Sound Financial Bites 083 - How Much Should You Own-What Should You Apply For

Episode Transcription

“The amount of life insurance is far more important than type.”

Paul Adams: I cannot encourage you enough that if you have an agent that gives you a bunch of quotes out the gate, and says, "Here's a bunch of different quotes from different insurance companies, or a bunch of different quotes for whole life insurance, and term, and universal life," and that's part of the sales process to you, I would encourage you to find somebody else, and here's why. You are wasting your time, they are wasting theirs because they're stuck in a sales conversation, when what you need to do is just find out whether or not you're even healthy.

Welcome to Sound Financial Bites, where we help you with bite-sized pieces of financial and life knowledge to help you design and build a good life. The knowledge that has been shared from stages at conferences, pages of national business magazines, and clients living across America, our host, Paul Adams, now brings directly to you.

Paul: Welcome. We're so glad you could be with us. We have a really great episode for you today, and what we're talking about is how to buy life insurance, and what we're going to talk about is not what most people talk about. Everybody rants and raves about this type of life insurance versus that type of life insurance. We're not going to do that at all for this conversation. This conversation is going to be targeted at what amount. That amount of life insurance is far more important than type. So, amount over type, amount over type.

Cory Shepherd: Real quick, just in case people haven't been watching, they're just jumping in, this is Paul Adams, CEO of Sound Financial Group. I'm Cory Shepherd, President and producer of this show, and we're --

Paul: Hence why you had to stay on top of me, make sure we cover all our legal obligations.

Cory: Yeah, that's right. So, yeah, glad to have you back if you're returning. Glad to have you here if you're just jumping in to the series, and Paul, take it away.

Paul: Yeah, thank you for letting me have my show back. So glad you guys could come because we're going to teach you the most important thing you need to know about the type of life insurance to get, and that is amount.

Now, why does the amount matter? Why the amount matters is it's actually the same thing you need to consider about having enough money one day when you're no longer working. Some people call that retirement. At our firm, we call that DFI, or definite financial independence. Most of our clients don't plan on building a 30-year career and then just checking out, not bringing value to society anymore, but they may change it. That's why we call it "financial independence".

What I want you to consider, though, is you need to know, and this is a fundamental rule, really smart people just don't own. Here's the question I would ask so you can sit with it a moment and think about it. How much money has to be invested somewhere to replace your current income?

Now, so often, people will say, "One day, when I get old..." Forget life insurance here for a moment, just how much money does it take to replace your human capital at work transacting the marketplace? People thought, "Well, I have a couple million dollars. When I'm old, that will be good enough." Probably not. Majority of our clients are between $300,000 and $1.5 million of annual income. $2 million isn't going to cut it.

Cory, how often have you had clients actually know how much money they should have just to replace their income. Just, one day, they make $300,000 a year, and they have the number?

Cory: It has happened, although, infrequently enough to not really know a number. It's kind of like baby pigeons. They have to exist for adult pigeons to be there, but when do you see them?

Paul: It's unoften. Yes, that is what we want to get across. Most people don't know this. If you don't know now, that's okay. You're just in the same room with everybody else we talk to. I've been at live events where I talk about how much it takes in capital at work to replace one's income, and you can see high-powered executives, business owners ashen white in the audience because, suddenly, they go, "I have not been aiming at that number, or they didn't have a destination. There's the old saying, "If you don't have a destination where you want to go, any path will do," and that is pretty much how most people are handling their money.

"Rules of thumb are likely only to produce mediocre outcomes."

The first thing, when you consider owning an amount of life insurance is you need to know this financial mechanic. How much money can be pulled off a capital sum, a large amount of money, an amount of capital at work, how much can be distributed from that every single year and not have it run out before you're gone? That's it.

It's pretty simple math. Most academics agree it's no more than 4%. Some have said, in this extended low interest rate environment, maybe it's less than 4%, but it's no more than 4%, so let's just use 4, 4% distribution rate.

Now, why? Because, if you take out -- even if you had a portfolio that's somehow averaging like 8% over time, it has ups and downs, and when you start taking withdrawals, you accelerate the erosion of your capital, and then you don't leave enough in there for it to rebound.

Really simple, like I'm a little country, just got back from a cousin's ranch for 40 days, my family and I spent time there, that's not leaving enough seed corn in the field to replant next year. So, we need to leave enough seed corn in our portfolio every year to take that distribution. Simple math would be if you're making $300,000 a year, or that's what you want to replace in your old age, it's going to take $7.5 million of capital at work to produce that $300,000. So, if that's bad news for you, super sorry. You can also watch our video, "When $22.5 million is not enough". I think that one will also be a bad of a groundbreaking for you if that information is new.

