, Retirement planning (after all other tax-deferred vehicles have been filled), medical insurability, and Forced savings (but it is not as good as other savings vehicles)

Permanent Insurance

Important questions to ask about permanent insurance:

- Are the premiums within my budget? Are costs reasonable?
- Can I commit to these premiums over the long-term?
- On a variable life policy, what is the assumed interest rate in the illustration?
- Is the classification shown in the illustration appropriate for me (i.e. smoker/non smoker, male/female)
- Which figures are guaranteed and which are not?
- Will I be notified if the non-guaranteed amounts change?
- Is the death benefit guaranteed?
- Will the premiums always be the same, even if interest rates are lower that the illustration?
- Is the illustrated premium sufficient to guarantee protection for my entire life?
- Is the "current rate" illustrated actually the rate paid recently? What was the current rate in each of the last five years?
- What assumptions have been used regarding company expenses, dividends, and policy lapse rates?
- Does all my cash value earn the current rate?
- Is the illustration based on the "cash surrender value" or "cash value?" The cash surrender value is usually lower and reflects what will be paid if the policy is cancelled.

Permanent Insurance for Students

- Key Questions:
  - Can you commit to the premiums over the long-term?
    - How can you when you may not have a job?
  - Do you need the tax benefits now?
    - A Roth 401k or IRA may be better. Fill those first
  - Are the rates of return guaranteed?
    - No. Be careful of people selling these products who do not know what they are selling
  - Do you have a history of medical problems that would preclude your ability to get term insurance?
    - In this case, you "might" look into permanent (or convertible term insurance)

Permanent Insurance Thoughts

- There may be a place for permanent insurance for some individuals. However, think about this:
  - Commissions: If permanent insurance is such a good product, why pay such high commissions for sales? First year commissions to agents can be 50-120% of first year sales.
  - Annual fees/expenses: Why must fees be so high on investment sub-accounts? These are not complex products. Why can't they use low-cost index funds?
  - Assumptions: Why are payments on cash value products (except whole life) are based on assumptions which the company is not liable for? Why not use real values?
  - Transparency: Why is performance data so very difficult to find for these products and why has it been so poor?

Permanent Insurance (continued)

- Expenses: The company generally has two sets of expenses, one with current charges and one with maximum charges. Why can the company change the contract and extract maximum charges even after the contract is sold?
- Medical Exam: If permanent insurance is such a good investment product, why require a medical exam before the contract? If you fail the medical exam, you must pay more for your insurance
- Right to Reject: Why after you have signed up for insurance, is the company is not required to accept you as a client? They can reject you at their discretion
- Returns: Why is anecdotal return evidence so poor, which shows that 20 year returns on permanent products have generally been only slightly above inflation?

Whole Life Insurance

- Whole life insurance gives life-long insurance coverage for a fixed premium
  - Mortality risk and investment risk is eliminated
  - Term protection with a savings element provided by insurance company bonds and mortgages
  - Premiums are based on when you buy the policy. The earlier you purchase the product, the less your costs will be generally
  - It is also called “Straight Life” or “Ordinary Life” insurance

Whole Life Insurance (continued)

- Advantages
  - Permanent protection, with a fixed premium and fixed death benefit and guaranteed minimum return
  - Fixed or stable cash-value that grows tax-deferred and is invested only in insurance company bonds and mortgages
- Disadvantages
  - Yield on cash-value portion may not be competitive with yields on alternative investments
  - May do better to buy term insurance and invest the rest
  - Less death protection than term for the same price

Universal Life Insurance

- Universal life is a type of whole life insurance, but the cash-value earns interest at current money market rates
  - Mortality risk is eliminated
  - Investment risk is low
  - A flexible policy that combines term protection and a tax-deferred savings element invested at current interest rates
  - Earnings will rise and decline with market interest rates
  - Illustrations are based on assumptions only and not guarantees. The company can change the terms after the contract is signed

Universal Life Insurance (continued)

- Advantages
  - Permanent protection with flexible premium and death payments
  - Cash-value grows tax-deferred and is invested in short-term interest-earning investments
- Disadvantages
  - Policies may lapse due to not making payments
  - More expensive than term for the same coverage
  - Savings may not accumulate as expected due to low short-term returns and high expense charges
  - Illustrations are assumptions only, not guarantees. The company can change the terms after the contract is signed

Variable Life Insurance

- Variable life gives life-long insurance coverage with the ability to direct where your cash-value is invested
  - Mortality risk is eliminated
  - Investment risk is substantial. You are responsible for the investment outcome with your chosen investment
  - Term protection and a tax-deferred savings element which can be managed by the account owner (within available options)
  - Illustrations are based on assumptions only and not guarantees. The company can change the terms after the contract is signed

Variable Life Insurance (continued)

