Sound Financial Bites 098 - The Basics of Disability Insurance Part 1: How Much Do You Really Need Disability Insurance?

Episode Transcription

> *"It's got to be catastrophic and infrequent, whatever thing we're protecting ourselves from."*

Paul Adams: Hello and welcome to Sound Financial Bites. My name is Paul Adams, CEO, Sound Financial Group. With me today is Cory Shepherd, president of Sound Financial Group. Welcome to the ...

Cory Shepherd: Well thanks for having me on. How many times do I have to be on before I'm not a guest anymore?

Paul Adams: I don't know. Given that you're actually driving the conversation today, I don't know. But we're glad to have you anyway. One day, you'll be glad to have me and I'll be the guest.

Cory Shepherd: I look forward to that day, very soon.

Paul Adams: That's going to be exciting. So, today's topic is talking about something nearly everybody owns at some point in your life. Nearly everybody knows someone who has had something happen to them that prevented them from working, either sickness or injury, and that's disability insurance. What gets skipped all too often is that people end up buying it either because it's a check box at work, like just check for the group benefits, or somebody intersects into their life and sells them a policy. But rarely, if ever, do you find a place or a resource you can go to simply say, "Here are the things that you need to think about philosophically when acquiring disability insurance and here are the contractual provisions you need to make sure are there if you can get them, given your occupation."

Paul Adams: That's our topic today. Cory's made a bunch of notes and really thought through everything that we should hit. With that, I'm gonna hand it to you.

Cory Shepherd: Great. Most of us do have some experience with disability insurance, whether we know it or not. We're all actively making a decision of omission or of action if we work for a corporation and we have group benefits. I think that a lot of people, a lot of times the corporation's paying for it. We're actually not even paying for the disability at all and we think that means it's all taken care of, when in fact those can be the situations where we're leaving the most gap on our balance sheet. So, we're gonna talk philosophically about why it's important and then some things that you really need to know when you're reviewing this for yourself.

Cory Shepherd: The first is, for any client who is not yet significantly compiled a good amount of assets, and that's a doctor right out of school, any professional in their 30s and sometimes 40s usually hasn't had the time at their income earning potential to develop a large balance sheet of a 401(k) or an investment account. Well that means your income is the single biggest asset on your balance sheet. I think Paul, you have something for us to look at to start illustrating that.

Paul Adams: Well, there's one thing I'd love to talk about before we get into it being the biggest asset on your balance sheet. That is all of the stuff that could be available through your work has nothing to do with actual long term disability insurance full protection. Let's start with why you'd protect yourself at all from anything. What are our two rules, Cory? What are the two things that must happen to say if you're gonna protect yourself, these two criteria are how to judge to protect yourself or not?

Cory Shepherd: Well it's got to be catastrophic and it's got to be infrequent, whatever thing we're protecting ourselves from. We have a podcast that goes deeper into that, but just for now, just think of it in terms of we probably wouldn't ever get insurance on, say, breaking our dishes in our house because it probably happens somewhat frequently and it's not really a catastrophic loss if we break one of our plates, for most of us. We aren't gonna insure something like that. But there is a reason why we're by law required to have car insurance, is that it happens often, people get in car accidents, but it's infrequent enough that we can actually have a corporation make an insurance policy around it, and it's catastrophic enough if it happens, it's got to protect.

"Their most valuable asset is not the capital in the 401k, but [rather] their human capital at work out in the marketplace."

Paul Adams: Yes. And the third component is if it's catastrophic it's loss, so we could better protect its full replacement. So, catastrophic, full replacement, and of course it's got to be infrequent enough or no one will insure it. At your work, oftentimes you'll see disability insurance and once again say it's handled, but it may be one of two things, short term disability, meaning it's gonna last you six months. Now that doesn't meet our criteria of being catastrophic. A six month disability is awful, no question, but we should have enough money on our balance sheets to weather that little bit. But it also needs to fully replace our income. So if we're disabled for five years, clearly the six months of disability insurance doesn't cover that gap. So, catastrophic, full replacement. The other thing that doesn't cover that are accidental disability plans.

Cory Shepherd: Oh yeah.

Paul Adams: You have all the things Cute Duck that tells you to get this coverage, and it saves the day for a bunch of people, and that could be true, but for the clients that we tend to work with, people between 300000 and a million five of income, those policies get little to nothing done, and they only pay in the case of accidents. Let's think about that for a moment. That means that if I get hit by a car or if I die in a plane crash, my family gets properly and completely financially remunerated for anything that would happen to me, but if I die the way everybody does, statistically speaking, everybody dies of a sickness or injury, or gets disabled due to a sickness or injury, not an accident, then my family is up a creek literally without a paddle. That's why we call that gambling, not planning.

Paul Adams: That's pure speculation that what's gonna take me down is that very unique niche thing, not something across the board because what we're protecting is the income. We're not meaning to speculate that I'm gonna be taken down by a rock climbing incident, or a-

Cory Shepherd: Airplane crash.

