Ashford Advisors
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Creative Wealth Maximization Strategies

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SELF-INSURANCE:
A DIY Project that Doesn't Make Sense

One of America's celebrated cultural values is individualism. We idolize people who are self-made, who rise up from their own bootstraps, who can say "I did it my way." This individualism is part of the American dream, the idea that with enough effort and perseverance anyone can be anything, even President of the United States.

This glorification of individuality not only inspires us to pursue our dreams, it also makes for great marketing opportunities. The essence of the do-it-yourself (DIY) business is if anyone can be or do anything, why not do it yourself?

> Want to build your dream home? You can do it yourself! (With our plans, our materials, our tools.)
> Need a will or trust? Write it yourself! (Using our inexpensive legal forms and advice.)
> Car trouble? Fix it yourself! (The parts store is just down the street.)
> Don't want to pay for a tax expert? File the returns yourself! (Download our program!)

From a popular culture standpoint, there can be an almost *obsessive* compulsion to find ways to operate independently. At the same time, this obsession can lead to a distrust of all large institutions – governmental units, banks, Wall Street, big corporations, even religious organizations. While some institutions perhaps deserve our distrust, it's not always because they are big. Even in America, some large-scale cooperative efforts often yield better results than going it alone.

In Garrett Gunderson's 2007 book, *Killing Sacred Cows*, the author takes on 10 prevailing financial strategies that he believes are harmful "myths" that diminish or deter prosperity. One of those myths is the idea that self-insurance is a profitable strategy.

The DIY version of self-insurance

In a nutshell, self-insurance is the idea that you can accumulate reserves of assets and resources so that you no longer need to pay an insurance company to protect you from the risks of life. If your house burns down, you have the money to rebuild it yourself. If your car is involved in an accident, you could make the repairs yourself – and pay for any damage you might have caused.

Self-insurance is the ultimate DIY financial project, and it has many advocates. From the perspective of the DIY financial gurus, insurance is something that should be bought in the smallest amounts possible, for the lowest price possible, and kept for the shortest time possible.

A prime example is self-insuring one's life. The DIY philosophy is to buy the cheapest term insurance possible in order to devote as much capital as possible to accumulation strategies. In time, the accumulation balance will be large enough so as to make life insurance unnecessary.

Defined this way, self-insurance seems theoretically possible. But is it practical?

> **"Are we better at providing insurance than the insurance companies? Can we provide equal benefits at a comparable price? If so, then we should become an insurance company for more than just ourselves. But if we cannot provide insurance as efficiently as an insurance company, then economically it is much less expensive to use insurance companies."** **Garrett B. Gunderson, from *Killing Sacred Cows***

Self-insurance is really no insurance

Insurance is a method where individuals can share the financial risk by spreading the cost of potential loss amongst many people. But when you self-insure your home, you assume all the risk for any losses that might occur on the property. When you self-insure your medical expenses, all the bills that may result from an illness or injury will be paid out of your pocket. According to Gunderson, "there's no such thing as self-insurance…You either have a way to transfer the risk of loss, or you retain that risk. Self-insurance is really ***no*** insurance."

This might sound like semantics. If you decide you won't buy homeowner's insurance because you have a pile of cash, you don't have insurance, that's true. So maybe the real question is "if I have enough cash, why do I need insurance?"

Gunderson's answer: "Producers (i.e., productive, wealth-building individuals) love insurance because it transfers their risk, and they know it ***saves*** them money in the long run." In other words, the more assets and resources you have, the more ***you should want insurance***, not want to get rid of it.

Gunderson provides the following example: "If a person owns a $1 million home and has no homeowner's insurance, and also has $1 million in cash, where can he invest his cash in such a way as to keep his home protected?"

> **"You either have a way to transfer the risk of loss, or you retain that risk.**
> **Self-insurance is really *no* insurance."**

If he wants to be sure he has fully protected his home, how aggressively can he invest the money? If he is serious about protecting the value of his home, most likely his investment options will be limited to those that are very safe – and lower in rate of return. On the other hand, if a $2,000 annual premium for homeowner's insurance means he can invest aggressively without fear, isn't buying homeowner's insurance a profitable financial transaction?

