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INVESTMENTS, LLC

Securing your future through Precision Investing™

# Understanding Life Insurance

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## 1. Introduction

Among the financial products which are commonly used by the public life insurance is one of the most complex. This note aims to eliminate the mystery that attaches to life insurance – explaining what it is, what it is good for, what it is not good for and how to use it effectively. After reading this note you should be comfortable you have a thorough user level understanding of life insurance.

## 2. What Life Insurance Is

At its most basic life insurance is a contract between the purchaser and a life insurance company. This relationship has its own little world of terminology. The contract itself is known as the policy. The purchaser is known as the owner or as the policy holder. The company with whom the contract is made is known as the insurer. Typically the purchaser acquires the policy by dealing with a salesman who is known as a life agent. Some life agents work directly for the insurer. But third party agents also are common. They work for independent selling organizations known as insurance brokerages. Typically a brokerage will have several insurers that it works with and it will attempt to match the purchaser with the policy that best meets the purchaser's need within the universe of products supplied by the insurers which the broker works with. Many insurance brokers are independent businesses, but others are subsidiaries of organizations with whom the customer has a natural non-insurance relationship. For instance, banks and automobile clubs often have insurance brokerage subsidiaries.

The life policy defines streams of payments. Payments which the purchaser makes to the insurer are known as premiums. Some policies call for just one payment at the initiation of the contract. Other policies call for periodic premium payments and the contract lasts only as long as the regular premium payments are being made. Payments made by the insurer are known as benefits. The person to whom the benefits are paid is known as the beneficiary. The owner might be the beneficiary but often the beneficiary is someone else. There

are two basic types of benefits: annuity benefits and death benefits.

An annuity benefit pays a periodic cash payment. Typically the benefit starts at a set point in time. It then continues for a fixed number of years, known as the term, or until someone dies. The person whose life determines the length of the annuity is known as the insured. The insured could be the purchaser, the beneficiary or someone else entirely. Some policies depend on more than one insured life, for instance a policy under which a husband and wife are the insureds. A death benefit makes a single payment at the time when someone dies. Again the person whose death determines the payment time is known as the insured. A policy might also make its payment on the last death of two or more insureds. Such policies are not very common however. Finally a policy may provide for a maturity benefit. This is typically a single payment made at the end of the policy. For instance a policy might provide for a death benefit of $1,000,000 on the life of John Smith or for a maturity payment of $1,000,000 to be paid on John Smith's 100th birthday, whichever event shall first occur.

A life policy may either be funded or unfunded. In a funded policy the premium payments made by the owner are credited to a fund. The insurance company invests the fund. Implicitly the funds accumulated in this way are applied to paying the benefits. In a variable life policy the amount of the benefits paid will be coupled to the investment performance of the fund. In this case, the insurer will typically provide a menu of investment options graduated by risk level and the owner will select the investment option which he wants. In a whole life policy the insurer controls the investment of the fund and the benefit level does not reflect the investment results. With a funded policy the purchaser may have the right to cancel the policy before its maturity date. Doing so is known as surrendering the policy and the amount the received by the owner is known as the surrender value of the policy. Insurance companies typically calculate premium payments so the build up of funds will be adequate to pay benefits. It is common for them to charge more premiums than necessary and once the fund is doing well to refund part of the premiums back to the purchaser. These premium

refunds are known as dividends. Insurers like to boast of there dividend paying history and imply that it is the result of their high investment acumen. Actually it may just reflect an initially high premium level – which is definitely less exciting for the purchaser.

Unfunded policies are simpler contracts. There is no fund and no investment selections to make. Benefits are defined independent of investment performance. The policy may be terminated by the owner, but it has no surrender value.

Because the insurers benefit payments depend on the health of the insured, the insurer may require the insured to undergo a health exam. The insurer will also require disclosure of any dangerous or unusual jobs or hobbies engaged in by the insured. Specialists at the insurer known as underwriters assess all this information. They place the insured into a rating class which reflects their assessment of how likely the insured is to die faster or slower than the typical insured. Premiums are then based off this rating class. If a purchaser has unusually characteristics (e. g. is an airplane pilot) many insurers may decline to write coverage (i. e. sell a policy) because they do not have adequate experience with that situation. Life insurance brokers know each insurer's accepted and excluded classes, and so they direct policy selection to the insurers who deal with the insured's particular situation.