Paul Adams: Airplane accident, yes. So those are two things just to keep in mind, even before we get into that. Let's just cut over. I'm gonna come back to what we call the pool of one gamble. All right. Let's take a look at some of these actual balance sheets. Here we have a family. This is using a tool that we have that helps clients aggregate everything they have, both things they might have with us, and things they would have anywhere else, to give the client full situational awareness and transparency about their money. Let's look.

Paul Adams: These people have an emergency fund. They have joint investments not in a retirement plan. A bunch of money in investments. Somebody in their mid 40's, they've even managed to acquire a vacation home. They've got a little bit of life insurance, reasonable mortgages, a little bit of credit cards they need to knock out. Not a big deal. Decent net worth, 1.8 million. Now if I were to ask you, what is the most valuable thing this person has in terms of assets, people would regularly scan through here and go, "Maybe that Roth IRA because it's gonna grow tax free for the long run or Frank's 401(k). It's got several hundred thousand dollars in it." People change what they value. Or they might say your home. Your home is the best asset. We have other videos on that. We don't think your primary residence is an asset.

Paul Adams: But right here is where people get really confused. What they forget is the most valuable asset is their not the capital in the 401(k), but their human capital at work in the marketplace. Let's just take for this person, say they're making 350000 a year. Can I put you on the spot, have you just grab a calculator. What we want to do is just take this person, say 38 years old. Let's just round it to 40, so it's a nice 25 year period, Cory. Saying that they plan on exiting the workplace at age 65, and they're making $350000 a year, and they never get a pay raise, for the sake of my example. They're doing good and that's it. That's all the best they're gonna do. What do we have in terms of total earnings over the lifetime without inflation?

Cory Shepherd: Yeah. Just the cash that's flowing through their paycheck over 25 years, 8.75 million.

"You are your most valuable asset not by a little, but by a long shot."

Paul Adams: 8.75 million. That really dwarfs-

Cory Shepherd: Anything.

Paul Adams: 1.8 million. It dwarfs nearly anything else you could have on your balance sheet. You are your most valuable asset. Not by a little, by a long shot. And yet people never think for a second to do without homeowner's insurance. Many people pay off their homes. In fact, I just asked a client the other day, whose home is paid off, and we were in this conversation. They said, "Disability insurance is kind of expensive. I think we have enough assets." They got a couple, three million. I said, "Well, can I just ask, you own your home outright. The odds of your home burning down are infinitesimal next to losing your income for over a two year period. Would you be comfortable if I told you let's go ahead and stop paying for your homeowner's insurance because what's the likelihood it's gonna happen?"

Cory Shepherd: The advances in fire retardant building materials have happened much faster than medical technology.

Paul Adams: Yeah, at least in terms of not ... and the other problem is now we don't die. When we get sick or injured, stuff that used to kill us 20 years ago, we just keep limping along. There are insurance companies where actuaries have come out and said, "We're not doing any more long term care because people have basically stopped dying. Really good for our life insurance business, really awful for any of our morbidity based businesses like disability and long term care." So that's first and foremost most important. It's the most valuable thing we have.

“The odds of your home burning down are infantesimal next to losing your income for over two year period.”

Paul Adams: But I just leaned into a little bit what are the odds. What are the statistics? How likely is this to happen? For those of you that have experienced our philosophy conversation or even looked at some of our YouTube videos, you're gonna be familiar with this concept of the parachuter's paradox, or the pool of one gamble. It's this. In the real world, everywhere outside. I won't say everywhere, but most everywhere outside of talking to us, this is the way we naturally relate to risk. If somebody says, "Well what are the odds?" I'm a parachuter. I'm strapped to the jump instructor, and we're getting ready to jump out of the plane. Right before we do I say, "What are the odds this doesn't work out?" We're about to jump out. We're at 13000 feet. It looks like a long way. What are the odds this doesn't work out? He says, "You know what, it's no big deal. Only one in 100000 times does this not work out."

Paul Adams: Here's what your brain does, is what my brain naturally does, is we look at that risk and what we mentally do is we spread the risk equally across all 100000 and make it not that bad of an impact. Like 100000 people jump out of an aircraft and everybody lands slightly harder. And as soon as I start saying that, your brain's already working ahead of me going, "But that's not how it works." How it really works is 99999 of them land fine and one of them makes a dent in the planet. That is the pool of one gamble, because there's a 0% chance of you getting disabled. Zero. It is not going to happen, especially if you're health enough that somebody would actually issue you a disability insurance policy. The odds are as close to zero as you could ever get, or they wouldn't give it to you, unless it's 100%. You see, it's either 0% likely or 100% likely to you.

Paul Adams: If there's a pool of people, you're looking at 100000 people, then you could make a judgment of likelihood. That's what the insurance company does. But to us as individual, catastrophic losses, what it takes is one time happening and it's 100% likely.