Risk vs. Return

Mainstream financial commentary often emphasizes the interrelated nature of risk and return in the context of a particular financial product. The typical comment is: higher return vehicles also come with higher risks. But there's another paradigm for risk and return when insurance is involved. Using insurance to decrease risk in one area makes higher returns possible in other areas. Go back to the example of the homeowner with $1 million. With insurance, the homeowner can pursue greater opportunities and still know one of his financial risks (damage to his home) is covered.

Understanding this connection between reducing risk and increasing return through insurance, Gunderson concludes that the most effective financial arrangement is to buy as much of it as possible, and make it the best coverage available.

Here's a quick quiz on a financial concept. Do you know the answer?

Suppose the following:

A 25-year-old college graduate begins his career as an engineer in a very stable industry, earning $50,000/yr. Being the calculating, numbers-oriented type, he projects to work steadily for the next 41 years (through age 65), averaging a 3 percent increase in salary each year. In his final working year, his annual income projects at $163,100, and his total accumulated earnings will be $3.9 million.

The 25-year-old decides not to purchase disability income insurance, but instead intends to build a large savings account should he need to replace his anticipated future income. This plan is put to the test 15 years later when, at age 40, an undiagnosed illness leaves him with a permanent disability.

The engineer has established a conservative portfolio that will deliver 5 percent returns each year. In round numbers, what amount of money must he have accumulated to replace his projected income for the next 25 years (including the 3 percent annual increases)?

$1.1 million
$1.5 million
$2.5 million
$3.2 million

(Answer on Page 6)

The Economic Value of Certainty

When people pool resources to share risk, one of the benefits is a higher level of certainty. Even if something unexpected or undesirable happens – i.e. your house burns down, you suffer an accident – you know you can respond. Knowing that you have decreased or eliminated the risk of financial loss provides a greater level of economic certainty. This certainty allows individuals to make better decisions, pursue bigger dreams, and focus on long-term results.

The value of economic certainty is not just an individual benefit. Entire societies benefit from economic certainty. Historically, tribal and feudal societies often languish at the subsistence level because of economic instability; when you are fearful that enemies or acts of nature may wipe out your wealth in

> **Using insurance to decrease risk in one area makes higher returns possible in other areas.**

an instant, it is hard to commit time and resources to any long-term projects. In his 2000 book, *The Mystery of Capital*, Hernando de Soto declares that capitalism has triumphed in the Western world and failed everywhere else because of two cultural "insurance" factors: the rule of law and property rights. When people know the law will be applied equally and what they have is theirs to use, sell, or borrow against, the certainty allows them to focus on prosperity.

In an August, 2003 opinion paper, financial commentator Les McGuire expanded on the economic value of certainty:

> **What people really want, when their minds are opened to the possibility, is the maximum value in every area of their life with as much certainty as possible. Even those who are self-proclaimed risk tolerant are kidding themselves. We should assume that every one has a risk tolerance of zero, meaning that if it was possible, they would want every economic choice they ever make to work perfectly. No one really wants to lose money; they just think it is a prerequisite to making big money because that is what they have always been told. If they could make the same returns with no risk, everyone would want to.**

Now, More Than Ever, Insurance Matters

For many Americans, one of the consequences of the recent economic upheaval is the loss of insurance. Maybe they no longer have health insurance or group benefits through an employer; maybe they are currently out of work. Even if they are still paying their bills, these people are feeling the effects of economic uncertainty. They know they don't have their risks covered.

At this point, some Americans feel that do-it-yourself reflex take hold. "Well, I'll just have to take care of it myself. I can do without cable TV; I can eat out less often. I'll stop paying the premiums or reduce the coverage amounts for these three insurance policies and use some of the savings to create an emergency fund that will cover anything that might come up. I'm probably better off doing that than wasting money on insurance."

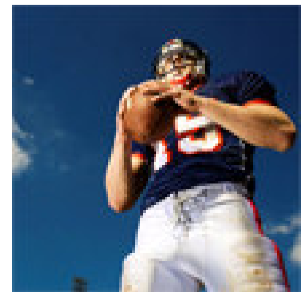
Admittedly, there's sometimes a difference between what's ideal and what you can afford. But right now is not the time to try the do-it-yourself insurance program. You want as much of your financial risk to be shared by as many people as possible, not to have more risk put on you. There are a lot of productive things you can do on your own, but insurance definitely works best as a group effort.