Now, let's talk about life insurance. So, consider if you die -- so, let's forget rules of thumb. By the way, rules of thumb are awful. Like, guaranteed, rules of thumb are likely only to produce mediocre outcomes, because the reason it's a rule of thumb or it's common sense is it applies to most people, and most people are not making great financial decisions.

A rule of thumb might work well if it's a rule of thumb that exists inside a group of triathletes. It's common knowledge in their group. So, if you want to be a triathlete, that might be worth listening to, but when the society and the on-average horrible financial decisions people make, those are not the rules of thumb to follow.

We're going to throw all those out. Let's just talk about if you die. If you die, you're no longer with us, I don't know how you died, it's awful, we all felt really bad at your funeral. But, if you died, how much do your household bills change? That's it. How much do your bills change? They go up, they go down? In all likelihood, if you really reflect on it, the next month's bills don't go down. They may go up. They'll go down a little bit, like maybe your spouse can sell your car. If you're a member of the golf club, maybe they can cancel your golf club membership.

Cory: I can eat me some steak.

Paul: Yeah, you can eat a lot of steak. Yeah, the grocery bill drops about like 10%, but it's not as if it's a 50% scale suddenly, and if you're not saving 100% of your income right now, then there is some financial loss to the family. So, how much do the bills change. When we simply ask that question, especially if we start with, "How much extra money do you have floating around now anyway?"

Let's think about that for a moment. How much excess money do you have? None? Meaning, even the money that's extra that you save is going and getting reserved for future utilization in your old age. But, nobody watching this podcast, I don't think, has like a cardboard box full of cash sitting in the bottom of their closet just waiting to be able, "Oh gosh, would somebody tell me what to do with this?" It's all getting deployed. It's all getting used, it's all getting utilized. Fair?

"The insurance companies will not let you insure 100% of your income."

Cory: Fair.

Paul: Okay, so even if you have a 20% savings rate, you're still reserving for future utilizations, so here's the problem. All the money that's coming into your household probably still needs to come to your household, or a good chunk of it. So, how much do the bills change? Well, they probably don't change that much.

You can do some math with your spouse and see if they change, but most people find, when they sit down, and just have an authentic conversation about it, they don't drop by half. They stay pretty much the same. If the bills are going to stay pretty much the same, then how much of your income do you need to replace to your spouse? The answers we get are darn close to 100%.

Now, here's the bad news. The insurance companies will not let you insure 100% of your income. We've already talked about 4% is the distribution rate. If you could insure yourself for 25 times your annual earnings this year, you could protect 100% of your annual earnings this year. But, as you have merit increases, your business grows, your career grows, and you would get pay raises, they will not insure any of that, and it's a controlled multiple of your current income, depending on what you own.

Because, people in their 20s have so much potential ahead of them, that's the only group that can own 30 times their annual income. Notice I'm giving you broad ranges across most insurance companies and where they will limit somebody's ability to acquire life insurance. If you are in your 30s, it's 20 times your annual income. If you're in your 30s, 30s in 20 times, 40s, 15 times, 50s, 10 times your annual income, and 60+ is one times net worth.

Now, there's some exceptions to that rule, there's some things we can do differently for business owners as an example because they are also a key person in their company, there's buy-sell agreements, there's other insurable interests, but bottom line is you can't own enough life insurance to leave your family rich.

Cory: Do you want to know the real reason why they set those limits? Because, the insurance companies have also seen that movie where the wife knocks off her husband for the insurance money, and they don't want that to happen, so they need to be clear that people are worth more alive than dead.

Paul: They need it to be an economic loss for your spouse to pass away. Now, my wife knows the amount of life insurance I have, about $14 million of total coverage, and she's also crystal clear that she has an economic loss if I'm gone and $14 million is all that takes my place for the rest of my life, or what my life would have been.

"Bottom line is, you can't own enough life insurance to leave your family rich."

That is a key distinction for most people. They don't realize that they are worth that much money if they just be around. For you, if you're in your 40s right now making $300,000 a year, the most coverage you're likely to be able to get is $4.5 million. Cory, $4.5 million at a 4% distribution rate is how much?

Cory: 500 will be 20,000, so 15, 16. I'm not good at math off the top of my head.

Paul: $4.5 million will be $180,000 of cash flow every year.

Cory: Oh, you said $400,000.