Cory Shepherd: It's kind of like the children's message I heard from my pastor once as a kid. The beach full of starfish, sea stars, drying out after the tide had gone out and this little kid throwing a few back in. The dad's like, "It's not gonna make any difference. There's so many out here." And the kid's like, "It matters to this one," and throws it back in the water. It matters to the person that the disability happens to, and it's ... I love that.

Paul Adams: It 100% happens to them or 0% happens to them. And that's more how we have to think about these risks when we're looking at systemic risk on your balance sheet. What are the things that could interfere with everything? I want to say that again. What's the one thing that could jeopardize everything? There might be more than one of those one things. We talk with clients as we're building the moat around their castle. That could be your will and trust. It could be having a proper umbrella policy. Maybe having an appropriate disability insurance or it may be a life insurance policy, but those are one things that could dismantle, jeopardize everything.

Paul Adams: And all we have to do is get them protected and protected properly. By doing so, what do we do? We assure that our plan has the best chance of completing. The appropriate amount and structure of insurance has the opportunity to become assurance that our plans can be complete. Okay.

Paul Adams: I want to do one more philosophical thing and then we could roll into part two, where we dig more granularly into contract, visions, etc.

Cory Shepherd: I'll allow it.

Paul Adams: Very good. Consider this. If you get sued, and somebody invades your balance sheet, what they're actually taking from you, realize it or not, is your time. Your time is what gets taken away from you. If you're 45 years old, you've been working in the marketplace for 25 years, you've accumulated $1 million of assets and you get in a car accident and get sued, what happens? Your time that you've put in thus far is taken from you. If they garnish your wages out to the future, future time is being taken from you, not to mention time in the present and distraction. Everything else it was to deal with a lawsuit like that, hire attorneys, wonder what's gonna happen. Time taken away.

Paul Adams: Same thing happens if you were to get disabled. Because what happens? All the time you put in progressing your career to the point that you make the amount of income you make now, all of that get taken away because now suddenly you can't do your career anymore. Maybe it's not permanent. Maybe it's just a couple of years. Here's what I want to have everybody think about. How many years, if you have 400000 or 500000 of investible assets on your balance sheet, how many years could you provide your current lifestyle before you wiped out everything you've done so far? I'm gonna say that again.

"How many years could you [live] your current lifestyle before you wipe out everything you've done so far?"

Paul Adams: Let's say you're making 350 a year, and you're good, you're really good at saving money, setting money aside in your wealth coordination account, buying assets, but you still have a household that consumes $200000 a year. Maybe you got as low as 150. $150000 of consumption each year would wipe out a $400000 or $500000 balance sheet in a matter of three years, and that's if it's all investible. I didn't count buying or selling your real estate property, all that. It's bad. It wipes out everything you've done so far in a very short period of time. And it steals your future earning potential.

Paul Adams: That's what we're trying to do, is control these controllables with protection so that we can embrace and tilt ... you don't know what you're gonna make the rest of your career, how you're gonna position yourself for the next raise, or if you're a business owner, the next market expansion. You don't know exactly how all that's gonna go, but there's certain things that we can know very clearly and do everything we can to bank on that economic certainty by controlling these controllables and giving ourselves enough time. Because if you save enough money and you don't make any radically speculative investments, all you have to have is enough time to produce the financial future you'd want that includes definite financial independence and being able to have a work optional lifestyle. All you have to have is enough time.

Paul Adams: Getting certain things done, putting the moat around your castle, is buying you the time necessary to make sure that your plans can come to fruition. With that-

Cory Shepherd: I'm gonna hook on a positive note, or places on a continuum. The question you asked was how many years can you provide a lifestyle, right? The person who retires with all the confidence in the world is doing that because they're answering that question with, unlimited. As many as I need. Disability insurance, your income, we're all in this continuum of how do we get your balance sheet to this spot where it can say, I'll give you all the years that you need. It's all one conversation.

Paul Adams: That's it.

Cory Shepherd: It's all one-

Paul Adams: Yeah. It's all still making sure that you have the assets that you want to have for the future to build the lifestyle that you want to have so that you get a chance to design and build a good life. That's it. That's it. Cory, do you want to share with everybody where they can reach us and then they can join us on next week for part two?

Cory Shepherd: Yes. Info@sfgwa.com or our website, SoundFinancialGroup.com, SFGWA.com.

Paul Adams: Connect with us on LinkedIn. Send us a note. Tell us what you'd like to see on future episodes. We'd love getting that from all of you. Or send us a note with something you learned in particular from this. If you want to have a conversation with us about our philosophy, we're always happy to do that to any podcast listener. Spend 30 minutes with you. Share with you a little bit about how we look at money, and give you the opportunity if you want it. You could apply to become a client. Have a great day and we hope this contributed to you being able to design and build a good life.

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