That's why now might be a good time to meet with your insurance professional(s) and review your situation. Their professional knowledge might give you options to rearrange your coverage, yet maintain a higher degree of economic certainty that can help you maintain your prosperity plans, and/or reposition you to succeed again.

- **FEELING THE PINCH OF ECONOMIC TURMOIL?**
- **NEED AN INFUSION OF ECONOMIC CERTAINTY?**
- **USE YOUR INSURANCE PROFESSIONALS TO MINIMIZE YOUR RISKS AND MAXIMIZE YOUR RETURNS!**

WHAT ATHLETES UNDERSTAND ABOUT DISABILITY

Imagine this nightmare: You're an adult, but you wake up back in school.



The instructor greets you with a one-question pop quiz. The question:

"What is your most important asset?"

Huh? What's this about? You're rattled. After all, when you woke up this morning you didn't expect to be transported back to a classroom, let alone take a test.

Things get stranger when you look at the person sitting next to you. Some hulking athlete with a varsity jacket is squeezed into the desk. He gives you a slightly goofy grin, then writes one word on his paper and turns it over.

"Time's almost up," says the instructor. Think quick. What's my greatest asset? My house? My retirement account? The rental property? Hurry up!

You scribble something and hand in your answer. The instructor says you will correct each other's quiz in class. You exchange yours with the jock. His answer, in big, capital letters: **ME**.

Turns out the jock is right. Who'da thunk?

The stereotypical big-time college athlete may be more interested in sports strategies on the field than financial strategies but it seems like many of them understand the importance of disability insurance.

A May 4, 2009 *Sports Illustrated* article "Common Policy" has the subtitle "More draftees insure their NFL careers before they start." *SI* writer Joe Lemire notes the trend among college athletes with the potential to play at the professional level is to obtain disability insurance *before* they begin their paid careers. While some players buy insurance that only covers them for the time between when they end their college careers and sign

their first contract, many high-profile players obtain coverage before their final season of collegiate competition.

The insurance is pricy – the typical premium is around $10,000 for each $1 million of coverage – and many athletes have to borrow to pay the premiums, often using their anticipated future earnings as collateral. Keith Lerner, a financial consultant quoted in the article, said that 20 years ago only about 15% of players drafted in the early rounds by the National Football League had the insurance. In 2009, "nearly every player projected to be drafted that early is insured."

Disability insurance for athletes, sometimes known as high-limit disability insurance, is not just for prospective football players. Several specialty companies (including the famous Lloyd's of London) insure a range of athletes, from jockeys to hockey players, to race car drivers. Occasionally, when a big-name athlete has a large, long-term contract, his or her team will also insure the player. Then, if the player is disabled, the insurance company will pay the team for its financial and on-field losses that result from the loss of the player's services.

The particulars of high-limit disability insurance may vary slightly from conventional disability insurance, but the concept is the same: ***Your ability to earn an income is your most valuable asset.*** And as your most valuable asset, you should consider protecting against the financial losses that could result from losing that ability.

For a professional athlete it's easy to grasp how vital his ability to play is to his financial well-being. But while the activities and incomes may be different, the financial reality is the same: If you can't work, your financial future is limited. Protecting against the risk of disability should be a financial priority.

Some people may believe Social Security or workers' compensation will deliver benefits in the event of a disabling incident. But the statistics don't support this assumption. A May 20, 2009 special feature in the *Wall Street Journal* on disability reported the following:

- 60% of individuals who apply for Social Security insurance are initially denied benefits, which average only slightly more than $1,000/mo.
- The National Safety Council estimates that nearly 90% of disabling accidents and injuries are not work-related.