Insurance companies face what is known as adverse selection risk. They hang up their shingle advertising a willingness to do business, but the population that responds is not a cross section of the general population. Term life is preferentially purchased by people who fear they may die young, while life annuities are purchased by people who anticipate they may live to very old age. These fears and expectations have enough reality at core that insurance companies experience different statistical outcomes than typical of the general population. The effort to rate purchasers and adjust premiums accordingly is how the companies mitigate the adverse selection risk.

Sometimes the companies are faced with outright fraud – for instance, the person who knows they are dying and who purchases a policy with a large death benefit. Suspicion of

fraud arises when outcomes are too coincidental and they trigger investigations by specialists in insurance fraud. If the company uncovers evidence of fraud it will typically cancel the contract. Then the would be beneficiaries must sue to enforce the contract. This puts to them the challenge of disproving the evidence of fraud. Most people, of course, have no intention of committing fraud. To be sure policies are honored, purchasers should make sure that all necessary disclosures have been made and that there are no inaccuracies. Purchasers should resist the temptation to tweak the numbers in hope of getting a better rating. Making sure the policy is honored is far more important than saving a bit on premiums.

## 3. What Life Insurance Is Good For

Individual lives are uncertain. Some people die young while they are still working with the result that their family does not receive the income they were expected to earn. Other people live into extreme old age and require income year after year to pay their living expenses. Life insurance provides a mechanism to transfer the financial impact of this uncertainty to the insurer. Doing so allows the purchaser to plan better and to mitigate the impact of either early death or great longevity. There are a number of common policy types which aim to address specific concerns.

## 4. Types of Life Insurance

Insurance companies have standardized the contracts they offer into a number of basic types. Typically each type is focused on solving a particular life problem for a person at a certain stage of life. Thus term life and whole life are both concerned with providing a death benefit. However, term life is intended for young people seeking protection against the rare event of premature death. Whole life is for older persons who are actively saving money to provide a bequest and who want to make sure that if an earlier than expected death interrupts their saving program the bequest will still get paid.

Generally speaking term life and disability insurance address the problems of younger people. Annuities, whole life, long term care insurance and tontines address the problems of old people. Variable life could address either group. Even if a

policy is addressing problems that occur in later life, people may start buying coverage in mid life to spread the premium payments over a wider period.

**4.1 Term Life –** A term life policy pays a death benefit when the insured dies during the period the policy is active. It is an unfunded policy. Typically the insured and the owner are the same person and the beneficiaries are the insured's heir(s). The simplest term life policy collects a single premium at the start of the year and provides coverage through the end of the year. The idea is that the purchaser keeps buying the policy as long as coverage is desired. However, there is the possibility that the insured's health would decline during the year and the insurer refuse to renew the policy. To avoid this difficulty one has the multi-year Term policy. This policy is noncancellable by the insurer as long as the annual premium is paid. Such policies will usually provide for a fixed annual premium or one which only increases according to a set schedule. Such policies provide the assurance that the purchaser will not be priced out of renewing the policy. Most term policies have a fixed benefit, but some provide for a benefit which is indexed to inflation.

Term life policies are most commonly used to protect a family against the death of an important wage earner. The death benefit is sized to provide the needed economic security for the family. Another use of Term life is to backstop a mortgage. As long as the wage earner lives the mortgage can be serviced, but if the wage earner dies the mortgage is likely to default. A Term policy paying a death benefit adequate to pay off the mortgage creates the assurance that the mortgage will be paid in full.

