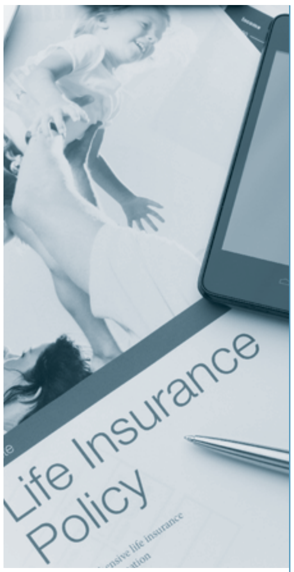
Life Insurance: Why Not Invest the Premiums for a Better Return?



By Mark MATOS, CFP®, CLU®, ChFC®
Senior Financial Advisor

After earning a degree in finance, I had an aversion to life insurance. I believed capital could be put to better uses. Instead of spending money on premiums, why not accumulate investments that are likely to produce a higher return? Why buy something with a negative net present value? After all, even though life insurance has characteristics of an investment, it's an expense.

Only after spending a year studying for the CERTIFIED FINANCIAL PLANNER® certification did I have a change of heart — a total change of heart. I realized I didn't want to just understand insurance; I wanted to become expert in it. It was my motivation to earn the Chartered Life Underwriter® designation. I saw the light. I now understand that education is a critical part of buying life insurance — and underpins why life insurance isn't bought, it's sold.

Life insurance is a necessity, like paying your electric bill or water bill. It should be considered prior to investing, as it guards against the one certainty in life: death.

THERE IS A STRONG MORAL COMPONENT TO BUYING LIFE INSURANCE.

About 10 years ago, a coworker, who was also a life insurance agent, told a group of us during a weekly staff meeting, "The greatest gift you can give a loved one is life insurance." I laughed. We all did. It seemed totally absurd. In hindsight, the statement is wise. When a buyer or insured forms an agreement with a life insurance company to pay a certain sum upon their death in exchange for premium payments, they are providing for their loves ones when they can no longer provide for them. That should give them peace of mind.

Many younger people may have difficulty seeing this far ahead. Insurance didn't quite click for me until I was in my mid-thirties. In hindsight, I wish I had paid insurance premiums since my early 20s.

WHAT'S A LIFE WORTH?

You can't put a value on human life. However, you can apply an assumed economic value on someone's earnings power.

From an economic point of view, children are expenses. They are dependents and have costs including education, food, housing, clothing, schooling, braces. There is a strong insurable interest to cover the cost of a child's life expenses (Figure 1 AEC). Parents should buy life insurance policies on their children.

As the child matures to adulthood, expenses increase but are covered through earnings (Figure 1: CEFD). From retirement through death (Figure 1: DFB), there is typically a deficit. In essence, from an economic perspective, a life is worth EFCD or career employment earnings.

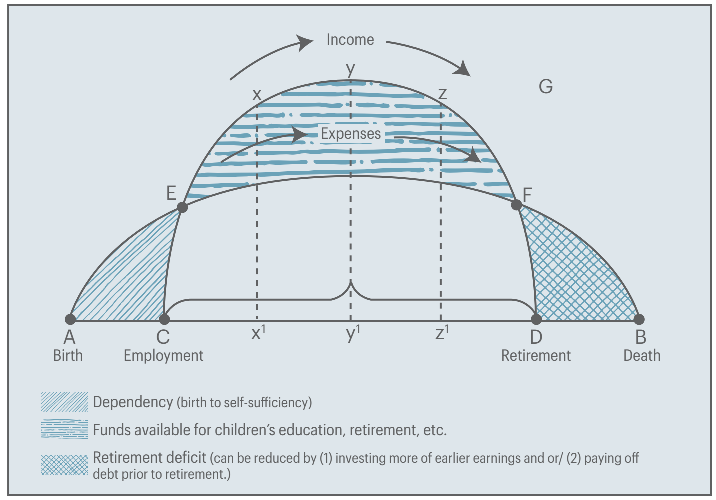


*Figure 1**

Figure 1 is unrealistic but demonstrates a point. Figure 2 is a much more accurate representation of lifetime expenses and earnings. Career earnings typically increase with time and hit a high point prior to retirement.

