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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

Emerging market companies have raised $53.7 billion year to date in initial public offerings. That pace is far ahead of any previous year, according to Dealogic.

In 2006, over $432 billion was spent by S&P 500 firms to buy back their own stock. That's 3.4% of the stock outstanding. 2007 is shaping up the same way.

Life Insurance Needs and Pricing

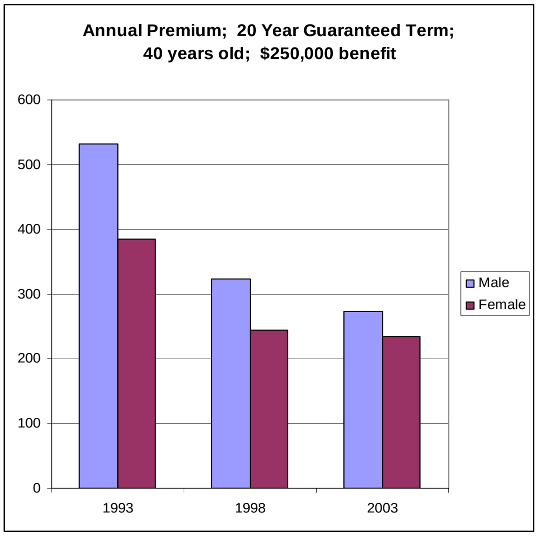
Term life insurance has become commoditized. Just type the term "life insurance" into Google and you'll be bombarded with websites offering instant quotes from a wide array of providers. The internet has greatly facilitated comparison shopping and information flow. Individuals are also living longer thereby driving down the overall cost of life insurance. It's a buyer's market but a market that is still fraught with pitfalls. This article will examine some key issues associated with term life insurance.

One measure of progress in longevity is the steady increase in life expectancies described in the Commissioners Standard Ordinary (CSO) life expectancy table. It is an insurance industry standard. Since 1941, the table has been updated about every 20 years. The latest edition from 2001 reveals that men and women are expected to enjoy retirement 3 to 4 years longer than they could in 1980.

Current Age	Male Predictions 2001/1980	Female Predictions 2001/1980
0	76/70	80/75
30	77/72	81/77
50	78/74	82/79
60	80/77	83/80
65	81/78	85/81

The relevance of the CSO table has become progressively more restricted to the regulatory arena. Insurance companies rely more keenly on their own customer mortality experiences to set rates. And these rates have been falling swiftly – up to 50% in the last 10 years.. The illustration in the next column, compiled by Compulife software, indicates that it may be worthwhile for individuals to shop their policy premiums over time.

The Wall Street Journal recently reported numerous anecdotes of individuals who revisited the term life market and obtained lower rates – despite the fact that they were 3 to 5 years older than at the time of the original quote! Anyone considering a policy switch should take care avoid lapses in coverage. Insurers have different underwriting standards and a quote from the internet is not binding.



Often, one's employer offers group life insurance at attractive rates. In fact, some baseline benefit may be provided free of charge. It's a good starting place to build life insurance protection. For example, University of Texas employees receive $10,000 in term life coverage free of charge. Its elective group coverage is competitive with individual providers and employees may buy up to $1,500,000 in benefit. The insured should verify that he or she can convert existing group life coverage to a comparable individual policy upon separation from service. Continued insurability is a key concern in the event that one changes jobs where group life insurance is involved.

While many trends in life insurance are pro-consumer, there are numerous special purpose policies in the market place that fulfill no real customer need. They are expensive and are usually worth avoiding.

Burial insurance: Often advertised on TV, such policies do not address an insurable risk. Final expenses are small relative to most overall family insurance needs. It is more price efficient to add a bit to the insured's basic term life policy to account for burial expenses.

Accidental Death Insurance: Usually offered as a rider to an individual or group life policy. Pricing is not good. From a financial standpoint, an

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accident death imposes no special burden. According to the Society of Actuaries, only 1 in 22 American deaths are accidental. Keep that in mind when pricing a policy.

Credit and Mortgage Life Insurance: You probably get these offers in the mail, especially if you are a homeowner. While it is generally a good idea for life insurance to discharge the insured's major debts, it is more efficient to compute family debt and add that to the term life death benefit. In Texas, a lender may never require credit life or credit accident and health coverage as a condition of a home loan.

Life insurance on Children: Children may be dear but they are almost never an insurable risk. From a financial standpoint, they represent a liability rather than an asset. Cash value life insurance products are often sold on children. There is almost never a need for this product.

Some Guidelines on Life Insurance Needs

Proper life insurance coverage requires a thorough review of the value of the insured's life to the family unit. The loss of either spouse has differing financial impacts on the remaining family members. Commonly, one provides primary income while the other provides primary child care.

There are two basic approaches to the calculation of an appropriate death benefit. The *replacement income approach* and the *needs approach*. The former method converts the future earnings of the spouse to single sum that will generate an income stream equivalent to the lost wages of the departed spouse. It's a top-down approach.

Let's illustrate the needs approach, which is bottoms-up, with an example. John Doe earns $100,000 annually and is 40 years old. His wife Jane is 39 and a homemaker. Their children are 10 and 7 years old. The family will have a number of distinct needs in the event of John's premature demise. The insured may want to provide for some or all of these needs.

If Jane goes back to work, she may need retraining and her children will need to be looked after by a third party. We estimate those monthly expenses at $250/month for after school supervision until age 13 and $400/month for full day care. We also estimate the retraining cost for Jane at $30,000 for as long as her children are aged 13 or less. Of course, "retraining" may include a bereavement period when the mother spends more time with children.

The family has a mortgage of $172,000. John wants to pay this off in the event of his death. He also wants to fund his children's college educations so we estimate their costs with assistance from data provided by the College Board. The household will also run at an operating deficit without John's income. While Jane and the children will receive Social Security survivors insurance benefits, these benefits will still be limited as John has not had sufficient time to accrue a large primary insurance amount. We estimate the household operating deficit at $24,000 each year.

Some insureds may want to consider setting aside additional funds to account for retirement contributions that will not be made. We do not model these here but it may be reasonable to consider that John and his employer set aside $15,000 to $20,000 annually for retirement.

The key attribute of each of these insurance needs is that they dissipate through time. The need for child care diminishes as the children mature. While the present value of the college education increases as college approaches, it falls off fast once the children enroll. The mortgage naturally amortizes with each succeeding payment. Even the present value of the household deficit decreases as fewer years stand between Jane and retirement. Consequently, the family's insurance needs tends to diminish once the last child is born.

The graph below recalculates the present values of these distinct liabilities using a 5% discount rate for each of the next 25 years. The precision of the mathematical calculations is less important than the thoroughness of the upfront assessment of family needs. Using the case above as a template, we project the life insurance needs of the Doe family through retirement.