

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

Financial Planning Workshops

Risk Management / Insurance

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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 at 9:00am; webcast only
 - Andy Prophet – Dividend Investing
 - Janet Brown
- **Financial Planning Discussion Group**
 - Debra Stikes: May 14 and June 4
- **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

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
 - 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...)

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 30%
 - Full retirement age
 - Depends on birth year; age 65 – 67
 - Currently 66 and 10 months
 - 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
- 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

Disability Insurance

- 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
 - 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 \$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 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 countless nights of good sleep without 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, 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 Annuity quotes
- <https://Livingto100.com> Calculates your life expectancy