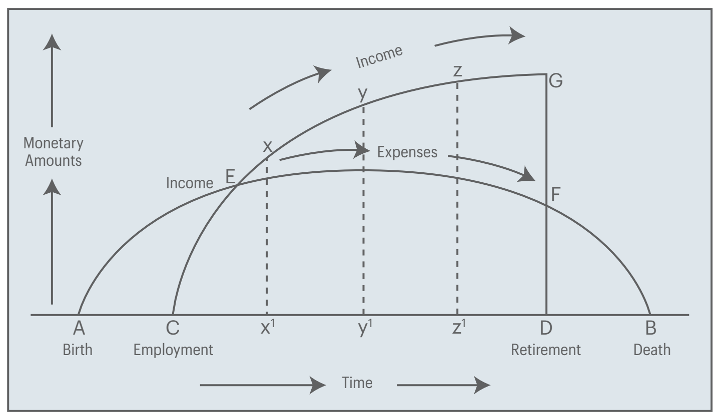


*Figure 2***

HOW MUCH LIFE INSURANCE DO I NEED?

Enough. A proper amount of insurance should include a cleanup fund to pay for credit card bills and funeral related costs, readjustment income for surviving spouses, dependents and family members, income for dependents during their dependency period, life income for your surviving spouse, money for the special needs of your surviving spouse and family, mortgage redemption needs, educational needs.

Everyone should have enough insurance to cover their full economic value. It's important to keep in mind there are some funds available, including Social Security, investments, work benefits and any other existing benefits. The gap between your needs and what's available is the total coverage you need.

PERSONAL LIFE INSURANCE NEEDS

- Cleanup fund
- Readjustment income
- Income during dependency period
- Life income for surviving spouse
- Special needs
- Mortgage
- Redemption needs
- Educational needs
- Emergency needs
- Retirement needs

In addition to personal life insurance, you should also consider your business needs. Business life insurance policies include key-person indemnification insurance, credit enhancement, business continuation insurance and employee benefit plans.

HOW MUCH LIFE INSURANCE CAN YOU AFFORD?

It depends on your financial situation. For many, life insurance is a necessity. Can your family afford for you to not have life insurance? Does your estate tax bill demand life insurance? Should life insurance be a requirement for your business?

A rule of thumb says 10 percent of your income should be used to purchase life insurance.

Although there are laws in place requiring people to carry auto insurance, there are no laws requiring life insurance. Maybe this should be reexamined. There is no guarantee a driver will have an auto accident, but there is a 100 percent chance life will end.

ARE THERE DIFFERENT TYPES OF LIFE INSURANCE?

Life insurance comes in many forms, simple and complicated. It usually falls into two broad categories: temporary or term insurance and permanent life insurance. Permanent life insurance is further broken down into subcategories, including traditional whole life, universal life, variable life and variable universal life. I'll define the differences in a future post.

HOW DO I CALCULATE MY INSURANCE NEEDS?

After a death, financial needs include lump sum needs and ongoing income needs. The lump sum needs include enough money to cover repayment of outstanding debt; estate taxes, if applicable; funeral, burial and cremation costs; costs of probate to validate the will; attorney's fees and operational expenses to cover ongoing costs of the survivor's household. Cash should be provided for mortgage or rent, utility bills, property insurance premiums, property taxes, food, clothing, costs of childcare, child education and an emergency fund. The emergency fund should include a safety net for unexpected expenses, from a car breaking down to appliance replacement, roof replacement and other things that can go wrong. Children's education should also be considered for the lump sum needs.

Ongoing income needs include income for a readjustment period after death; income that changes over time, from the initial transition period until the youngest child becomes self-sufficient (the blackout period); and income for the surviving spouse, before and after eligibility for Social Security and pension benefits.