- Advantages
  - Permanent protection with returns earned tax-deferred
  - Allows for either a fixed (straight variable) or flexible (variable universal) premium, with fluctuating cash-value, reflecting the investment performance
- Disadvantages
  - High costs to administer, and higher premiums than term for the same coverage
  - More risky as investments can lose money and policies may lapse due to not making payments
  - Illustrations are assumptions only, not guarantees

Variable Universal Life Insurance

- Variable universal life mixes the investment flexibility of variable life with the premium and face amount flexibility of universal life.
  - Mortality risk is eliminated
  - Investment risk is substantial. You are responsible for the investment outcome with the chosen investment
  - Term protection with full policy flexibility and which can be managed by the account owner (within available options)
  - Illustrations are based on assumptions only and not guarantees. The company can change the terms after the contract is signed

Variable Universal Life Insurance (continued)

- Advantages
  - Permanent protection with returns earned on a tax-deferred basis, which allows for either a fixed or flexible premium
  - Flexible death benefit and fluctuating cash-value, reflecting the self-directed investment performance
- Disadvantages
  - High costs to administer and much more expensive than term
  - Much more risky as investments can lose money
  - Policies may lapse due to not making payments
  - Illustrations are assumptions only, not guarantees. The company can change the terms after the contract is signed

Equity Indexed Universal Life Insurance

- Equity indexed offers some of the upside of the equity market returns with the downside of insurance protection should the market returns be negative
  - Allocates assets to a stock market index, generally with options (and has a limited upside)
  - Has a minimum guaranteed rate of return component
  - Gives some (but limited) upside in equity returns
  - Gives downside protection in down equity markets
  - Illustrations are based on assumptions only, and the company can change contract terms even after it is signed

Equity Indexed (continued)

- Advantages
  - Offers exposure to the equity markets
  - Limits downside exposure—the rate of return can't go below zero for the cash value portion
- Disadvantages
  - Huge commissions—very high fee structure, large surrender charges, and not transparent
  - Caps on returns are generally lower that historic market returns, with limited upside 6-12% and spreads of 4-6% resulting in actual upside of 2-6%
  - Unless aggressively funded, the cash value is often insufficient to keep the policy in force later in life
  - Illustrations are assumptions only, not guarantees and the company can change the contract after signed

E. Determine Which Type of Life Insurance Is Best for You

- For most, ***level convertible renewable term*** (convertible to a permanent policy and renewable for up to 30 years) is the cheapest and best alternative (especially for students)
  - Goal: Income Replacement of breadwinner
    - Relatively low cost
    - Affordable coverage when life insurance is needed the most
    - Can afford to carry the coverage needed for the time needed
    - While it becomes very expensive with age, it ***<u>may</u>*** be less necessary as your other assets grow so you may need less insurance in the future

Which Life Insurance Is Best (continued)

- Permanent insurance may be the best choice if you meet ***very specific*** criteria. The goals are:
  - Estate Planning. Your assets are very large (>$22.4mn), and you have estate planning issues (i.e., you need to shield some assets should you die)
  - Medical Insurability. You have a history of medical problems (and if you already have convertible term insurance) you can't be denied life insurance if you convert
  - Retirement Savings. You have already maxed out your tax-deferred accounts (IRAs, 401k, Roths) and want additional tax-deferred savings
  - Forced Savings. You can do better elsewhere!

Which Life Insurance Is Best (continued)

- Still unsure of yourself?
  - Consider a level convertible renewable (5-20 year) term policy
    - It allows the low cost of term insurance, with the ability to convert to a cash policy in the future within a specific number of years
    - It gives you time to re-evaluate your current situation and still retain coverage for you and your family

Which Life Insurance Is Best (continued)

Caution 1:

- Be careful if your only source of life insurance is company life insurance
  - If you get sick and lose your job, your insurance may terminate with your employment
    - It will be difficult to get new life insurance if you are sick
  - It is recommended that you have some additional life insurance from outside your company insurance plan
    - That way you will still be covered even if you lose your job due to sickness

Which Life Insurance Is Best (continued)

- *Caution 2*
  - Because of the complexity and high setup costs for permanent/cash value life insurance, it is very expensive to change. It is of critical importance that you understand why you are buying and what you are buying ***before*** you purchase your policy
    - Consumers lose a significant amount of money each year because they buy policies they don’t understand and then cancel them later
    - Following is a list of different methods of comparing costs of various life insurance policies

