

Risk Management ... The Role of Insurance

Insurance model

The insurance contract transfers a risk that you are unwilling to take yourself to a third party.
Suppose your home is worth \$1M (excluding land), and there is a 1 in 2000 chance that it could burn to the ground in any given year:

$$\begin{array}{rcccc} \text{Premium cost} & = & \text{Actuarial cost of risk} & + & \text{Overhead cost} & + & \text{Profit} \\ & = & \$500 & + & \text{say } \$100 & + & \text{say } \$50 \text{ per annum} \end{array}$$

Insurance is inherently expensive

Only buy insurance where you really need it; self-insure for small items

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.

Insurance is **not an investment** (or at best a lousy one!)

Theory of Large Numbers the big advantage the insurance companies have:

You cannot predict your personal future

..... but the actuaries know to the day the lifespan of the average person.

Auto Insurance

Liability: Bodily injury, property damage, e.g. \$250k/500k/100k

\$1,000 deductible collision, \$1,000 deductible comprehensive, uninsured motorist, etc.

Homeowner's insurance

Dwelling, personal property, loss of use. Personal liability, property damage, etc.

Does not cover damage from a flood or an earthquake.

Flood insurance

Mandatory if you live in a flood plain.

Earthquake insurance

Dwelling (5% - 25% deductible), contents, living expenses, etc.

Cost ~0.2% pa with 15% deductible, e.g. ~\$2,000 pa for \$1M coverage with \$150,000 deductible

Liability insurance (Potential train wreck) www.whatsmyliability.com

Protects against claims in excess of your auto and homeowner's policies for

Bodily injury to others: Your teenage driver hits a carful of attorneys on the freeway.

Property damage: Your prized oak tree crashes thru your neighbors living room.

Lawsuits for slander, libel, mental anguish, etc.

Who needs umbrella insurance? Probably anyone with assets greater than their auto/HO policies

How much coverage?

\$1M to \$2M minimum: incentivizes the insurance company to provide good legal support

\$2M - \$5M typical: Net worth + small delta ?

\$5M - \$10M maximum except for HNW people

Cost is relatively low: approximately \$150 - \$300 per \$1M per annum.

Life insurance

Suitable for a wage-earner with two young kids to put thru college

Replaces his/her future earnings if he/she should die prematurely

Less necessary as he/she builds an investment portfolio to cover the costs himself/herself

Term insurance (pure insurance) is suitable for younger people to protect their family.

Whole life policies are usually sold, not bought, and make lousy investments
 Sales commission is typically 50% - 100% of first year's premium
 Usually have a negative return for the first 5 - 15 years, 2% - 4% long-term.

Disability insurance (Potential train wreck)

Premature death is not the worst case for our young wage-earner. The family could be in a much worse financial condition if a freeway accident disables him/her for life. They could not only lose the wage-earner's future income stream, but could be burdened with expensive long term care for decades.

Health insurance

Very expensive in U.S: Twice the cost compared to other developed countries with inferior care.

Medicare

Health care for those over age 65: Covered in detail at our March discussion group.
 Major gaps require independent supplemental coverage, e.g. foreign travel, long term care, etc.

Long-term care insurance (Potential train wreck) www.aaltc.org www.genworthltcquote.com

70% of people over age 65 will need assistance with the activities of daily living
 Bathing, continence, dressing, eating, toileting, transferring and (cognitive impairment)
 Average stay is 2 to 3 years, but dementia patients could need 20 years of care.

Expensive: >\$100k pa for assisted living facility. Not covered by health care policy or Medicare
 Most suitable for middle income people; rich can self-insure and poor can't afford it.

Important parameters:	Coverage: Qualified facility, in-home care
Premium cost: 3% to 10% pa at age 65	Term of policy: 3 - 5 years, longer if possible
Elimination period: Typically 3, 6, 9 months	Inflation rider if possible
\$ amount of monthly benefit	Rating of the insurance company

Consider a hybrid life insurance policy or an annuity to get longer coverage.

Social Security

Pension benefits starting at age 62 to 70. Covered in detail at our March discussion group.

Annuities www.stantheannuityman.com www.immediateannuities.com

Single premium immediate annuity (SPIA)

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

\$100,000 premium at	Male	Female	Joint (same age)
..... age 60	\$480/mth (5.8% pa)	\$463/mth (5.6% pa)	\$420/mth (5.0% pa)
..... age 70	\$614/mth (7.4% pa)	\$578/mth (6.9% pa)	\$506/mth (6.1% pa)
..... age 80	\$920/mth (11.0% pa)	\$840/mth (10.1% pa)	\$691/mth (8.3% pa)

Single premium deferred annuity (SPDA), or longevity annuity

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

\$100,000 premium at	Male	Female	Joint (same age)
..... age 60	\$4,635/mth (56% pa)	\$3,596/mth (43% pa)	\$2,450/mth (29% pa)
..... age 70	\$3,015/mth (36% pa)	\$2,477/mth (30% pa)	\$1,699/mth (20% pa)
..... age 80	\$1,652/mth (20% pa)	\$1,454/mth (17% pa)	Call for quote

Estate Planning next month: June 13th, 2018

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