A rule of thumb is survivors will need 70 percent of pre-death income to carry on after death. Keep in mind life insurance is a tax-free benefit and is paid with pretax dollars.

Another consideration is how the ongoing income needs will be approached. Will the life insurance proceeds be liquidated to fund the needs? Or will the life insurance proceeds produce income so the proceeds are preserved? If the intention is to preserve the life insurance through a non-liquidating or capital-needs approach, a higher face value of insurance should be purchased. The capital needs approach is a more conservative strategy. The insurance proceeds are used to purchase an investments which produces income and capital gains to distribute while preserving or even growing the initial principal balance.

BUSINESS LIFE INSURANCE USES AND NEEDS

- Key person indemnification insurance
- Credit enhancement
- Business continuation insurance
- Employee benefit plans

I KNOW I NEED INSURANCE. WHAT'S MY NEXT STEP?

Life insurance is both simple and complicated. You should meet with a competent financial advisor who understands the nuances of insurance. At a minimum, your advisor should be licensed. A CERTIFIED FINANCIAL PLANNER® (CFP®) or CHARTED FINANCIAL CONSULTANT® (ChFC®) should know the basics. A Chartered Life Underwriter® (CLU®) is an advisor who specialize in life insurance and estate planning. The CLU® is the highest level of education in life insurance.

Once you've identified the advisor you'd like to work with, he or she will help you find your ideal life insurance policy amount by calculating your long-term financial obligations and then subtracting your current assets.

Simply buying 10 times your income doesn't take into account your family's existing savings, unique needs, existing life insurance policies, or your family's unique situation. For example, a stay-at-home parent may not have a salary, but their work certainly has a value and replacement cost that needs to be insured.

Before visiting your planner, add up your total debt, including your mortgage, and if you have children, the cost of their education. Calculate your income. You probably need to buy more coverage than you think. Your income and expenses should increase over time. You should work with your advisor to determine the right mix of coverages for your life insurance portfolio.

In the end, you might have a blend of insurance policies to cover your needs over time. You may decide to use a combination of term and permanent policies or various hybrid policies with other benefits like long-term care or annuitization.

Taking action is an important next step to ensure your family's financial security. We are happy to help.

*Figure 1. Chart of Hypothetical Economic Value of a Human Life. Adapted from "McGill's Life Insurance" by Edward E. Graves, 2013, Strong. Retrieved February 27th, 2019, from iPhone photo of text Copyright 2013 by The American College.

**Figure 2. Figure 1. Chart of Typical Path of Earnings. Adapted from "McGill's Life Insurance" by Edward E. Graves, 2013, Strong. Retrieved February 27th, 2019, from iPhone photo of text Copyright 2013 by The American College.

The information included in this document is for general, informational purposes only. It does not contain any investment advice and does not address any individual facts and circumstances. As such, it cannot be relied on as providing any investment advice. If you would like investment advice regarding your specific facts and circumstances, please contact a qualified financial advisor. This document does not contain any accounting or legal advice. If you would like accounting, tax or legal advice, please contact a qualified accountant or attorney.

Mark Matos, CFP®, CLU®, ChFC®

Senior Financial Advisor, HBKS® Wealth Advisors

Mark Matos serves as a senior financial advisor in the Naples, Florida, office of HBKS® Wealth Advisors. He provides comprehensive financial planning services and investment management strategies to affluent individuals and families. Along with having his own financial advisory clients, Mark works with Christopher Sorce in the Naples office.

Mark began his financial services career in 2006 as a portfolio manager with a large regional bank. In 2009, he began working at Global Wealth Consultants as managing director and chief investment officer. He joined HBKS® in 2016 after Global Wealth Consultants merged with the firm.

Mark earned his Bachelor of Arts degree in finance and computer information systems from the Florida Gulf Coast University. He is a CERTIFIED FINANCIAL PLANNER™, a Chartered Life Underwriter® and a Chartered Financial Consultant®.