

**Silicon Valley Chapter  
American Association of Individual Investors**

***Financial Planning Workshops***

**Risk Management / Insurance**

**Slides: [www.siliconvalleyaaii.org/financialplanning](http://www.siliconvalleyaaii.org/financialplanning)**

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# Silicon Valley Chapter American Association of Individual Investors

Please check us out!

- Chapter website: [www.siliconvalleyaaii.org](http://www.siliconvalleyaaii.org)
- Meetups: [www.meetup.com/AAll-Silicon-Valley-Meetup](http://www.meetup.com/AAll-Silicon-Valley-Meetup)
- Facebook: [www.facebook.com/sv.aa](http://www.facebook.com/sv.aa)
- Slides and Recordings  
[www.siliconvalleyaaii.org/financialplanning/](http://www.siliconvalleyaaii.org/financialplanning/)
- AAI National website: [www.aaii.com](http://www.aaii.com)
- My email address: [dstikes.svaaii@gmail.com](mailto:dstikes.svaaii@gmail.com)

# **Our Next Event and Special Interest Group Webcasts**

- **Monthly Event:** Saturday March 9<sup>th</sup> at 9:00am; webcast only
  - Janet Brown CEO Fundx Investment Group
    - Investing In Uncertain Times
    - Sustainable Investing
- **Financial Planning Discussion Group**
  - Debra Stikes: Second Wednesday of each month at 6:30pm
- **Investing Discussion Group**
  - Lynn Gillette: Fourth Monday of each month at 6:30pm
- **Computerized Investing Group**
  - Don Mauer: First Thursday of each month at 6:30pm

# Financial Planning Workshops

- Financial Planning ... The Big Picture
- Investing 1: Modern Portfolio Theory, Building a diversified portfolio
- Investing 2: Efficient Market Hypothesis; Can you beat the market?
- Taxes: TCJA, SECURE Act, Tax diversification, Asset location, QCDs
- Retirement Planning 1: Tax-advantaged plans, RMDs
- Retirement Planning 2: Safe withdrawal rates, Bengen's 4% rule
- Risk Management/Insurance: Annuities, Long-term care, Litigation
- Social Security and Medicare: Claiming strategies, Medicare traps
- Estate Planning: Probate, Executor/trustee duties, Philanthropy
- Wrap-up: Case study reviewing previous material

## Today We Will Cover ...

- Insurance model
- Common insurance policies
  - Auto and Homeowners' insurance
  - Flood and Earthquake insurance
  - Health insurance, Medicare and Social Security
- Other potential train wrecks
  - Life insurance
  - Disability insurance
  - Long-term care insurance
  - Longevity insurance, annuities
  - Liability insurance, umbrella policies

## The Insurance Model

- Insurance contract transfers a risk ...
  - ... you are unwilling/unable to bear yourself
  - ... to a third party
  - ... for a fee
- Think of it as buying a service from an insurance company

## An Example

- Suppose your home is worth \$1M (excluding land) and there is a 1 in 2000 chance it could burn to the ground in any given year
- Three components to the premium cost
  - Actuarial cost of risk =  $\$1\text{M}/2000 = \$700$  pa
  - Overhead cost, say \$210 (30%)
  - Profit, say \$70 (10%)

Total premium = \$980 pa, i.e. 40% markup above cost

## Insurance is Inherently Expensive

- Only buy insurance when you really need it
  - Risks that could be life-changing
- Self insure for small items you can handle
- Best suited for low probability risks with a high financial cost, e.g. homeowners' insurance
- Least suitable for low cost events with a high probability of occurrence, e.g. vision care
- Insure against worst case outcomes
  - Don't bother calculating the return on your "investment" under average conditions

# Theory of Large Numbers

- Insurance companies have a big advantage over self-insuring
- For example, you cannot predict how long you may live
  - Your retirement portfolio may have to last another 10 years? 20 years? 30 years? More?
  - Must plan for “worst case”, maybe live to age 100
- Insurance actuaries know the lifespan of the average person
  - Can price their products on average parameters rather than worst case assumptions

# Auto Insurance

- Liability
  - Bodily injury: Typical limit \$250K/person, \$500K/accident
  - Property damage: Typical limit \$100K/accident
- Medical Payments
  - Limit of Liability: Typically \$5000 per person
- Comprehensive: Typical \$1000 deductible
- Collision: Typical \$1000 deductible
- Uninsured motorist coverage
  - Bodily injury: Typical limit \$250K/person, \$500K/accident
  - Property damage: Typical limit \$100K/accident