Methods of Comparing Life Insurance Policies

SUMMARY OF KEY POINTS OF COMMON POLICY COMPARISON METHODS

	Traditional Net Cost	Interest Adjusted Net Cost	Interest Adjusted Payments Index	Equal Outlay	Cash Accumulation	Linton Yield	Belth Yield	Belth Price	Baldwin Method
Technique	Net premiums less cash value and dividends; ignores interest	Net premiums at interest less dividends at interest and cash value, divided by annuity due factor	Average time value adjusted difference between net premiums at interest and dividends at interest	Accumulate premium differences at interest	Accumulate premium differences at interest while holding death benefits constant	Accumulate premium differences at interest rate that causes equal future values and equal death benefits	Ratio of "benefits" to "investment"	Policy "investment" less "benefits"	Rate of cash and life insurance "benefits" to "investment"
Solves for	"Net cost"	Average net cost	Average net cost	Surrender value and death benefit differences	Surrender value differences	Average rate of return that causes equality	Yearly rate of return	Yearly price of protection	Yearly rate of return
Assumptions needed	Money has no time value	Rate of return	Rate of return	1 Rate of return 2 Equal outlay	1 Rate of return 2 Equal outlay 3 Equal death benefits	1 YRT rates 2 Equal outlay 3 Equal death benefits	YRT rates	Rate of return	YRT rates
Compares similar policies?	No	Yes	Yes	Yes, but results often ambiguous	Yes	Yes, if common YRT rates used	Yes, if common YRT rates used	Yes	Yes, if common YRT rates used
Compares dissimilar policies?	No	No	No	Yes, but results often ambiguous	Yes	Yes	Yes	Yes	Yes
Requires computer?	No	No, but time consuming	No, but time consuming	No, but time consuming	Yes	Yes	No	No	No, but recommended
Good for replacement evaluation?	No	No	No	Yes, with modification	Yes, with modification	Yes, with modification	Yes, but results often ambiguous	Yes, but results often ambiguous	Yes, but results may be ambiguous

Source: Stephan R. Leimberg and Robert J. Doyle, Jr., Tools and Techniques of Life Insurance Planning, 3rd Edition, National Underwriter Company, Cincinnati, Ohio, 2004.

Steps to Buying Life Insurance

1. Understand what you want
    - Know yourself
    - Know your goals
    - Know your budget
    - Know how much insurance you need
    - Know how much money you want to spend

BYU MARRIOTT SCHOOL OF MANAGEMENT

Steps to Buying Life Insurance (continued)

- 2. Compare costs of competing policies
  - Do your homework and shop around, not just on price, but on benefits, coverage, and exclusions. Possible comparisons:
    - Annual Premiums: Participating or non-participating? If participating, the 5 year dividend history? This year?
    - Total premium cost over the next 10 years (excluding dividends)
      - In 10 years, what will be your cash/loan value? Paid-up conversion value? Extended term conversion value?

Steps to Buying Life Insurance (continued)

- Compare costs (continued)
  - Total Premium cost over 20 years?
    - In 20 years, what will be your:
      - Cash/loan value?
      - Paid-up conversion value?
      - Extended term conversion value?
  - At what interest rate can you borrow against the policy?
    - Is the interest rate guaranteed?

Steps to Buying Life Insurance (continued)

- 3. Select only a high-quality insurance company based on company ratings
  - Price is not the only criteria. You also want the company to be around to pay the benefits. Remember, you are looking for a long-term insurance relationship
  - Ratings Companies:
    - A.M. Best http://www.ambest.com/
    - Fitch Ratings 800-893-4824
    - Moody's 212-553-0377
    - Standard & Poor's 212-438-2400
    - Weiss Research 800-289-9222

Steps to Buying Life Insurance (continued)

- 4. Select an insurance agent with whom you feel comfortable and are not pressured
  - Study the agent’s recommendations and ask for a point-by-point explanation if there are items you don’t understand
  - Understand how the agent is getting compensated. Know what the agent’s commission is on each product recommended
  - If they can’t (or won’t) explain all the costs and benefits, go to someone who can
  - Do your homework

Steps to Buying Life Insurance (continued)

- 5. Use wisdom in your decisions
  - Make sure you check out the insurance company and read your policy when you receive it to ensure it is correct. It must all be in writing!
  - Consider alternative approaches: the net or an advisor
  - Make sure you feel good about the decision before you sign anything or send money. Don't rush into a decision.
  - Make your check payable to the insurance company, not the agent, and be sure you are given a receipt for all money's given.

Steps to Buying Life Insurance (continued)

There is a difference between choosing an agent and being chosen by an agent

- The selection decision is up to you—use it wisely
  - Read your policy carefully during your “free-look” period. Review your insurance policy annually after that
  - If you are changing policies, make sure you clearly understand the consequences. Surrendering your policy to buy another could be ***very, very, very (get the hint)*** costly
  - If you have a complaint, contact your agent and the state insurance department

Questions

- Do you have any questions on buying life insurance?

