THE NEED FOR LIFE INSURANCE-THE MONEY MARATHON - SEPTEMBER 2011

Recently, I recommended life insurance to a young couple who are about to have a baby. This discussion prompted this article.

The place to begin with this discussion is to understand the reason to buy any insurance. That reason is to protect against a financial disaster or hardship. A person doesn't need to insure every risk in life, only the ones that would create a real hardship. As an example, it is a disaster if a person's house burns down (which is a why it is important to get home insurance) or if a person's new car is demolished, (hence the need for car insurance) or if a person is diagnosed with cancer (hence the need for health insurance). However, it is usually not necessary to insure for every small appliance breaking or covering the first small dent a person put on his car (hence a deductible for the insured to pay before the insurance pays). These small items are not financial catastrophes and should be covered out of a person's emergency fund which should be three to six months of a person's income held in a very liquid account like a savings account. Insuring small items is also not cost efficient. This means it is better to self insure for small items that can be paid for out of an emergency fund.

Life insurance may not be needed for everyone. For a single person, it is possible to make the case that his or her death would not cause a financial catastrophe in that there are no ongoing expenses at death. However, even in this case the single person may want to consider the fact that he may not always be single and additionally his health status may change, which may not allow him to buy life insurance cost efficiently.

For a married couple, the issue is if one or both spouses dies what would be the financial hardship on the remaining spouse to maintain their desired standard of living? If they both have jobs and income and one dies would the survivor be able to maintain his or her standard of living with the one salary? Are there debts like a house and or car payments that would be difficult to pay without the two incomes?

When a child or children are involved the question becomes even more important. If one or even worse both parents die, what money is available to pay for the child or children? Recently, I heard the statistic on a television program that the cost to raise a child to age 18, not including college, is $271,000. How would these expenses be covered without life insurance?

The rule of thumb for insurance has been is to own 6 to 8 times the amount of a person's annual income, or 10 times income if there are children. Obviously every person's situation is different based on many factors. Rule of thumbs gives a person a place to start. For example, if a couple earned $60,000 per year, a financial planner might recommend 6 to 8 times that amount in insurance or $360,000 to $480,000; and if there are children involved possibly 10 times the income or $600,000. If both spouses earn the same amount of money both might need to be insured equally. Even if the wife stays at home to take care of the children, it needs to be considered that there would be additional costs to take care of the children in the event of the wife's death. Therefore, it may make since to consider life insurance here also.

The two types of life insurance are whole life insurance and term insurance. Whole life is insurance plus a saving and investment component. Term life insurance is pure insurance with no saving component. There are advantages of whole life primarily that it is a forced savings and the investment portion grows tax free. Even with these advantages, I typically recommend term insurance, because in many cases it is one tenth the price or it is possible to buy 10 times as much insurance for the same price. Then a person could save and invest on his own and hopefully exceed the return from the whole life insurance investment component.

In this particular case, 30-year term insurance of $250,000 for a young person under 30 (non smoker and in good health) was about $25 per month. Alternately, the person could also choose a return of principal (money paid in) at the end of the term; however the cost was about double for this feature. At the end of the 30 years, the hope is that the children are grown and out of the house and the young people have saved enough on their own over this period to protect their income out of their savings.

In the event of the death of one or both spouses, this insurance would allow the surviving spouse to pay off debt and provide at least a cushion for several years to help pay for the child and or provide an additional source of income(interest of the principal) to help cover expenses.

The likelihood of death of a young person is very remote, but that is also what makes the insurance inexpensive. That is what allows an insurance company to offer this coverage by collecting small premiums from a large group of people who are all protecting themselves from a rare but catastrophic event.

Protecting assets and income streams and financial catastrophes is very important and can usually be done very cost effectively. Don't overlook the important financial protection of life insurance.

Remember every investor's situation is unique and it is important to review your specific situation with a financial professional.

Ed Douglas is a Certified Financial Planner/Consultant, Chairman Emeritus of Citizens Bancshares and author of three books, "Making a Million With Only $2000-Every Young Person Can Do It", "The Money Marathon: 7 Simple Steps to Financial Freedom" and his new book " 25 Truths: Winning Wisdom for a Better Life", available at www.eddouglas.com. Ed may be contacted for financial planning services or seminars based on his books at ed@eddouglas.com or 660-646-2066 or at his office at 601 Locust.

25 TRUTHS: WINNING WISDOM FOR A BETTER LIFE. TRUTH NUMBER 7: Be Quick to Apologize. -- Ed's books are available at eddouglas.com, Hy-Vee, Amazon, or Boji Stone.