# Homeowner's Insurance

- Dwelling
  - Dwelling extension
  - Personal property
  - Loss of use
    - “Cash value” policy reimburses depreciated values
    - “Replacement cost” policy covers what it takes to buy a new item today
- Personal liability
  - Damage to property of others
  - Medical payment to others
- Does not cover damage from a flood or earthquake

# Flood and Earthquake Insurance

- Flood insurance
  - Mandatory if you live in a flood plain
- Earthquake insurance
  - Dwelling: 5% to 25% deductible
  - Contents
  - Living expenses
  - Cost: ranges from 0.01% to 1.5% pa in California

# Health Insurance

- Very expensive in U.S.
  - Approximately twice the cost of other developed countries
- Medicare
  - Health care for those over age 65
  - Major gaps require independent supplemental coverage
    - e.g. foreign travel, long-term care, etc.
  - Covered in more detail at the next workshop

# Social Security

- Primary insurance amount, PIA
  - Early retirement
    - Age 62, reduces PIA by 25%
  - Full retirement age
    - Depends on birth year; age 65 - 67 for most people
    - Benefit is the full PIA
  - Late retirement
    - Earn additional 8% for each year benefits are delayed up to age 70
- Covered in detail at next workshop

# Life Insurance

- Term insurance
  - Suitable for younger people to protect family
    - e.g. wage-earner with two young kids to put thru college
  - Replaces future earnings if wage-earner dies prematurely
  - Less necessary as wage-earners build an investment portfolio to cover the family costs directly
- Typical cost for \$1million 20 year term insurance
  - Depends on age, health, smoking habits, etc.
  - About \$3,500 pa for 55 year old non-smoker
  - Over \$11,000 pa for for 65 year old non-smoker
  - Smokers can expect significantly higher premiums

## Variations of Life Insurance

- Whole life policy
  - Includes a “permanent” investment account
  - Sales commission can be high, often over 50% of first year’s premium
  - Typically has a negative return for first 5 – 15 years
  - Long-term return can be as low as 2% to 4% pa
  - Consider buying term instead, invest difference
- Hybrid (combo) life insurance policy
  - Whole life insurance with a long-term care rider
  - Lump sum premium or payments over 5 – 20 years
  - \$ not spent on long-term care go to death benefit
  - Removes uncertainty over rising premiums

## Disability Insurance

- Premature death of the wage-earner is not the worst calamity for a young family
  - The family could be in much worse financial condition if a freeway accident disables him/her for life
    - Lose the wage-earner's future income stream
    - Burdened with expensive long-term care for decades
- Often provided free by employer
  - Otherwise typically costs 1% to 3% of earnings
- Usually pays ~65% of earnings to age 65
  - Note “own occupation” or “any work” clause
- Not covered by Medicare except for limited days in a skilled nursing facility after hospitalization

## Long-Term Care, LTC

- ~70% of people over age 65 will need assistance with the activities of daily living (ADLs)
  - Bathing
  - Dressing
  - Eating
  - Transferring
  - Continence
  - Toileting
  - Cognitive impairment, dementia?
- Average duration of LTC needs is about 3 years
- 14% to 20% of people will need over 5 years of LTC
- Women live longer, have a greater need of LTC

# Long-Term Care Insurance

- Long-term care is expensive
  - Typically over \$100K pa for assisted living facility
  - Not covered by health care policy
  - Minimal Medicare coverage for rehab after hospitalization
- Consider purchasing a LTC insurance policy
  - Most suitable for middle income people
    - Financially challenged can't afford it
    - Rich can self-insure
- Or consider a hybrid Life/LTC policy or a hybrid annuity/LTC policy
  - 1035 exchange an old life insurance policy for a hybrid

## LTC Insurance is Expensive

- Number of insurers has dropped drastically
  - Premiums have spiked recently
    - For a \$3,000 a month benefit, typically \$1,800 to \$3,000 pa for a 55 year old
    - Premiums are frequently higher for women
    - Beware; Premiums can increase for a given class
- Purchase LTC insurance early
  - Age 40 to 50 instead of typical age 60 to 70
  - Captures lower premium
  - Protects against becoming uninsurable
  - Think of it as your retirement portfolio insurance
- Consider using independent agent representing multiple carriers