**4.2 Annuities –** An annuity pays an annuity benefit. How long the payment stream lasts determines the type of annuity. A term annuity lasts for a fixed number of years. A life annuity lasts for the life of one or more insureds. A life annuity with term certain lasts a least for a minimum term and also for the life of the insureds should that be longer. Life annuities are differentiated by the number of lives insured. A single life annuity has just one insured. A joint life annuity has two insureds and makes payments as long as either insured is alive. It may provide for different levels of

payment, however, depending on whether both or just one insured is alive. Typically the maximum payment is made when both insureds are alive and then the benefit is reduced when just one of the insureds is alive. The benefit paid after the death of the first insured is known as the survivor benefit. Such policies are referred to as joint and survivor annuities. Finally there is the survivor policy. This policy has two insureds, call them A and B. The survivor policy makes no payments before A dies. After A's death it makes payments until B dies. If B dies before A then the policy either makes no payments, or it may pay a death benefit.

Some examples serve to illustrate why these different annuities exist. A term annuity is simply an investment used to generate income. A single life annuity ensures that its beneficiary will have a set income for life. It would be bought by an elderly person who wants to make sure they will always have income even if the live to extreme old age, i. e. they are concerned about the possibility of outliving their savings. A single life annuity with term certain might be used to protect a widow with minor children. Normally the widow's life is expected to exceed the term certain and her income will be used to raise the children. But if she should die prematurely then the term certain ensures the income will continue at least until the children are grown. A joint life annuity could be used to provide lifetime income to a married couple. If the policy is of joint and survivor type the reduced survivor benefit reflects the circumstance that the couple's living expenses decrease once one of them dies. Thus it may provide a better matching of income to cost than a policy with a level benefit. Suppose a situation where A has a life annuity and he then marries B. The couple would like to have a joint life policy. The solution is to purchase a survivor annuity. That annuity in combination with A's existing single life policy then provides them the same payouts as joint life policy would. Finally, if the couple is supporting a child (say a grandchild whose parents have died) a joint life policy with term certain provides the couple with life time income and provides support for the child's growing up should they die before the child is old enough to be self supporting.

Most annuities provide for a level annuity payment and are said to be fixed annuities. If, however, annuity payments go

on for many years then inflation is likely to erode the purchasing power of the annuity income stream. An indexed annuity links its payments to the Consumer Price Index. As a result, the income stream is protected from erosion. A graduated annuity is intermediate between a fixed annuity and an indexed annuity. With a graduated annuity the payment steps up according to a schedule. For instance, one might guess the average inflation rate will be 3% and purchase an annuity whose benefit increases 3% each year. A graduated annuity does not provide full protection against future inflation, but it provides some protection and it may be cheaper than a fully indexed annuity.

An annuity typically does not charge a premium during the period it is paying a benefit. A single premium immediate annuity (SPIA) charges a single premium and commences the benefit period immediately. This is a common type of annuity. A deferred annuity does not start making payments until a later date. A deferred annuity might have a single premium payment, but more common is for it to collect a premium each year until the end of the deferral period.

Normally life annuities do not have a surrender value. However, the insurer may provide for a viatical settlement. Typically the insured has been diagnosed with a terminal disease and is expected to die at a fairly determinate point. The insurance company calculates the amount of benefits that is expected to be paid in these circumstances and pays that sum to the beneficiary as a single lump sum payment in return for canceling the annuity policy. A viatical settlement pay be helpful for paying the extra care expenses associated to the insured's health condition. If a life policy has a term certain then there may be a surrender value associated to the term certain.

**4.3 Whole Life –** A whole life policy is a funded policy. It typically has an accumulation phase and a benefit phase. During the accumulation phase premiums are collected. During the benefit phase an annuity benefit is provided and no premiums are collected. A death benefit is provided up to the maturity date of the policy. At maturity a maturity benefit is provided and the policy terminates.

The most common use of a whole life policy is to provide income in retirement. The accumulation phase corresponds to the owner's working life and a fund is built up. At retirement the fund is used to purchase a SPIA on either the owner's life or on the joint life of the owner and spouse.

Another common use of whole life policies is to pay expenses incurred at death. For instance the owner of a profitable private company may be faced with a heavy estate tax bill when the owner dies. A whole life policy provides a mechanism to gradually accumulate the funds needed to pay the tax. If the owner dies earlier than expected, then the death benefit ensures there will still be a large enough payout to meet the tax.