Paul: Did I say $400,000? I meant $4.5 million. $300,000 of the income, $4.5 million of life insurance is the most that person could get. So, that would leave their family $180,000 a year. Now, you'd be like, "Well, that's pretty good living, that's fine." Well, wait, then where's the rest of the money going that's currently coming in at $300,000 right now that there's nothing left on the sidelines? Does that mean your spouse isn't planning for college for the kids? Does that mean your spouse doesn't have any money left when it comes to retirement? Does that mean your spouse needs to move out of the family home, relocate to some other part of the country with lower standard of living away from everybody's friends? What is the move that they're going to make?

Here's the thing, that is the most you can get. That is the most. You can't get more than that without some exceptions. There's some exceptions possible, but you just can't get more. So, now let's talk about applying.

Say, you find yourself an agent, you're working with somebody. I cannot encourage you enough that if you have an agent that gives you a bunch of quotes out the gate and says, "Here's a bunch of different quotes from different insurance companies, or a bunch of different quotes for whole life insurance, and term, and universal life," and that's part of the sales process to you, I would encourage you to find somebody else, and here's why. You are wasting your time, they are wasting theirs because they're stuck in a sales conversation when what you need to do is just find out whether or not you're even healthy.

Find an agent, understand how much you need to own. You can reach out to us and we'll either take you through our process or refer you to somebody that can get you just life insurance, if that's all you're after. But, here's the key, key piece: you need to know whether or not you're healthy first. The insurance companies do not charge you to go get a paramedical exam, a nurse comes to your home, they'll do an EKG, they'll take your blood pressure, they'll make you pee in a cup and take some blood from you. That's it. They then take six to eight weeks for that application to go through, you do the medical exam, the agent takes an application, goes meet up somewhere at that insurance company's home office, and then they give you a health rating.

“Recreational marijuana use with most of these insurance companies is looked at more favorably than cigarette smoking.”

That's the first time you should be looking at actual quotes. Because, without that health rating, you do want to understand mechanics of products, know the difference between term, whole life, universal life, and all its variations. Like, that's good to learn to understand, but if you're looking at the actual quotes you're being sold that's going to be about this much, you're wasting your time.

Cory: So, with the analogy in car insurance being getting quotes for insurance before you've actually bought a car?

Paul: Yeah, or the bigger one I give is like the mortgage business. When somebody says, "Here's the rate we can give you," they have no idea. They have no idea if that's the rate they can give you. They haven't seen your credit report, they don't know what your banking history looks like, they don't know what your current debt load. They have no clue, but they will throw out, "Here's a mortgage rate," and how you know you're dealing with a professional in that space is when they say, "We just recently introduced a client who needs to do a refi to a set of consummate professionals in the mortgage business," and literally what they told the client was, "Here is the financial packet I need you to send me before we have conversation 1 about rates or whether or not we can help you refi, period."

That is what you want out of anybody that's transacting for you around life insurance. Get you underwritten. The same could be said - although it's not for the series - for disability where the professional that you're working with should know some good companies and they should have you apply with one of the key companies that they know will treat you well if your health is good. If you have substandard health ratings, they need to go out on a different path. If there's something wrong with you, they may have to go out on a different path if they find out about it ahead of time. But, be fully disclosive.

What can you do to help your health rating? I would encourage you to, one, don't eat a huge steak the night before, two, take it easy on your liver for about the week prior. Like, if you've got a friend's bachelor party, or you are celebrating the 21st birthday of your grandson, give it some space. Let your liver rebound after that particular evening before you do it.

"We are all one doctor's note away from never being able to acquire life or disability insurance."

Some people will not apply because they're worried about what's going to happen with marijuana use, and in fact, recreational marijuana use with most of these insurance companies is looked at more favorable than cigarette smoking. But, just be fully disclosive, because you want that contract to be one that holds up if something happens to you. Any other tips you give somebody about applying?

Cory: I like to work out, get swole, but I take a break from that right before a life insurance exam. You don't want to have a huge rush of that lactic acid or all the other things that go crazy.

Paul: Yeah, take a couple days off of the gym if you're going to do it. Oh, fasting, fast through the night.

Cory: Fasting is helpful. A lot of companies say they don't actually require it anymore, which is great, but I just prefer to just take all the variables out of the table. My favorite time to get a medical exam is in the morning so you can get up, have a few glasses of water, do the exam, and then have your coffee and breakfast afterward. You don't have to starve yourself throughout the day.

