Jonathan Pond's Quick Guide

Life Insurance—
How Much Do You Need and What Kind?

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I encourage you to speak with your insurance agent or an SBLI representative about how SBLI can help you secure the life insurance you need to protect your loved ones. Best wishes for a wonderful financial future.

– Jonathan Pond

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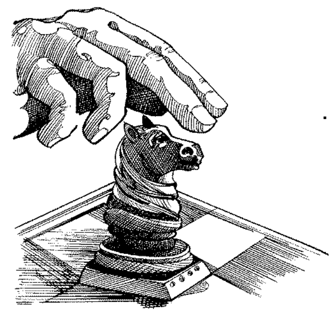


All life insurance policies can be divided into two broad categories—term and cash value. But there are numerous variations upon these two categories. Before deciding upon what type of policy is best, you must first determine the amount of coverage you need, then the type of policy that is appropriate, and finally, the source from which to buy it. The following will help you master all three moves in the life insurance game.

DECIDING HOW MUCH LIFE INSURANCE YOU NEED

Before you start talking to insurance salespeople, searching the Internet, and reading policy booklets, you should first determine how much coverage you are going to need. Try to come up with your own estimate, but even before that, you must first determine whether you need life insurance at all. If you have no dependents, you may not need it. But be careful. You may have dependents and not realize it. Obviously, a stay-at-home spouse and children who haven't yet left the nest qualify as dependents. But you also may have other dependents. It is possible that your parents may at some time in the future need to rely on you for financial support? Even DINK couples (dual-income no kids) may need life insurance because they have managed to get their spending up to a level that the surviving spouse could not sustain in the event of the death of the other spouse. Finally, even though you have no dependents, you may want to use life insurance to provide a bequest to a long-term partner or favorite charity.

If you determine that you do need life insurance, the next step is to realistically estimate your minimum needs. Once you know the bare minimum of coverage you require, you will be prepared to determine which kind of insurance is right for you and then compare premiums so that you get the best value. If you have family members who are truly dependent on your income, a base minimum life insurance coverage should be the equivalent of four or five years' worth of your current net income (in other words, after-tax salary). If you have young children, you should have six to seven times your salary in coverage. In theory, this will give your family some breathing space to get back on its financial feet. If, as is the case in the majority of families, you and your spouse both have jobs, you may not need as much life insurance as this bare minimum, but you will probably need at least the equivalent of a couple years' net income in life insurance coverage on each spouse, and probably more if there are young children.

Once you have determined your bare-minimum life insurance needs, you can make a rational assessment of the amount of life insurance that you think is appropriate. For example, you may be confident that your family will be fine with your bare-minimum amount of coverage. Others would like to increase their coverage to assure a sound financial future for the family. For example, you may want to add insurance over the bare minimum to pay off the home mortgage, or use additional insurance to set up a college fund for the kids (or grandchildren). It's not that difficult to estimate how much life insurance you should carry. The following example illustrates one of many ways to do so.

CASE STUDY

Roderick Random is age 35. Roderick and his 33 year old wife, Clarissa, have two children ages 7 and 3. The Randoms have a combined annual income of $75,000. (Roderick earns $45,000, Clarissa earns $25,000, and their investments earn about $2,000 a year.) Should Roderick die tomorrow, his pension, in which he has only recently been vested, would be worth $3,000 a year.

At Roderick's death, annual income would be available from the following sources:

Clarissa's earnings:	$25,000
Investment portfolio:	$2,000
Survivor pension benefits:	$5,000
Total:	$30,000

Roderick estimates that in order to finish educating the children while maintaining his family's current standard of living, and to provide Clarissa with a fund that would provide for her retirement, the family would need about 80 percent of their current income level, or $60,000 of income ($75,000 x 80 percent).

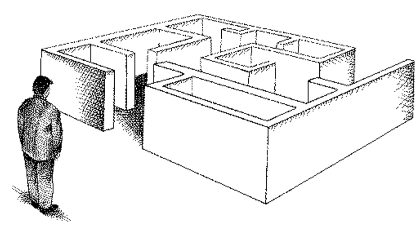
Based on these assumptions, Clarissa would have an annual income "shortfall" of $30,000 ($60,000 - $30,000) should Roderick die. Assuming that the insurance proceeds could be withdrawn at a rate of 5 percent per year, Roderick would need life insurance in the amount of $600,000 to provide $30,000 in annual investment income. Actually, Roderick estimates that the investments could earn 7 percent interest, so Clarissa would actually earn $42,000 per year from the invested insurance proceeds. She would, however, have to reinvest $12,000 ($42,000 - $30,000) to insure that the amount that is to be withdrawn will increase each year to keep up with inflation. Roderick's $600,000 in insurance is a lot more than a bare minimum of four to five years' net income, but he prefers to provide the family with a higher level of financial security. Now that he has determined how much insurance he needs, Roderick can shop for the best policy or policies. A similar analysis should also be prepared to estimate Clarissa'a life insurance needs.

