



# Life Insurance Defined



*Do you need life insurance for your entire life?*

*Is buying term and investing the difference really the right choice?*

## Introduction

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**In today's complex economic environment,** financial advisors and their clients are drawn to the “names” in the industry, many of whom have acquired a celebrity status through television appearances and book-signing events. As always, there is an upside as well as a downside to this – on the upside, it helps mobilize people into taking action for their financial future. The downside is that some of the advice is misleading or simply inaccurate, and particularly so with life insurance.

As a company that has been in the business of insuring families and businesses for nearly a century and a half, we know of no other financial product that has the ability to build wealth, protect and conserve assets in your lifetime, and transfer those assets to future generations – all with the simplicity, guarantees, and tax advantages inherent to this unique product.

## How Much Life Insurance Do I Need?

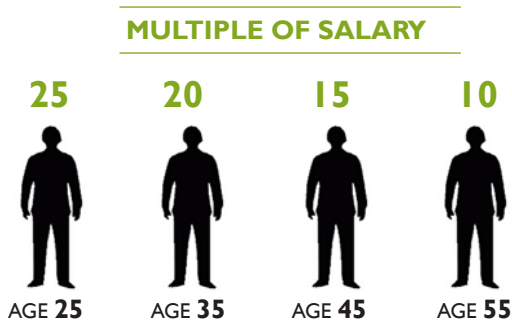
### The primary reason to purchase life insurance

is to replace loss of income needed to meet the survivors' ongoing expenses. A portion of the whole life premium, paid when due, funds this death benefit. But how do we determine how much is enough? There are many different philosophies and formulas that can be applied, but the two most common approaches are Capital Needs Analysis (CNA) and Human Life Value (HLV).

Capital Needs Analysis budgets for current and anticipated expenses, and takes into account other income sources as well as projections on what costs such as Health Care could amount to in the future. The analysis will tally expenses, including a factor for inflation, calculate the present value using a conservative rate of return, then offset that by existing assets. Ultimately, the net number produced reflects the amount of life insurance believed to be needed to support survivors.

Human Life Value (HLV) evaluates the economic life of the decedent – the monetary total of all that he or she would have produced and accumulated in a lifetime, thus the method reflects earnings potential and is not cost-based. It is similar to the formulas used to calculate and claim damages under a wrongful death suit, the theory being that the survivors are entitled to the economic value of what the deceased would have produced during a lifetime. For example, a 33 year-old earning \$100,000 and working to age 70 might earn a total of \$10 million, including 5% annual raises and not discounted for the time value of money.

A recent LIMRA International study portrays a sizeable gap between needs and the coverage people have purchased – and that 28% of the wives and 15% of the husbands in the study had no life insurance at all. Experts recommend that coverage is sufficient to replace 7-10 years of income.<sup>1</sup> Human Life Values at different ages can be estimated from a simple underwriting guideline frequently used by life insurance companies to determine the proper amount of coverage:



## What Should It Cost?

**Life insurance costs are based on life expectancy of various age groups.** From the probability statistics, a premium amount can be calculated – if the insurance company can estimate how much it expects to pay out in death claims in a given year, it must collect at least that much to cover the cost (that doesn't take into account other expenses and profits). Important in the calculations is the timeframe from acquisition to life expectancy and this is why premium amounts increase the older the buyer is at the time of the issue.

A common misconception is that whole life insurance is a "good deal" only if the insured dies prematurely, so purchase should be delayed as long as possible. The first consideration is that life insurance is much more economical if purchased at earlier ages. However, unique to life insurance, the full face amount of the policy is paid out as a death benefit as long as the policy remains in force and all premiums have been paid. The asset does not need to "appreciate" in order to leave the desired legacy value. No other asset can offer that certainty. More to the point of the purpose of life insurance is the security and protection it provides as well as locking in one's insurability, which can potentially change at later ages due to health factors.

## Modern Life Insurance Product Options

This section offers succinct descriptions on the wide range of life insurance products available in today's market, and includes a Product Matrix that visually depicts how they compare and contrast.

## Transforming Needs

**An important step in purchasing life insurance** is to assess as closely as possible how needs may change during a lifetime. This helps determine the type of insurance best tailored to suit the needs and desires of the buyer, and allows for flexibility in planning for the future.

Life insurance is like no other financial vehicle in its **ability to complement over the years** other components of a well-designed financial plan.

## **Whole Life (WL)**

Whole Life insurance is considered the oldest form of lifetime, level premium insurance, dating back to 1759. Because a contract can be in force over decades, the careful pricing and design of the policy make this a strong and stable financial vehicle no matter what the economic conditions. In a Participating Whole Life policy from a mutual life insurance company, premiums are returned to policyholders in the form of dividends as their pro-rata share of gains through investment returns, mortality experience, and expense control.

## **Cash Value, Whole Life, and Participating Whole Life Insurance**

One essential difference between Term life and a permanent policy is that the reserve in the Term policy is typically not accessible to the policyholder, as the reserve represented by cash value is to the policyholder with permanent insurance. Additionally, the longer the Term guarantee period (20-30 year Term), the funding becomes more like the permanent policy, but there still is no cash value – living benefits – to Term insurance.