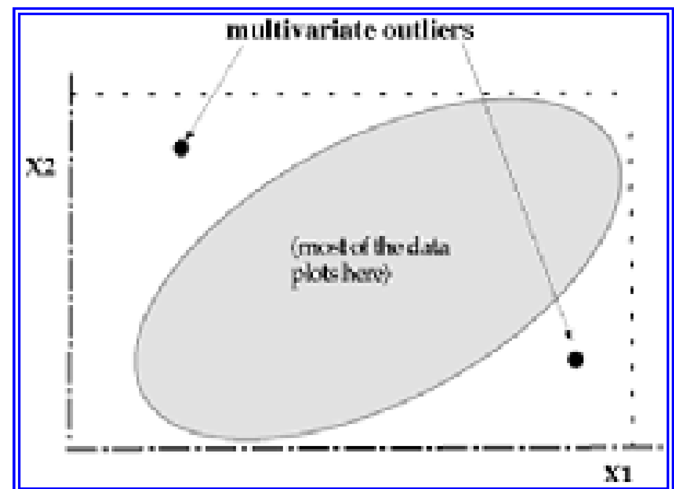
And, contrary to popular belief, accidents and injuries are not the most likely cause of disability. Rather, according to the 2008 edition of the *JHA Disability Fact Book*, "90% of disabilities are caused by illnesses."

Further, an extended period of disability often results in significant financial devastation. A Harvard study of nationwide bankruptcy filings in 2001 found that almost half were caused by medical disabilities.

As fewer Americans find lifetime employment with large corporations, the responsibility for obtaining disability insurance is shifting to the individual. Those who previously obtained coverage as a group benefit offered through their employers may find their best option is to secure coverage on an individual basis. With individual coverage, premiums and benefits can be customized to meet personal circumstances, and the coverage is portable; you may change employers, but the coverage remains with you.

If the jock understands the value of his/her ability to work – and is willing to borrow to protect it – how smart would it be for you to overlook this vital piece of financial protection?

OUTLIERS: Avoiding Them, Becoming One



Outlier: a statistical observation that is markedly different in value from the others of the sample

The word "outlier" is experiencing a surge in popularity, for reasons both good and bad.

Outlier is a term from statistics used to identify information that falls outside the range of what is typical or expected. Because outliers are unusual, statisticians must decide whether or not they are relevant to the particular event or situation they are studying; sometimes outliers are so vastly different from the majority their inclusion can skew calculations and conclusions.

Suppose for example you were making a statistical study of high school seniors and their performance on a college entrance exam. At random, you choose 100 high school seniors from a particular geographical area. Of this random sample, one of the seniors happens to be the brightest high school senior in the United States, and the other is the dullest. While the scores of the other 98 students in the survey group tightly in a range between 18 and 26, the smartest senior has a score of 38 and the dumbest has a 5. These two scores are the outliers, and the statistician doing the study has to consider whether their scores are so far outside the normal range that they should be excluded from calculations of averages, medians, etc. because the scores are so unusual.

On the other hand, the statistician may be prompted by the existence of an outlier to wonder if there's a reason for it being so far outside the normal range. An as athlete, Tiger Woods is an outlier – even among professional golfers, Woods is extra-ordinarily skilled. What factors combined to make Tiger so much better than everyone else? This is the discussion in *Outliers*, a 2008 book from Malcolm Gladwell that tries to find reasons why some people achieve outstanding success while others do not.

If a rare or unusual circumstance could devastate your financial well-being, the only way to effectively deal with it is by assuming it can happen – and taking the appropriate protective and preventive measures.

Some recent statistical reports from the financial world highlight the roles, both positive and negative, that outliers can play in one's financial decisions.

MONTE CARLO MODELS: OUTLIERS NOT ACKNOWLEDGED?

In the past decade, a number of sophisticated financial projection programs have gained popularity in the financial services community. These programs, often called "Monte Carlo" programs, are named after the casinos in Europe, because they assess the odds of specific future outcomes based on historical results from the past.

In a typical Monte Carlo calculation, individuals enter information about their ages, earnings, assets, retirement-plan contributions, investment mix and other details. Using this data, the Monte Carlo calculators then process hundreds or thousands of potential market scenarios, and generate a report which shows the statistical likelihood of different retirement outcomes, from going broke to living large.