Changing Insurance Needs

Family insurance needs follow a cyclical pattern, so you may be best served by purchasing insurance that allows you to change the level of coverage. As your family grows, your insurance needs increase. The needs peak when the children are young, but they decline as the kids get nearer to leaving the nest. In the above example, Roderick's insurance needs will decline over the next several years—his pension benefits will increase and hopefully his investment portfolio as well. Roderick's children will eventually graduate from college and leave home for good. Should Roderick die twenty years from now, his need for coverage would be reduced. Indeed, many people's life insurance needs decline significantly once the children are permanently out on their own (if they're *ever* permanently on their own). Retirees may not need any life insurance at all.

As if all this weren't confusing enough, there is one more matter to worry about. If you think that your estate will be subject to estate taxes, life insurance may be used to help pay those taxes. And if your estate is likely to incur estate taxes, your life insurance policies should probably be placed in a so-called "life insurance trust."

THE VARIED MENU OF LIFE INSURANCE POLICIES



Once you have an idea of how much life insurance coverage you need, and before you start shopping, it is important to understand the kinds of life insurance products that are available. Life insurance comes in two basic flavors—term and cash value—plus a hybrid, universal life. The basic distinction between term and cash value insurance is that term insurance is pure life insurance, while cash value provides both insurance protection and a savings/investment feature. Beyond this basic distinction, how do they differ? And what about all those variations on whole life and term insurance policies that have been introduced? The following will help you make sense out of all the confusion.

Term Insurance

Term insurance is designed for one purpose only: protection for your dependents if you die. Only your heirs will benefit from the money you spend on term life insurance premiums. On the other hand, term insurance is comparatively cheap, which usually makes it the coverage of choice for young heads-of-household. When you are just starting out in life and have young children, protection is crucial but funds are scarce. Young breadwinners usually don't have a lot of money to spend on life insurance premiums, so the low cost of term coverage makes it most attractive. You can buy term coverage that is quite flexible, allowing you to up- or downgrade coverage as your need for protection changes. For some individuals, term insurance could therefore provide good coverage during all of their working years.

One of the problems of term insurance, however, is that the older you get, the more expensive it becomes. On the other hand, for many people, the older they get, the lower the level of insurance protection they need.

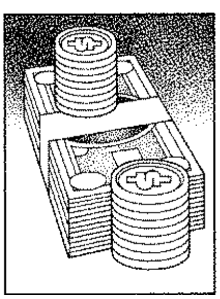
ANNUAL RENEWABLE TERM

If the term insurance you purchase has a fixed lifespan, when the policy expires you have to buy an entirely new policy. You will have to have a physical all over again and endure all the other tasks associated with buying an insurance policy—even if you are buying a policy identical to the old one. If health problems have arisen, you may not be able to get a new policy. The solution to this potentially serious dilemma: Buy an “annual renewable” term (ART) policy, which allows you to renew your insurance without having to prove your insurability all over again. Make sure any term insurance you buy is annually renewable for as long a period of time as you are likely to need the insurance protection.

Level premium term life insurance policies are particulary attractive for those who need life insurance protection for a specific period of time. Level premium policies provide a fixed amount of protection at a fixed annual premium over a fixed period of time (which generally ranges from 10 to 30 years). For example, the parents of a young child might purchase 20 year level premium policies for each parent so that the family is protected until the child graduates from college.

You can also buy **decreasing face value ART policies**, in which premiums stay level—or decrease slowly—while the value of death benefits decrease. Another alternative is a fixed face value ART policy, where the premium goes up with each renewal while the value of the death benefit stays constant.

A **convertible term policy**, on the other hand, gives you the option of transforming your insurance from term to whole life with no questions asked. This feature may not, under ordinary circumstances, seem particularly thrilling. But should your health condition decline, owning a convertible insurance policy could be advantageous since you could convert the term policy before it expires, thereby providing you with insurance for the rest of your life.



CASH VALUE INSURANCE

The debate on the merits of cash value versus term insurance is one that will continue as long as people buy and sell insurance. This section discusses the many varieties of cash value policies.

WHOLE LIFE INSURANCE

With whole life, you pay a fixed premium as long as you live, and the insurer pays a set death benefit. Since both the face value and the death benefit are fixed, the whole life policyholder overpays for coverage at first but pays comparatively lower premiums later on.

Whole life combines the protection offered by term insurance with a savings aspect. A portion of each premium that the whole life policyholder pays goes directly to pay for the protection; the insurer invests the amount remaining on behalf of the policyholder. The policyholder’s “investment portfolio” constitutes the policy’s “cash value,” which can be withdrawn in the form of loans, added to the death benefit, or used to reduce future premiums.

While whole life’s forced savings aspect may make it attractive to some people, premiums are steep when compared to term insurance. Furthermore, with their fixed death benefits, whole life policies cannot be altered to reflect changes in the level of coverage a policyholder may need as his or her life progresses. But if it's certainty you want with your life insurance program, whole life can be the answer. In fact, many insurance experts hightly recommend whole life insurance despite the apparent flexibility offered by other types of cash value life insurance.