## LTC Policy Parameters

- Important policy parameters
  - Rating of Insurance company
  - Coverage: Qualified facility, In-home care
  - Term of policy: 3 to 6 years, longer if possible
  - Inflation rider
  - \$ amount of monthly benefit
  - Elimination period: Typically 3 to 12 months
  - Waiver of premium once care starts
  - Spousal discount for couples
- Consider a hybrid life insurance policy or an annuity to get longer term coverage

## Progression of LTC Needs

- Assistance provided by family and friends
- Home visits from health care aides
- Adult day care centers
- Continuing Care Retirement Communities, CCRCs
  - Independent living
  - Assisted living
  - Skilled nursing
  - Memory unit
- Hospice care
  - Facility expenses are not covered by Medicare

# Continuing Care Retirement Communities

- CCRCs usually provide meals, housekeeping, transportation, assistance with ADLs, recreation and social activities
- Sample CCRCs in the Bay Area offering progression of care levels from independent living thru memory units
  - Acacia Creek, Union City
  - Lincoln Glen, San Jose
  - Sunny View, Cupertino
  - The Forum, Cupertino
  - The Sequoias, Portola Valley
  - The Terraces, Los Altos and Los Gatos

## Longevity Risk

- Difficult to generate a viable retirement plan to cover expenses above Social Security benefits
  - Duration of retirement
  - Unknown expenses for health care, etc.
  - Return on retirement portfolio
  - Rate of inflation
  - Plus unknown unknowns
- Consider buying an annuity to transfer some of the risk to an insurance company but ...
  - ... first delay taking Social Security benefits to age 70
  - Best inflation adjusted annuity available!

## How Does an Annuity Work?

- Basic annuity model
  - You pay a premium to an insurance company now
  - The insurance pays you a monthly “pension” for life
- The monthly payout includes yield plus a partial return of principal
- Payout on basic annuity usually higher than an equivalent pure investment
  - Short-lived people subsidize the payouts for those who live longer
- Impossible for you to calculate your rate of return

## Variations on the Annuity Theme

- Immediate or deferred
  - Deferred to age 75?, age 80?, age 85?
- Fixed payment or equity indexed
  - What index?, Guaranteed floor? Cap?
- Single life or joint
  - If joint, what percentage does the second-to-die receive? 100%, 50%, Other
- For life or period certain
  - What period? 5 years?, 10 years, Other?
- Countless complex variations

# Single Premium Immediate Annuity, SPIA

- Pay premium now to buy a monthly cash flow for the rest of your life, starting immediately

Typical monthly payout for \$100,000 premium now, and percentage cash flow per annum ...

(estimate using Schwab annuity calculator)

	<u>Male</u>	<u>Female</u>	<u>Joint</u>
...age 60	\$561 6.73%	\$544 6.53%	\$495 5.94%
... age 70	\$687 8.24%	\$650 7.8%	\$576 6.91%
... age 80	\$997 11.96%	\$915 10.98%	\$756 9.07%

## Deferred Income Annuity, DIA

- Pay premium now to buy a monthly cash flow for the rest of your life, starting at say age 85

Typical monthly payout, starting at age 85, for \$100,000 premium now, and percentage cash flow per annum ...  
(estimate using Schwab annuity calculator)

	<u>Male</u>	<u>Female</u>	<u>Joint</u>
...age 60	\$6,383 77%	\$4,992 60%	\$3,717 45%
... age 70	\$3,712 28%	\$3,167 23%	\$2,143 26%
... age 80	\$2,029 24%	\$1,756 21%	\$1,310 16%

# Hypothetical Internal Rate of Return for SPIAs, and DIAs (age 85)

EOL	SPIA	SPIA	SPIA	DIA	DIA	DIA
Age	60	70	80	60	70	80
60	Buy	-	-	Buy	-	-
70	-5.5%	Buy	-	-29.3%	Buy	-
80	0.1%	-3.5%	Buy	-13.8%	-28.7%	Buy
90	1.5%	1.4%	0.2%	1.6%	1.5%	0.6%
100	2.0%	2.6%	3.9%	2.9%	3.5%	4.7%
110	2.3%	3.0%	4.6%	3.3%	4.0%	5.4%

## Annuity Takeaway

- Consider buying an annuity to cover the shortfall between your Social Security benefits and your basic living expenses
- Invest the rest of your retirement portfolio to cover discretionary expenses such as hobbies, travel, etc.
- With an annuity you are buying countless nights of good sleep without worrying how to put a roof over your head and food on the table for your 110<sup>th</sup> birthday party !!!