A similar case is when the owner wants to be sure of leaving a certain bequest to his heir(s.) For instance, an owner could have a child who is a divorced mother raising a family of several grandchildren with little support from the ex spouse. The insurance purchaser might want to leave the mother enough money to purchase a house and to educate the grandchildren. If the insured lives long enough, then enough funds can be accumulated from income to fund the desired benefit but if the insured dies prematurely the death benefit makes sure the inheritance is still provided.

**4.4 Variable Life –** A variable life policy functions similar to a whole life policy but allows the owner to control the investment policy of the fund that is being built up. Typically a medium to highly aggressive investment policy is followed which, if successful, will provide for a higher level of benefits than a whole life policy could. Of course, if the investments are unsuccessful a variable life policy provides less benefit than a whole life policy – an unattractive outcome. To address this issue a variable life policy may provide for a minimum guaranteed benefit. In effect such a policy is equivalent to buying a combination of a whole life and variable life policy where the whole life component is sized to pay the minimum benefit. Whatever premium is left over after paying for the whole life component is then directed to the variable life component.

**4.5 Disability Insurance –** Disability insurance is intended to protect wage earners in much the same way as

term life. An injury that prevents a policy holder from working is the triggering event which initiates payment of disability benefits. Policies generally provide an annuity payment which replaces a percentage of the lost wages. This percentage might be fixed or it might be related to the degree of injury. For instance an injury which allowed the policy holder to work in another lower paid position might pay only the difference in the two pay scales, whereas a full disability benefit would be based on the wage level previously held. A temporary benefit is one which is time limited – generally to a certain number of months. It is intended to provide income while the policy holder is recovering from the injury. A permanent disability benefit is paid to a person who is never expected to fully recover. The US Social Security Program provides some permanent disability coverage. Privately provided disability policies generally plan their benefits to coordinate with the government program.

**4.6 Long Term Care Insurance –** Some people face the need for long term health care, delivered either at home or in long term care hospitals (also known as nursing homes.) Several different paths lead to this outcome. An automobile accident can leave a victim partially or fully paralyzed and in need of extensive personal care. Some slow moving lethal diseases, such as multiple sclerosis, have a similar profile. Many elderly persons become so infirm as their life draws to a close that regular care is needed.

Dementia and mental illness may both result in a need for long term institutional care. Generally government and employer provided health insurance is oriented towards acute care. Acute care involves a pulse of expenditure in a short window of time and is often focused on immediate repair or recovery from injury and illness. Long term care has a different profile. Often it is nursing services which are required. These are less expensive than medical services. But the services must be rendered for long periods of time, often for rest of life which could be anywhere from months to decades.

Long Term Care Insurance is a privately provided insurance which is intended to fund long term care needs. It is a funded policy similar to whole life. Once the need for long term care

is established it pays an annuity like benefit. That benefit may last for a fixed period (say five years) or it may continue for rest of life. Policies with a time limit are mostly oriented towards taking care of elderly people in final illnesses since death usually comes before the coverage runs out. Unlimited policies, by contrast, are more appropriate for young people who face the rare risk of requiring decades of care.

Long Term Care Insurance is similar to Disability Insurance in that the triggering event is a health issue rather than death. The benefit under long term care is tied to the cost of care, however, whereas the benefit under disability insurance is tied to earning power.

The Social Security Program provides a form of long term care coverage. Eligibility is restricted to those who become permanently disabled prior to age 21. This program is oriented towards serving persons with catastrophic birth defects, mental retardation or severe mental illness with early onset. Basically it helps those who never safely make it to adulthood.

**4.7 Tontines –** Tontines were the first form of life insurance. Early tontines were organized around social clubs. The club members would gather periodically for a supper and would pay in a fee to a common fund. This fund would be invested – often in long term government bonds. This pattern would continue for many years and gradually some members of the club would die off. At a predetermined date the fund would be cashed in and the residue paid to the survivors. The benefit would thus represent a combination of the member's personal savings, the return earned on the investment and a share of the funds built up by members who died before the cash in date. This last benefit component would give the survivors a better result than they could have achieved by saving and investing on their own. Basically the tontine provided insurance against living to extreme old age. If you died before the pay out date that was not your concern and you did not need the benefit. But if you lived to the pay out date then that was a present reality and the tontine benefit addressed it.