While most financial professionals see Monte Carlo models as a vast improvement over calculations made simply on client assumptions of rate of return, inflation, etc., a May 2-3, 2009 *Wall Street Journal* article titled "Odds-On Imperfection" indirectly mentioned the problem of outliers.

The magnitude of downturn in financial markets over the past 18 months has been significant and unusual. As Paul Kaplan, Vice President of Quantitative Research for Morningstar, Inc. noted "the probability of getting one of these extreme outcomes we're seeing is basically zero."

But even though the probability was "basically zero," it happened. Unfortunately, because it was so unlikely, many people didn't feel they needed to plan for it. When the current plunge in economic values occurred, they were unprepared for the loss.

In response, some statisticians are trying to recalibrate their Monte Carlo models to illustrate greater fluctuations and "scarier scenarios." But while resetting the variables may change the reports, it still doesn't get to the heart of the issue: Using math to better identify which events are less likely to occur isn't enough. If a rare or unusual circumstance ***could*** devastate your financial well-being, the only way to effectively deal with it is by ***assuming it can happen*** – and taking the appropriate protective and preventive measures.

PREVENTIVE MAINTENANCE: THE BENEFITS OF BECOMING A HEALTH OUTLIER

A January 6, 2009 *Reuters* online news item, by Will Dunham, titled "More Americans Getting Multiple Chronic Illnesses" began:

"More Americans are burdened by chronic illnesses such as diabetes and high blood pressure, often having more than three at a time, and this has fueled a big rise in out-of-pocket medical expenses."

Some sobering statistics followed:

- Based on government survey data, 44% of all Americans in 2005 had at least one chronic medical condition, which could include diabetes, high blood pressure, high cholesterol levels, cancer, arthritis and heart failure. In 1996, the number was 41%.
- A larger change was reported in the number of Americans reporting three or more chronic illnesses. In 1996, 13% of those between the ages of 45-64 reported three or more chronic conditions. In 2005, the number more than tripled, to 45%. For those aged 65-79 the number rose from 38 to 54%.

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Reduce the odds of having high medical costs in retirement, such as nursing homes, by 75% simply by eating right, exercising and reducing stress.

- Chronic disease increase was seen not just among the elderly, but also in middle age and early old age, and across every gender, ethnic or income demographic.

According to the article, "the rise in Americans with multiple chronic illnesses comes as obesity and sedentary lifestyles have grown more common." Of course, having chronic multiple illnesses results in increased medical costs. The *Reuters* article states that chronic disease accounts for three-fourths of all health care expenses.

The 75% number coincided with another 75% statistic.

Steve Vernon, the author of the book, *Live Long and Prosper,* believes the best way to pay for medical costs is to maintain or adopt a healthy lifestyle now. Echoing the findings of the government studies, "A lifetime of bad habits will result in higher medical costs," says Vernon.

The idea that taking care of yourself can decrease your medical expenses is logical, but not necessarily profound. But the "wow" moment is this: Vernon estimates that preretirees and retirees "can reduce the odds of having high medical costs in retirement, and especially those associated with long-term care, such as nursing homes, by 75% simply by eating right, exercising and reducing stress."

Obviously, the "average" American is not following this advice. But here's one area where being the outlier – instead of average – can pay big dividends, physically and financially.

WHAT IF THIS ADVICE WAS APPLIED TO YOUR *FINANCES*?

Perhaps you could reduce the odds of running out of money in retirement simply by having an action plan for:

- **Saving money regularly**
- **a "protection *first*" plan of risk management (insurance).**

FINANCIAL LITERACY QUESTION: "D.I.Y. DISABILITY"

Answer: b.

In order for the engineer to fully replace his projected income for the next 25 years, he would need to have accumulated approximately $1.53 million by age 40. Since his total earnings for the period from age 25-40 are less than $1million, saving that much is almost impossible. This is the mathematics of self-insurance.

Note: This is a simplified illustration. Withdrawals and interest are calculated annually, not monthly, which would affect the amount needed.

Material discussed is meant for general illustration and/or informational purposes only and it is not to be construed as tax, legal or investment advice. Although the information has been gathered from sources believed reliable, please note that individual situations can vary, therefore the information should be relied upon when coordinated with individual professional advice.

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