How much life insurance do I need?

Wrong question!

We are often asked this question or some variation of it. We believe it is **NOT** the right question to ask.

What you **REALLY** need is **money, cash.**

So the question should be – ***"How much cash will I need?"***

Many life events cause a need for cash. At **Petra Life Services** we focus on the amount of money needed at death. Generally, life insurance is an effective way to create cash at death because it is created at exactly the time the cash is needed. That does not mean you ***need*** life insurance. Your needs will be based on your objectives and your cash resources.

A simple, somewhat comical example:

> Two men - same age, same family circumstances (wife, two kids) same financial situation (same income, same assets, same size house, same mortgage, etc.) - one difference – the first man loves his family dearly and wants to leave them financially stable – the other is bitter toward his family and wants to leave them destitute (not a pretty picture, true enough). Their "needs" will be quite different as you can imagine.

We encourage you to see death, at least in this context, as a risk – the risk that there will not be enough cash available to accomplish your financial objectives. We call it your **"Cash Availability Risk."**

There are 3 ways to deal with any risk

1. **Reduce the risk**. This includes changing your objectives or circumstances.
2. **Transfer the risk.** This is what insurance accomplishes.
3. **Accept the risk.** Do nothing. You can certainly decide the risk is small enough to ignore or too costly to reduce or transfer and that you will simply live with it. In effect, you self-insure.

Before you deal with a risk you must see that the risk exists and then determine how big the risk is. That is what calculating your "**Cash Availability Risk**" is all about. What is the risk of not having enough money to fulfill your legacy objectives?

If you have plenty of cash to meet all your needs, you probably don't need life insurance.

There are only 3 reasons to need cash at death in our view:

1. **Commitments**- pay things off
2. **Income**- replace lost income
3. **Liquidity-** provide liquidity to avoid the need to sell good assets at the wrong time, to pay taxes or for other purposes

1. **Commitments – pay things off:** This includes liquidating debts, fulfilling other obligations, or funding your legacy for your family and the personal passions you are committed to, such as a final gift to your church or United Way.
    - These needs usually require a lump sum of money.
    - If you have a lump sum of cash available, you then have the option of paying off debts or not, based on circumstances at the time. However, we always strongly recommend living debt free if at all possible.
2. **Income - replace lost income or a portion of it:** If your income is necessary, when it goes away it may need to be replaced – perhaps for a short recovery period or perhaps for the life of those dependent on the income.
    - There are only two sources of income – people at work or money at work. If you are not at work, you may want to provide enough money at work to provide income.
    - The amount of money you need to provide an income for a fixed period of time, like for 20 years or until age 65, is an easy calculation and varies by the interest rate you assume. The higher the interest rate the lower the amount you need because there is more interest to be earned to help produce the income.

Amount of Money Needed
For $24,000 per year for 20 years

Rate of Return	Amount Needed
3.0%	$ 367,771
5.0	314,048
8.0	254,486

Note:

- We have not adjusted for inflation or taxes.
- This approach is subject to investment risk.

- However, if income is needed for the balance of the lifetime of another person, more complex actuarial calculations may be necessary. These calculations may need to include assumptions as to mortality for the recipient.

- There are two ways to provide income for the life of an individual:

  - **Asset Preservation** – In this approach a pool of money is created anticipating investment income to provide for the income desired. As a simple example, if the need is for $24,000 per year and you feel a reasonable investment return is 6%, a pool of $400,000 may provide the income. Using this approach, you would want to have $400,000 available for investment at your death, dedicated to producing income.

Asset Preservation
Amount of money needed
For $24,000 per year

Amount needed	$400,000
Rate of Return	6%
Annual Income	$24,000

Note:

- We have not adjusted for inflation or taxes.
- This approach is subject to investment risk.

Since none of the pool of money is used for income, the income stream can go on indefinitely (as long as the interest rate holds up). Therefore, this strategy can provide income for the lifetime of an individual and leave the full pool of money for other beneficiaries after the death of the individual.