# Liability Litigation

- Consider an umbrella policy to protect your net worth from a tragic mistake
- Augments liability coverage on auto and HO policies
  - Bodily injury to others
    - Your teenage driver hits a carful of attorneys out for lunch
    - A guest leaving your house causes a drunk driving accident
  - Property damage
    - Your prized oak tree crashes thru your neighbor's living room
  - Lawsuits for slander, libel, mental anguish, etc

# Who Needs an Umbrella Policy?

- Probably anyone with assets greater than the liability coverage of their auto and homeowners policies
- Classic scenario for insurance model
  - Low probability of a high risk event
- Some assets may be protected already
  - Assets held in employer-sponsored retirement accounts are generally protected from civil liability by ERISA
  - IRA protection varies by state
  - The equity in your home may be protected by state law
  - Social Security benefits may be protected from private debt
  - I am not an attorney; Check with your own lawyer!

## How Much Coverage?

- How do you determine the coverage?
  - \$1M to \$2M minimum
    - Incentivizes the insurance company to provide good legal council rather than just settle
  - \$2M to \$5M typical
    - Net worth is a common but mistaken belief
    - Suppose you have \$2M net worth and a \$2M policy
      - You can still be wiped out by a \$5M suit
      - Need to protect net worth + future earnings potential
  - \$5M to \$10M maximum except for high net worth people
- Average cost is around \$380 pa for first \$1M
  - Less for each additional \$M

## Further Reading

- *5 Types of Insurance You Must Know About*, Karen Cheney, AARP Bulletin, July/August 2020
- *Assessing Your Life Insurer's Financial Performance*, Brian Fechtel, AAll Journal, April 2016
- *The Importance of Planning for Long-Term Care*, Wade Pfau, Retirement Researcher, November 22, 2019
- *What You Need To Know About Long-Term Care Insurance*, Paula Hogan, AAll Journal, May 2005
- *The Benefits and Costs of Long-term Care Insurance*, Terry Savage, AAll Journal June 2020
- *Long-term Care ... What you see isn't all there is*, Jean Young, Vanguard Center for Investor Research, November 7, 2018

## Further Reading continued

- *5 Long-Term Care Stats That Will Blow You Away*, Selena Maranjian, The Motley Fool, September 2, 2018
- *The True Cost of Long-Term Care Insurance*, James Blasé, Wealth Management.com, June 25, 2018
- *An Action Plan for Long-Term Care*, Christine Benz, Morningstar, October 31, 2019
- *4 Ways the Pandemic Is Affecting Long-Term Care*, Christine Benz, Morningstar, August 7, 2020
- *Understanding the 4 Key Annuities Types*, Christine Benz, Morningstar, July 20, 2020
- *Is an Annuity Right for You?*, Christine Benz, Morningstar, June 25, 2020
- *Using Annuities for Long-Term Health Care*, Stan Haithcock, AAll Journal, July 2015

## Further Reading continued

- *Immediate or Income Annuities*, AAll Staff, AAll Journal, May 2008
- *Activating an Annuity's Income*, Ben Mattlin, Financial Advisor Magazine, September 2019
- *You Are The Biggest Threat to Your Retirement Plan*, Jerry Golden, Go2income.com, August 14, 2018
- *5 Things to Know About Annuities*, Ellen Stark, AARP Bulletin, February 2019
- *Is Buying An Annuity In A Bear Market A Good Idea?*, Wade Pfau, Retirement Researcher, April 8, 2020
- *Analyzing a Variable Annuity*, Darrow Kirkpatrick, CanIRetireYet.com
- *How Much Umbrella Insurance Do You Need?*, Darrow Kirkpatrick, CanIRetireYet.com,

# Useful Websites

- <http://aaii.com> Broad selection of investing material
- <http://siliconvalleyaaii.org> Previous presentations on various topics
- <https://scclld.org/resources/business/> Business & Money  
Morningstar Research Center, S&P's NetAdvantage, Value Line
- [NetQuote.com ValuePenguin.com SelectQuote.com Term4sale.com](#)  
General insurance information and quotes for various policies
- <https://www.genworth.com/> Long-term care quotes
- [immediateannuities.com](http://immediateannuities.com) Annuity quotes
- <https://Livingto100.com> Calculates your life expectancy