About 1905 some popular novels were written about tontines in which one member went around killing off other members to maximize his payout. Excited legislators who did not understand life insurance (a then still new idea) got together and passed laws forbidding tontines. After about a century it was realized this was absurd and the laws were repealed. Tontines are gradually making a comeback as they still represent an effective solution to providing a benefit keyed to longevity risk. In modern tontine's however there is no longer a social club hosting monthly suppers. The club is replaced by an underwriter constructed rating class and its members assemble only in the databases of the insurance company. With members no longer knowing each other, the novelistic plots of yore no longer apply.

Tontines are very similar to Variable Life policies but with two subtle differences. First, the tontine has one investment fund for all members, while a Variable Life policy gives each policy holder their own individual fund. Second, in the tontine the benefit of an early death inures to the surviving policy holders, whereas in Variable Life the death benefit inures to the policy holder's designated beneficiaries.

**4.8 Key Man Policies –** A key man policy is a Term Life policy purchased by a company with itself as the beneficiary. The insured is typically an executive of the firm ("the key man".) Generally the unexpected death of the key man would be a serious blow to the company and the death benefits help the company navigate the issues that creates. Key man policies can be purchased by a company owned or controlled by the key man – there does not have to be a complete separation between the two. In this case the key man policy may be an indirect life policy for the owner. To give an example of how such a policy might be used, consider John who has just started a business. Let us suppose he has invested $500,000 in getting the company up and running but so far there is only the beginnings of commercial progress. Were John to die at this point the company would have to shut down and John's investment would be lost. A key man policy with a $1 million death benefit would provide enough funds to shut the company down in an orderly fashion

and return John's initial investment to his estate. As such it may provide the financial security for John's family that allows him to enter into this business venture.

5. Taxation of Life Policies – Special rules apply to taxation of life insurance benefits. In general death benefits are not subject to income taxation. If the beneficiary of a death benefit is someone other than the insured's estate, then the death benefit will not be subject to estate tax. Annuity payments are treated as partly ordinary income and partly a return of capital. A formula determines how much of each payment is ordinary income. This part is taxable while the return of capital is not taxed. The same logic applies to maturity payments. Dividends paid on life policies are treated as a return of capital until the entire capital is returned and thereafter they are taxed as ordinary income. Funded policies may allow you to take loans against the policy up to some percentage of the fund value. Such loans are deemed a return of capital and the loans reduce the basis of the policy. Once the basis is reduced to zero, loan proceeds are treated as ordinary income. Typical the investment returns earned on the fund associated to a funded policy are ignored and not subjected to tax. Instead the tax is recognized when the benefits are paid out. If, however, the build up of value in the fund exceeds a threshold set by the tax authorities then the policy is said to be a modified endowment contract (MEC.) In this case the policy loses some of its favorable tax treatment.

Beneficial tax treatment may provide a reason to purchase a funded life policy. The Federal Government provides 401k plans and IRAs that work similar to a variable life policy. One saves money each year into a fund. One selects how the accumulated funds are invested and the investment earnings are not taxed immediately. Loans may be taken against part of the accumulated fund value. Loan proceeds are typically tax free up to return of basis. At a certain age withdrawls from the fund commence. These last either for a term certain or are in the form of a life annuity benefit. These payments are taxed similar to annuity benefits. The tax authorities place dollar limits on how much can be contributed to a fund each year. Typically the contribution must be from salary income and not investment income. While these Federal programs are a

great way for people with steady incomes to save money toward their retirement, they perform less well for people with variable earnings to save. Salesmen who derive a large part of their income from commissions can experience fluctuating incomes. Business executives paid bonuses based on results of the business can have fluctuating incomes. During high income years, the earner may not be able to contribute as much as he would like to his retirement account due to the dollar limits on annual contributions. And in low income years, the earner may not have the discretionary income required to make a large contribution. For earners with fluctuating incomes a variable life policy that permits variable premium payments may provide a better way to build up retirement savings than does the government's 401k plans and IRAs.