Universal Life Insurance

Universal life insurance combines the protection of a conventional term insurance policy with the current yields available from short-term investments. Universal life policies separate the insurance component from the cash value. A charge is made for pure protection—the equivalent of term insurance, company fees, and profits—and the money that remains is the cash value of the policy, which earns interest according to a company contract or agreed-on financial index. Unlike the cash value of a traditional whole life policy, the cash value of a universal life policy grows at a variable rate.

Universal life policies also offer greater flexibility to tap into cash value than do other types of insurance. Under most traditional whole life policies, you must either take out a loan or surrender the policy to have access to their built-up cash value. With universal life—and some whole life policies—you can make partial withdrawals from the policy's cash value through the receipt of dividends.

Universal life does have its drawbacks. As an investment product, the returns offered by universal life—like most insurance products—do not stack up against other savings and investment alternatives. Also, company fees and agent commissions are generally quite high, and they eat away at overall investment return.

Variable Life Insurance

This hybrid policy gives you a large measure of control over the buildup of cash value. As with whole life and universal life insurance, a portion of the premium buys pure protection, while the rest is invested by the insurance company on the policyholder's behalf.

While whole life premiums are invested in low-yielding but safe securities, the variable life policyholder is presented with an array of investment choices. You can direct the company to invest premiums in one of several combinations of stock, bond, and/or money market mutual funds. Variable life insurance is an attractive product if you like to take a hands-on approach to money management, and the returns you can achieve may be an improvement over the generally steady performance of whole life portfolios.

There are two kinds of variable life policies. **Straight** variable life has a fixed annual premium. The more popular **universal** allows more flexibility insofar as the policyholder can vary the premiums that are paid as long as the basic minimum payments for death benefits are paid. So in addition to deciding how the money will be invested, you can choose how much to invest in a universal variable life policy.

But with the increased possibility of reward comes an increased risk, in the form of an uncertain cash value. The death benefit of a variable life policy is paid for by the pure insurance part of the policy and never falls below a certain floor level. But the amount of cash value is not guaranteed and could be severely reduced in the event that the company's investment portfolios perform badly. While the policyholder can choose the type of investment, insurance company money managers or their designees still choose the underlying securities.

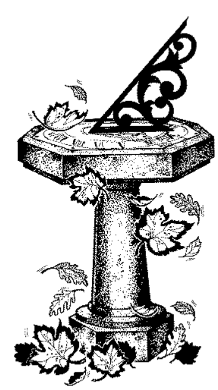
Increasingly, variable life insurance policies are giving policyholders greater flexibility and choice in how premium proceeds are invested. Variable life insurance cash values, like all cash value insurance, do receive favorable tax treatment, however, in that cash value increases are not taxed until the money is withdrawn from the policy. In other words, policyholders get tax-deferred buildup of cash values.

Single-Premium Life Insurance

If you have substantial cash reserves, single-premium life insurance may be an attractive option to build up some tax-deferred savings for retirement. By paying a single lump sum—which can be as low as $5,000—you can purchase death benefits and a cash value that grows free of current taxation. These policies may offer attractive interest rates but they usually impose stiff penalties for canceling the policy in the first few years after purchase. Policyholders do have access to cash value through loans. Given the way single-premium policies are structured, the emphasis is usually on investment, not insurance.

Travel Insurance

You no doubt have seen ads for accidental death insurance in airports. Policies are sometimes sold right out of vending machines at what appears to be a ridiculously low cost. The cost is ridiculously low because the chances of your survivors ever benefiting from one of these policies are also ridiculously low. Don't buy travel insurance. Some credit card companies now offer travel insurance at an extra cost. Believe me, they are making a bundle on this outrageously expensive insurance.



A PLAN FOR BUYING THE RIGHT KIND OF LIFE INSURANCE AT THE BEST PRICE

Once you have estimated the amount of life insurance that you need, and you understand the various types of life insurance that are available, it is time to become a wise insurance buyer. If you take control of the insurance purchase decision, you're bound to save money. If you use an insurance agent, understanding the alternatives that are available to you will help you get the right coverage at the right price. Even if you already have sufficient life insurance, the following tips may help you in the future.

TERM OR CASH VALUE?

The debate over whether term or cash value life insurance is preferable will never be resolved. One thing is for sure, however: Term insurance is usually cheaper in the long run than cash value insurance. If you're concerned about providing the most insurance coverage at the lowest cost now and the bulk of your life insurance needs will eventually diminish, emphasize term.

Nevertheless, many people have benefited, are benefiting, and will benefit from cash value insurance. People who are otherwise unable to discipline themselves to save regularly can benefit from cash value insurance's forced savings feature. Even disciplined savers can take advantage of the tax-deferral feature of cash value life insurance as part of a program for saving for retirement. In spite of the ever-present fees and commissions, some cash value insurance products can offer attractive tax-advantaged returns on the investment portion of the policy. The problem with trying to meet all or most of one's life insurance needs through cash value insurance is simply that it can become prohibitively expensive.

What's the upshot? Like most things in our financial lives, term versus cash value insurance should not be viewed as an either/or proposition. You may well be best served by a combination of term insurance to provide needed insurance protection for your dependents and cash value insurance to provide additional life insurance protection and, just as important, to accumulate tax-deferred savings.