These “living benefits” of life insurance – the aspect that will generally appreciate over time – can be utilized to fund expected or unexpected needs, although it may take a number of years to achieve substantial cash value build-up with some policy designs. When dividends (which are not guaranteed) are used to purchase paid-up additional insurance, the guaranteed cash values may equal or exceed premiums after a number of years. What other financial vehicles are self-completing?

## **Term Life Insurance**

Term is known as the simplest or purest form of life insurance, typically purchased for short-term financial protection. On products purchased for a specified number of years, the initial premium is guaranteed and level, reflecting a mathematical smoothing over the years as life expectancy changes. Premiums often follow the model for permanent life insurance, based on life expectancies which make them basically unaffordable for renewal after the initial period.

The following also impact the calculation of Term premium:

- To determine gross premiums, 15-30% is added to the pure mortality costs for expenses, reserves, and profit margins.
- In a company with many preferred rating classes, the basically healthy will pay more than if there were fewer preferred classes.

Although not economically viable as longer term financial protection, there are specific uses for Term insurance, such as to:

- secure loans
- satisfy a divorce or alimony agreement
- insure a short-term business obligation

In contrast, Permanent insurance is purchased to:

- protect income for a longer horizon
- supplement retirement income
- equalize estates
- assist in payment of estate tax or for other liquidity needs at death

## **Universal Life (UL)**

First introduced in the 1970s, UL was the first product to transfer sufficiency risk to the policyholder, as there were fewer guarantees and no fixed premiums or benefits. The policy featured flexibility in amount and timing of premium payments, so that the policyholder simply had to maintain a positive balance in the policy account to cover fees and expenses month-to-month.

## **Variable Policies (VL and VUL)**

Variable Life and Variable Universal Life policies offer the opportunity (and responsibility) for the policyholder to direct premiums among various investment options – typically equity and a fixed account – to support the underlying policy and death benefit. The long-term viability of the policy becomes a function of the funding premiums paid and the market values of the sub-accounts.<sup>2</sup>

<sup>1</sup> Life Insurance Consumer Studies, LIMRA International.

<sup>2</sup> Variable life insurance products and their underlying investment options are offered by prospectus only. Prospectuses contain important information, including charges and expenses, and should be read carefully before completing an application, investing, or sending money. Please consider the investment objectives, risks, fees and charges, and expenses in the investment company carefully before investing. A prospectus containing this and other important information can be obtained from a sales associate or by calling 1-800-441-6455.

## Insurance Product Matrix

POLICY TYPE	YEARLY RENEWABLE TERM	LEVEL PREMIUM TERM LIFE	UNIVERSAL LIFE	VARIABLE UNIVERSAL LIFE	NO-LAPSE GUARANTEE UNIVERSAL LIFE	PARTICIPATING WHOLE LIFE
BEST FOR	Very short-term needs such as securing a 1 year term loan	Longer-term needs that are clearly not lifetime needs	Lifetime coverage with considerations of budgetary restrictions or the need for flexible payments	Lifetime coverage with little or no budgetary restrictions and a high tolerance for short-term volatility	Lifetime coverage at the lowest possible cost – with no need for flexible premium arrangements or the possibility of an increasing death benefit	Lifetime coverage in which cost is less of a factor than long-term benefits including increasing death benefit and access to cash value
NOT BEST FOR	Any uncertainty as to how long coverage will be needed	Any uncertainty as to how long coverage will be needed	When flexible payment opportunity may lead to failure to pay needed premiums	Those with anxiety over volatile market activity	Need for cash value and/or death benefit growth	Need for large amounts of coverage and limited resources to pay premiums. High initial premiums may restrict death benefits in Trusts with few Crummey beneficiaries.
ISSUES	Presumably a conversion option will not be needed; can be “shopped” on the basis of premium; A M Best rating no less than “A”	Pay for a conversion option in the event the need later becomes lifetime. Can be “shopped” on the basis of premium; A M Best rating no less than “A”	Dilemma: carrier has transferred all the sufficiency risk but retains all the control to make the in-force block of policies “profitable.” Do NOT shop on basis of premium; A M Best rating no less than “A”	Illustrations do not reflect effects of volatility. First determine asset allocation and historic rates of return, and then ask for a “Monte Carlo” estimate of a premium that will sustain the policy at least to age 100.	Make certain to understand the conditions under which the guarantee can be lost – and reinstated. A M Best rating no less than “A++”	Purchase from mutual insurance company; consider “paid up additions” for dividend election. A M Best rating no less than “A”
RISK INDEX	<b>0</b>	<b>0</b>	<b>3</b>	<b>15</b>	<b>0</b>	<b>1.8</b>
SAMPLE PREMIUM-33-M-PREFERRED	\$385 first year	\$590 level – 20 yrs	\$6,304/year	\$4,824/year	\$4,478/year	\$13,895/year
DEATH BENEFIT AT LIFE EXPECTANCY	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$3,665,327
NPV @ 5% OF ALL CASH FLOWS	\$(21,729)	\$(21,761)	\$(27,332)	\$(442)	\$5,844	\$67,176



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The information contained within this piece was compiled from an award winning research paper, *Life Insurance as an Asset Class: A value-added Component of an Asset Allocation*. For more information on this industry leading topic, please visit [www.lifeinsuranceasanassetclass.com](http://www.lifeinsuranceasanassetclass.com).

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