

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

Financial Planning Workshops

Risk Management / Insurance

Slides: www.siliconvalleyaaii.org/financialplanning

Email: dstikes.svaaii@gmail.com

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Silicon Valley Chapter

American Association of Individual Investors

Please check us out!

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

Our Next Event and Special Interest Group Webcasts

- **Main Event:** Saturday May 9 at 9:00am; webcast only
- **Financial Planning Discussion Group**
 - Debra Stikes: Second Wednesday at 6:30 pm PT September to June
- **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
- Social Security and Medicare: Claiming strategies, Medicare traps
- Taxes: TRJA, SECURE Act, Tax diversification, Asset location, QCDs
- Investing I: Modern Portfolio Theory, Building a diversified portfolio
- Investing II: Efficient Market Hypothesis; Can you beat the market?
- Retirement Planning I: Tax-advantaged plans, RMDs
- Retirement Planning II: Safe withdrawal rates, Bengen's 4% rule
- Risk Management/Insurance: Annuities, Long-term care, Litigation
- Estate Planning: Probate, Executor/trustee duties, Philanthropy

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 = $\$1\text{M}/2000 = \$1,000$ pa
 - Overhead cost, say \$300 (30%)
 - Profit, say \$100 (10%)

Total premium = \$1,400 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: Typical \$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
 - Maybe mandatory if you live in a flood plain
- Earthquake insurance
 - Dwelling: 5% to 25% deductible
 - Contents
 - Living expenses
 - Cost: varies by location, age of structures, and type of structure (single or multistory, soft first story, etc...)
 - Homeowners doesn't cover fire resulting from earthquake

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, vision, dental
 - Covered in more detail in the Medicare workshop

Social Security

- Primary insurance amount, PIA
 - Early retirement
 - Age 62, reduces PIA by 30% (varies with FRA)
 - Full retirement age
 - Depends on birth year; age 65 – 67
 - 67, for those born in 1960 or later
 - Benefit is the full PIA (Primary Insurance Amount)
 - Late retirement
 - Earn additional 8% for each year benefits are delayed up to age 70
- Covered in detail during the Social Security workshop

Life Insurance

- Term insurance
 - Suitable for younger people to protect family
 - e.g. family with two young kids to put thru college
 - protect the wage-earnings income
 - also, child care costs for a stay-at-home parent
 - Replaces future earnings if wage-earner or stay-at-home parent dies prematurely
 - Less necessary as family build an investment portfolio to cover the family costs directly

Life Insurance

- Typical cost for \$1million 20-year term insurance
 - Depends on age, health, smoking habits, etc.
 - About \$600 pa for a 25-year-old non-smoker
 - 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

Whole 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
 - Young families often can’t afford sufficient Whole Life coverage

Variations of Life Insurance

- Hybrid (combo) life insurance policy
 - Also, called Combination or Asset-based LTC 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

- Usually pays ~65% of earnings to age 65
 - Note “own occupation” or “any work” clause
- Disability is Not covered by Medicare except for limited days in a skilled nursing facility after hospitalization
- Social Security Disability Insurance (SSDI)
 - Convert to Social Security at FRA
 - No coverage for partial or short-term disability
 - Disability must be expected to last for more than 12 months or result in death (if less than 12 months)

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
- Long and short-term disability
 - SDI in California provides 6 months of coverage
 - Long term disability starts after 6 months
 - Typically costs 1% to 3% of annual earnings or 2% to 6% of monthly benefit
 - Premium pre or post tax determines if the benefit is taxable or tax free

Long-Term Care Insurance (LTC)

- ~56% 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 approx 3 years
- 30% 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
 - Financially "secure" 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 \$3,300 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

LTC Policy Parameters

- Careful about requirements for the facility. If the requirements are not met, the LTC policy is useless.
 - Some but not most policies require facility to have 24 medical staff with a minimum time per patient
 - To decrease costs, facilities have been cutting back on medical staff
- Sufficient coverage
 - Estimating is difficult
 - Too little monthly coverage means paying for a policy that will not be of value unless there are assets to make up the difference

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 ...

... consider delaying taking Social Security benefits
(Changes will be made to Social Security)

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 2024)

	<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 2024)

	<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 a guaranteed income which means not worrying how to put a roof over your head and food on the table for your 110th 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, AAI 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, AAI Journal, May 2005
- *The Benefits and Costs of Long-term Care Insurance*, Terry Savage, AAI 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, AAIL 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 Annuity quotes
- <https://Livingto100.com> Calculates your life expectancy

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