Insurance companies heavily advertise the tax benefits of how life policies are taxed. Insurance companies typically charge a management fee on the funds held in a policy. As a result, they are eager to see funds build up in policies. The tax authorities are less eager to see the insurance companies building up these tax sheltered funds, however. The complex rules about MECs represent an effort on the tax authorities part to keep the companies in the business of providing insurance and not in the business of providing tax sheltered investments. Thus the rules generally provide that a less favorable tax regime applies if the build up of value in the fund is too fast. In this case the tax authorities infer that the policy is more an investment contract than an insurance contract and they deny the preferential tax treatment given to insurance policies.

**6. Regulation of Insurers –** An insurer collects premiums from you today and typically only provides benefits in the distant future. This contract is open to the abuse that the company will collect the funds but fail to pay the benefits. To prevent this abuse the government requires insurers to maintain adequate reserves to pay estimated benefits. These reserves must be invested conservatively until such time as benefits are paid out. Supervision of insurance companies is carried out by state regulators with the result that rules vary somewhat from state to state.

Some states collect a tax on insurance premiums. This tax is deposited to a state guarantee fund. If an insurance company's reserves should prove inadequate to pay contracted benefits, the guarantee fund steps in to cover the deficit. The combination of conservatively invested reserves and guarantee funds makes insurance policies generally quite safe.

The A.M. Best Company publishes ratings of the claim paying ability of insurance companies. On policies from top rated companies there is very little risk in the policies. Purchasers can assume benefits will be paid in full. However on less well rated companies full payment of benefits may not occur. However, even in the worse case that an insurance company goes bankrupt, policy holders will generally be paid ahead of other creditors and will receive at least part of contracted benefits.

## 7. Costs of Insurance

Like many things, the price of life insurance has quite a range. Term life is probably the simplest most generic life insurance product. It does not require a lot of client education and is sold by many different distributors. As a result pricing is quite competitive in the marketplace and this is not a costly product. Whole life and variable life, by contrast, are quite complex products. A life agent will generally need to spend several hours with each prospect to explain the product, walk them through configuring it to their needs and presenting the sales case for the product. The product is sold by a direct sales force of generally fairly aggressive salesmen. Compensating this sales force requires high commissions which are generally paid out of the premium stream. Commissions are also front loaded so that initial premiums go mostly to paying commissions and not to building up the investment fund that is key to the product. Opaque contract language generally hides this unpleasant reality from the purchaser. If, however, the purchaser decides to exercise early surrender rights they may discover that all their premiums have gone to commissions and no actual savings has occurred. These features can make these policies quite expensive.

This moment is a convenient one at which to mention riders. Riders are supplemental coverages which are tacked on to

main policies. Generally riders are not viable stand alone products, but they represent quite attractive additions to the basic policy. Riders on insurance policies function much like options on new car purchases. They give the salesman a chance to enlarge the sale with a fairly easy to sell add on. Just as with cars, purchasers should assure themselves that the basic policy has not been stripped of essential components to get a low advertised price while actually numerous riders will have to be purchased as well to get the needed coverage so that the realized price will be considerably more than the advertised price. Also note that because comparison shopping is usually done on the basis of the basic policy and not riders, the pricing of riders can be more favorable to the company than the pricing of the basic policy. In short, riders can be the salesman's cream. Despite these cautions, there are reasonable riders offered whose purchase should be considered. Typically they have sales cases that are only applicable to some of the purchasers of the main policy and that is why these extra items are broken out as separately priced decisions rather than being standard features of the main policy.

Another reason why life insurance can be costly is regulation. Regulations impose conservative investment policies which restrict investments to lower return possibilities. This results in an opportunity cost which grows dramatically in long lived policies. Variable life policies are an effort to mitigate this problem. These policies transfer the investment decision making to the purchaser and thus avoid the costly prudential regulations. The offset is the high sales cost that may be experienced in these products.

Life insurance is a fairly complex product with subtle features in terms of benefits, tax consequences, borrowing and surrender rights. Pricing is equally complex and often made deliberately opaque. At the same time, life insurance solves real financial problems and in specific circumstances can be the best solution of the problem.