F. Understand Life Insurance Strategies for your different stages in life

- Following are a few ideas of life insurance strategies over different time periods
  - You can choose your Plans and Strategies that are appropriate to you and include those in your Insurance Plan

Life Insurance Strategies (continued)

- Following are a few ideas of life insurance strategies over different time periods
  - Students and young marrieds
    - If married, buy a $250 - $500k 20 year annual renewable term product with the convertibility option. In case of health reversal, you can convert to a (generally) whole life policy without a medical exam in the first 10 years
    - Once children come, ladder on additional renewable convertible term products, extending out the life to the time that children leave home
    - If term insurance rates have decreased, you can purchase a new product ***then*** cancel the old

Life Insurance Strategies (continued)

- Married with families
  - Make sure you have sufficient term policies consistent with LT 29 to protect those you love
  - Continue to ladder in additional policies and keeping their maturities longer consistent with the time children leave home
  - If you have filled your Roth/traditional 401k and Roth/traditional IRA investments and are looking for additional tax-deferred investments, you may want to look into permanent products. Be careful
  - If term insurance rates have decreased, you can purchase a new product then cancel the old

Life Insurance Strategies (continued)

- Empty nesters
  - As your investment assets increase and children leave the home, you can allow some of the policies to terminate without renewing as the need for income replacement is diminished
  - If you would like to leave money to your heirs, think to maximize your contribution to Roth products, as these are wonderful assets to leave to heirs (the taxes have already been paid)
  - If your desire and plans for estate planning materialize, you can utilize permanent insurance for some of those options. Be careful of costs

Review of Objectives

A. Do you understand the benefits of Life Insurance?

B. Do you understand the five key questions about Life Insurance?

C. Do you understand the different types of term life insurance?

D. Do you understand the different types of permanent life insurance?

E. Do you understand which type of insurance is best for you and the steps to buying life insurance?

Case Study #1

Data

- Bill is 45 and is concerned for his family's welfare should he die. He is currently making $80,000 per year, has two children, and his company gives him $50,000 in life insurance coverage as a benefit. If he died, his wife could invest the insurance settlement and make a 5.0% return with 2% inflation each year for 20 years until the kids finish school.
- Calculations
  - What is the process for determining needs? (Assume a 22% drop in living expenses after death)
  - How much insurance should Bill have?

Bill, married, 2 children, makes $80,000 per year. His wife could invest insurance settlement making 3% after taxes and inflation for 20 years. What is the process for determining needs? How much insurance should Bill have?

- a. Adjust salary downward
  - Generally, family living expenses fall by 30% with the loss of an adult. The larger the size of the surviving family, the less living expenses drop. Family size after death and percentage drop: 1 (30% drop), 2 (26%), 3 (22%), and 4 (20%).
  - Since Bill's family would go from 4 to 3, his target replacement is $80,000 * (1-.22) or
  - $62,400
- b. Choose the appropriate interest rate
  - The return after inflation is (1.05/1.02)-1 or 2.94%

Bill, married, 2 children, makes $80,000 per year. His wife could invest insurance settlement making 3% after taxes and inflation for 20 years. What is the process for determining needs? How much insurance should Bill have?

- c. Determine the income stream replacement
  - Number of years to replace income N = 20 years
  - Estimated after tax and inflation rate I = 2.94%
  - Target $80,000 * (1-.22) or PMT = $62,400
  - Solve for the Present Value. Bill wants the payments at the beginning of each year, so use “Begin” mode.
    - Bill needs $960,877
- 4. Subtract out current insurance available of $50,000:
    - $960,877 - 50,000 = $910,877

    The multiple of salary he needs is:
    - $860,877 / 80,000 = 10.76x

Six Methods of Calculating Life Insurance Needs (LT29B)

Current Age	22	Nominal Return on Earnings	5.0%
Current (or needed) Salary	80,000	Marginal Fed & State Tax Rate	0%
Years to Replacement Income	20	Estimated Inflation Rate	2.0%
Current Annuity Interest Rates		Real Return after Taxes & Infl.	2.94%
Payment Period Desired (1 = Beginning)	1	Mortgage remaining	
Spouse and Number of Children	3	Final Expenses (funeral, burial):	
Current Life Insurance	50,000	Debt and other Needs (college)	

6. Earnings Multiple Approach (Detailed)

a. Adjust Salary Downward				
Current Salary		80,000		
Percentage Adjustment to Salary (or needed salary)		22%		
Salary to be Replaced		62,400		
b. Determine the Income Stream Replacement				
Salary to be Replaced		62,400		
Number of Years to Replace Salary		20		
After tax Return	5.00%			
Real Return (after tax and infl.)	2.94%			
Payment Period Desired (1 = Beginnin	1			
Present Value of this Needed Annuity		960,877		
Earnings Multiple of Needed Annuity		12.01	x	
c. Subtract Current Life Insurance and Earning Assets		50,000		
d. Calculate Additional Life Insurance Needs				
Present Value of Needed Annuity		910,877		
less current life insurance		50,000		
Total Additional Life Insurance Needs			860,877	
Earnings Multiple of Needed Annuity after current Life Insurance			10.76	x