- **Asset Liquidation** – The Asset Liquidation strategy is exactly what it sounds like – a strategy to liquidate the money over the life of the individual. Since the date of death is unknown, the only way currently available to be certain the money will last for the entire life of the individual is to purchase an income annuity from a life insurance company. The price will vary based on the age of the recipient. The older the individual is the less money that will be needed to provide a lifetime income. The advantage – it costs less. The disadvantage – nothing is left.

Asset Liquidation

Amount of money needed
For $24,000 per year for life

Age when cash flow starts	**Estimated amount needed**
40	$375,000
50	$350,000
60	$315,000
70	$265,000

Note:

- We have not adjusted for inflation or taxes.
- The amount needed is an estimate of the cost of a life only annuity and will vary with prevailing interest rates.
- Payments are guaranteed for the life of the recipient.
- There is no investment risk beyond the credit condition of the life insurance company.

- The following chart summaries the differences in the two strategies.

	Asset Preservation	Asset Liquidation
Core Strategy	keep the assets	spend the assets
Value at death	full value	no (or minimal) value
Advantage	assets transfer to beneficiary	larger cash flow
Disadvantage	smaller cash flow	assets don't transfer to beneficiary
How	live on investment earnings only	live on principal and investment earnings
How to handle Inflation	reinvest a portion of cash flow	program an increasing cash flow or reinvest a portion of the cash flow

- We believe the **Asset Preservation** strategy makes more sense for individuals below age 60 when interest rates are low. For individuals over age 60, the lower amount of money needed using the **Asset Liquidation** strategy may be appealing. Often, a combination of the two is cost effective and appropriate.
- Taxes: These strategies have different income tax implications. For example, Generally distribution from an annuity are only partially taxable because a portion is considered to be a return of principal. You should consult your accounting and tax experts for the details appropriate to your circumstances.

3. **Liquidity – avoid the need to sell an asset before you (or your heirs) want it to be sold:**
   Here are two situations that encourage having cash available at death.

   - **Estate taxes:** When husband and wife both die, Uncle Sam gets his last shot at your money through the estate tax. He wants his tax money in cash. The tax can be significant if your estate is large.
     - Note: There is great uncertainty as to the future existence and size of estate taxes. Legal and tax counsel should be consulted in your planning to help align your plans with the existing tax environment.
   - **Estate equalization:** Let's assume your primary estate asset is a family farm or family business and you want to leave it equally to your children or other heirs. Some of the heirs may want the farm or business while others may only want their share of the inheritance in cash. Problems can arise

when multiple beneficiaries inherit a property that is difficult to segment. Having cash available can help provide the flexibility to allow the property to be given to those most interested in maintaining it while providing a cash inheritance to the others.

Cash can come from many sources. Life insurance is just one of them.

- **Cash and investments.**
- **Retirement Plans, including 401(k) plans and IRA's.**
- **Life insurance or other assets.**

If you don't have enough cash available, life insurance is an effective way, given the uncertainty of the timing of death, to help provide cash at your death. Deciding the amount of cash needed can be challenging given the changing nature of circumstances but estimates can be made with the help of an objective advisor.

An often ignored problem in planning is recognizing that the value of most assets will change over time. Sometimes the value increases and sometimes it decreases. And remember, inflation can change the real value even if the dollar amount stays the same.

As family and business circumstances change, your objectives may change as well. For a plan to succeed in the midst of continuous change, it must be flexibly designed and diligently monitored.

Petra Life Services offers a confidential, proprietary report – our **C.A.R.E. (Cash Availability Risk Evaluation) Report** – that can assist you with the estimates and help you determine what options may best fit your needs to help fill any gaps in your cash availability needs. We also offer our ongoing **Stewardship Support Program (SSP)** to help you keep your plans on target. If you would like to discuss your situation with us please feel free to contact us and we will be glad to discuss how we can help.