## 8. When to Use Life Insurance

The most basic reason to purchase life insurance is because you need the insurance. Suppose the triggering event were to occur. Would you be able to handle the consequences from

your other resources – for instance by selling assets, borrowing against the equity in your home and perhaps relying on family. Or would the consequences of the event be catastrophic for your family? In the later case you need the insurance.

Insurance is most likely to be needed when savings and other assets are low. The most common cases are a need for term and disability coverage for wage earners with young families or unemployed spouses. A second common case is a need for long term care insurance for elderly couples with no close family to look after them.

Often a need for liquid assets arises at the time of death but immediately available funds are not adequate. For instance most of wealth may be in the form of real estate, private company stock or hard to sell assets like art. Cash may be needed to pay final expenses of the decedent (medical, funeral and burial), to pay immediate ongoing expenses (rents, mortgages and property insurance), to support dependents or to pay estate taxes. The solution is a policy with a death benefit – either term, whole life or variable life insurance. Note that if the named beneficiary is the decedent's estate then the death benefit will be subject to estate tax and funds will be tied up until an estate administrator/executor is appointed (which can take several months.) If the beneficiary is either the ultimate heir or a trust with trustee in place then funds will not be taxed and they will be released as soon as a death certificate is presented. The death certificate is normally available within a month of the decedent's death.

The second reason is for a planning benefit. Insurance passes the uncertainty of life to the insurer and leaves the purchaser with a more fixed and determined situation to manage. The purchaser can then optimize his financial plans to that well defined situation. In particular, he does not need to set aside reserves to handle rare contingencies. Efficient management of resources has greatest value when there are just enough assets and no extra funds from which reserves can easily be created. In the situation of tight finances, which might still be large finances, insurance can be quite useful. This is where life annuities and tontines can play a role. Whole and variable

life also play a role in planning for expenses realized at death or where bequests are important planning objectives.

The third reason is a variant of the second. The insurance product is used in conjunction with other arrangements to ensure that the plan for meeting some goal is met. The example of a mortgage coupled to a term life policy was mentioned earlier. Again one is buying the policy for the certainty it gives rise to.

The fourth reason to buy insurance is for the tax benefits. In our discussion of Variable Life we gave an example of very specific circumstances which could make this an appropriate purchase. In our opinion life agents oversell the tax angle. People do not like writing big checks to insurance companies but they like writing checks to the tax man even less. Salesmen stress the idea of "sticking it to the government" as a way to sugar coat the bitter pill of writing a check to the insurer. While some people will be so circumstanced that this aspect of life insurance is quite important, for most people there are either better ways to handle things or the tax benefits – while real – are not particularly material.

The fifth reason to buy insurance is as an alternative to creating a testamentary trust. During ones life time one has been supporting someone. One wants that to continue for some time after ones death. One possibility is to create a trust in your will (a testamentary trust), fund it with all or part of your assets and order the trustee to apply the assets to providing the support. Doing so incurs all the costs of running the trust. It may also tie up your assets for an extended period of time and delay their payment to your ultimate heirs. This delay can incur the heavy opportunity costs of conservative trust investment management and the heirs inability to apply the funds to their life goals. An alternative approach may be to have your executor purchase an annuity to provide the support you wish to see delivered. That funds the support goal at a fixed known cost and releases the remaining assets for other purposes. Each situation should be analyzed to determine the best course of action. This analysis can be performed by the executor as the estate is being administered. That is generally the moment when the

facts are established most clearly and the best decision can be taken.

The sixth and worst reason to buy insurance is as a savings and investment vehicle. Insurance companies are not particularly astute investment managers – whatever claims they may make otherwise. In addition they are subject to return killing regulations. Finally the primary vehicles they provide for this purpose are whole and variable life (also known as universal life.) These policies are laden with heavy fees. Most people have better alternatives.

## 9. Summary

People have strong opinions about life insurance. They either "believe in it" or they loathe it. We favor a more balanced assessment. Life insurance provides an excellent solution for a number of common real life problems. But it is not the solution to every problem and it is often missold into situations where it is a second best solution.