Paul: Absolutely, and last but not least, key, if you are meeting with your doctor, and this is something for you to think about all the time, if your doctor says, "Well, you might want to get X, Y, or Z looked at," like you might, what you need to do is make sure, if that's a might or maybe, that they say -- they need to be super-clear in their notes that they did not give you a referral, that you guys just talked about the possibility of.

Because, we are all one doctor's note away from never being able to acquire life or disability insurance for that matter, and we need to be responsible for what those physicians write in the medical reports. It needs to be truthful, but don't have like a casual conversation with your doctor about, "Yeah, I was thinking about, maybe, I should just get some counseling." That's fine if that's what you need, absolutely. You should discuss that with your physician.

But, if it's like, "Hey, you might consider X," be really clear with your physician if they need a referral for you or if they're just going to note that your record is a general, "We talked about this, not really a problem, not recommending a referral," they need to say that, and then if they do recommend you go get something done, or a test done or something else, you need to go get the test done. That absolutely needs to happen.

Cory: Right away, and with the insurance companies and the medical exam, by the same token, if they ask you a question, answer it honestly, but answer exactly what they ask and don't feel you have to volunteer any more information, and that is your protection as a consumer, and also remember they don't have very much of a sense of humor. So, the jokes about the liquor and women don't need to happen.

Paul: To Cory's point, if they're asking, "Tell me about your father and mother," you don't need to talk about that crazy uncle that has some wacky history unless they ask about that part of your family history. So, be totally truthful and disclosive in answering exactly what they want you to answer.

That's it. Apply for life insurance, find the right amount, apply for that first. Do not get distracted by any sales techniques by the advisor. Rather, make sure you're getting the correct amount. Because, here's one last thing: once they approve of you, you can always take less. You don't have to take the whole thing. You can literally apply for $4.5 million with the coverage.

Even if you have other coverage, you just file replacement notices, they send everybody notes that says, "Hey, this client might be replacing their life insurance." They might call you and say, "Hey, I'm just exploring some cost options."

Now, the real quote comes in, maybe if you've got other term insurance and a new term insurance is a longer term, less expensive, that might be great. You can go ahead and take the new coverage, or you might take just $2 million to the new coverage, whatever happens. You could take none of it and you're not obligated. Although, I did forget one thing, Cory. They could also bind coverage.

Cory: Yes.

Paul: Would you explain to our audience what binding coverage is?

Cory: Most of the time, you have the option to have $1 million of coverage conditionally enforced from the moment you do the application. What is conditionally enforced means? It means you kind of have the insurance unless they wouldn't have given it to you, meaning if you're healthy and you haven't lied about anything on the application, and something happens to you before you actually get that final policy enforced, they will finish the underwriting and pay out the claim as if you had actually gotten the insurance. So, you give a check for what we estimate the month's premium to be for that million dollars, the agent takes it in, and you have $1 million of coverage right then.

Paul: Usually, they'll limit how much they can bind.

Cory: Up to a million, yeah.

Paul: If you have the ability to bind the coverage, highly encourage it. It's not going to save the day if it turns out they find cancer markers in your blood. That's not going to do it. It's not enforced; it's conditionally enforced. So, if you get hit by a Mack truck and they were going to approve it anyway, you're good.

Okay, so here's what we'd love you guys to be able to do. Double check yourself. After this YouTube video, check and see how much life insurance you have. Use that 4% distribution rate. It doesn't matter if you're, "Oh, I'm going to pay off credit cards, I'm going to pay off the home," that's all bull. I don't even know if we could bleep. That's where I would cuss. I don't know if we have a bleep button. We're going to add one because there's some times I'm going to get a little fired up.

But, here's what you need to know. All that is still just a 4% use of money. You pay off your home altogether, one, it's only the mortgage. It's not the taxes or insurance that are still going to climb. Those are still consumables, and you could pay off credit card debt, anything else. That's all decisions you made. Somehow, while you're working, you've got to do your best to replace your full income or at least try, and then work with your financial professional to help you build whatever cash flow has to be built to be able to acquire the right amount of life insurance.

Check yourself. Are you near your human life value, 30 times your income in your 20s, 20 times in your 30s, 15 times in your 40s, 10 times in your 50s, or 1 times net worth, 60+? Check, see how close you are. Feel free to send us a note if you need help or you need direction, and as always, if you just want to make sure that this ties into your entire planning, we're happy to help you, take you through a philosophy conversation, have you fill out a client assessment to see if we're a fit. Have a great rest of your day, so glad you could join us. Watch us in the next episode where we're going to dig into the most effective types of companies to buy from and how to go about acquiring it efficiently.

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