I Don't Need Life Insurance

by David M. Cordell, Ph.D., CFA, CFP®, CLU®

David M. Cordell, Ph.D., CFA, CFP®, CLU®, is director of finance programs at the University of Texas at Dallas.

DON'T YOU JUST LOVE rules of thumb? For example, as a rule of thumb, there's no problem getting a table at my wife's favorite restaurant on Thursday nights. That rule of thumb was reliable, until the time when our anniversary fell on a Thursday. Aargh!

Rules of thumb in financial planning aren't always reliable, either. For example, one rule of thumb is that the amount of life insurance needed is seven to 10 times annual income. Sometimes it makes sense, and sometimes it doesn't. Even when it works, it's a pretty lame way to approach an issue worthy of serious analysis.

Do I Need Life Insurance?

I don't need any life insurance! Until a few months ago, I had a policy with a seven-figure death benefit, and I let it lapse. No more monthly checking account drafts for me.

Is this heresy in a journal committed to financial planning? I know that life insurance is a critical component of a financial plan, but consider my situation. My children are on their own (more or less). My wife is a retired teacher with a pension, and I have reached full retirement age. Although I still draw a salary, we are blessed to have accumulated

enough money to provide a comfortable retirement for my surviving spouse.

My employer provides a $20,000 death benefit if I die while employed, and $10,000 if I die while retired. We have plans for inexpensive cremation and have already purchased a columbarium niche at our church. We don't have debts that need to be paid off upon my death, so there's no need for a lot of immediate cash. Even if there were, we have sufficient liquid assets that are accessible quickly.

Monte Carlo analysis provides a back-door way to consider the relative need for life insurance.

We don't have legacy issues such as business ownership or a farm that could be problematic to divide equitably among heirs, so we don't need a death benefit for estate equalization. My will is structured so that my wife receives everything and the vast majority passes to her as a beneficiary or as community property. Almost nothing will go through probate, and probate is cheap in our state anyway. It would be nice if we had enough wealth to worry about generating cash to pay for federal estate taxes upon the second death, but we don't. Since we live in a state with no inheritance tax, that isn't an issue.

I should mention that my life insurance policy was a 20-year, level premium version purchased when we had three minor children. I could have continued

that policy at a reduced death benefit for a substantially increased premium. I also looked at the possibility of a smaller policy since my family's need for income replacement is no longer an issue. But why buy something that my wife doesn't need?

The point of having life insurance on an income-generating individual in a family situation is to replace the income. That is the human life value concept of Solomon S. Huebner, founder of what is now called The American College of Financial Services.

Although I still have earning capacity, it is excess capacity at this point. It is not earning capacity that I want to insure. Rather, I want to insure a lifestyle. Notwithstanding the fact that my death would deprive my wife of, ahem, the pleasure of my company, I don't want her quality of life to decline because of finances. On the other hand, I don't want to use life insurance to help her ascend the social ladder after I die! The capital needs analysis approach is appropriate in my case.

What Will Happen to Expenses?

Although my death would cause only a modest decrease in retirement income, the outflows would shrink considerably.

There will be one less car to purchase, insure, fuel, and maintain. Medical and health insurance expenses will drop in half. Travel expenses will decline by half, especially since my wife will have no reason to travel by herself just to get away from me. Food purchases, especially for ice cream, will decrease by more than half. The wine and beer bill will drop by at least three-fourths

because I won't be drinking and she will have less reason to want to drink. The Amazon charges will be totally eliminated. Concerts, plays, museum memberships, and the like will be reduced considerably. We …I mean, she will save at least $20 per year in movie tickets. Maybe she'll cut back on the cable TV bill. (It's easier to eliminate cable than to learn how to operate the six remote controls.)

You're probably thinking, "Yeah, but what about expenses that will increase? Who will take care of the yard, and how much will it cost?" Answer: the same guys who take care of it now, and for the same price. The same HVAC guys will replace the filters. The same pool guys will service the pool. I tried as hard as I could to identify costs that would increase after my demise, but it turns out that the ledger isn't simply unbalanced. It is entirely one-sided.

What about household tasks that I currently perform, but that my wife is not physically able to do? Will my wife have to hire someone to carry the boxes of out-of-season clothes into the attic and bring the in-season boxes down? No need. With me out of the picture, half of the master bedroom closet, dresser, and chest of drawers become available for out-of-season clothes. For other tasks, our two sons would be pleased to help their widowed mother. Ergo, no expense.

This is depressing. It turns out that I am totally dead weight. I am reminded of "It's a Wonderful Life" when Mr. Potter points out to George Bailey that George is worth more dead than alive.

How Much Capital Does My Wife Need?

I approximated my wife's inflation-adjusted financial requirements for the rest of her life, and I assumed age 100. I made a few expense adjustments during that period. For example, we still have a mortgage at a rate that is low enough that there is no reason to pay it off now, but it will eventually be retired. I also allowed for increases in health care expenses due to aging.

I compared these annual expense amounts to the income generated from Social Security and two defined benefit plans, neither of which is inflation adjusted, to determine the size of the deficit that would need to be made up by savings withdrawals.

Enter Monte Carlo Analysis

Many financial planners use Monte Carlo analysis to estimate the probability that a retirement fund balance will last for a specified period. For example, assume that the client has $1 million, wants to withdraw $40,000 per year (the 4 percent rule), and wants the money to last for 35 years. Using the client's specified asset allocation and the means and standard deviations for several decades of stock, bond, and money market returns, Monte Carlo analysis (1) picks a random return for each asset class for the first year; (2) calculates the ending balance for that year; and (3) subtracts the $40,000 withdrawal. It repeats this process sequentially for the remaining 34 years, typically considering inflation in the withdrawal.

The process is replicated with thousands of iterations, each with a different set of returns. The analysis reveals the percentage of the iterations in which the $1 million lasts for the entire 35 years. For example, it may indicate that the fund survives in 95 percent of the iterations. What the analysis typically doesn't show is the terminal amount at the end of the time horizon in each of the iterations. That is, although the fund is depleted in 5 percent of the runs, it doesn't deplete 95 percent of the time and may even have multiplied. (I should note that the terminal amount isn't as interesting to me as it is to my sons.)

The Vanguard website (vanguard. com/us/insights/retirement/nearing/ when-can-i-retire) provides an easy-to-use Monte Carlo calculator that allows the user to play with the starting balance, withdrawals, time horizon, and asset allocation. Of course, it relies on historical returns, which as we know, may not be representative of future returns. Also, the biggest cause of failure other than an unreasonable withdrawal rate is a set of very negative returns at the beginning. This is a particular concern when the stock market is at a peak, as it is when this column was written. On the other hand, post-retirement adjustments are possible, such as postponing pleasure travel and changing asset allocation.

Back to Life Insurance

Monte Carlo analysis provides a back-door way to consider the relative need for life insurance. Let's say the analysis indicates that the client's $1 million will survive 85 percent of the iterations, but the client wants a 95 percent success rate. You can simply increase the size of the fund for the analysis and re-run it. When you identify the fund amount that generates a 95 percent probability of success, simply subtract $1 million from that amount and the difference is the life insurance need. Of course, because the withdrawal amount remains constant, this process essentially reduces the withdrawal rate, which naturally increases the probability of success.

As you probably surmised, before I performed the calculations for my surviving spouse, I performed the analysis under the assumption that we would both live to 100, that is, as a retirement planning exercise. Of course, the probability that our fund will survive is higher if I die as soon as possible. This is yet another reason to suspect my wife if I should come to an untimely and suspicious end! ■