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October 2016

## Making Life Insurance “Occam Simple”

**“Simplicity is a great virtue but it requires hard work to achieve it and education to appreciate it. And to make matters worse: complexity sells better.”**  
- Edsger Dijkstra, noted 20<sup>th</sup>-century computer scientist

 ur digitally-saturated culture does not tend toward simple explanations or applications. It’s just too easy to produce a 10-minute video and attach 50 photos, instead of distilling our message into a concise, well-ordered document. But there’s a point where minutely detailed, all-inclusive explanations actually obstruct our comprehension. That’s when it’s time for Occam’s Razor.

Occam’s Razor is a problem-solving principle named after William of Ockham, a 13<sup>th</sup>-century English philosopher and theologian. In his writings, Ockham championed the idea of explaining the universe, whenever possible, in the simplest of terms. His defining statement: *“Among competing hypotheses, the one with the fewest assumptions should be selected.”*

The metaphorical “razor” expressed in Ockham’s writing is the discipline to shave away unnecessary complexity. Simple explanations – even if they contain small inaccuracies – are often the most practical. This is particularly evident in a numbers-driven field like finance. Institutions are in an arms race to roll out ever-more sophisticated models for investing, retirement planning, and financial management. But it is questionable if the fine-grain detail of these programs produces better outcomes.

Take the issue of life insurance. An Internet search for “How much life insurance do I need?” delivers over 26 million results, the majority of them on-line calculators that use a series of consumer-provided assumptions to arrive at a number. Some make their calculations based on a few basic assumptions, like annual income and current age. Others go deeper, taking into account health history, funeral costs, debt, ages of dependents, inflation, college funding, rates of return, etc. Invariably, each calculator arrives at a different amount of life insurance. And greater complexity doesn’t narrow the range of answers.

When complexity leads to greater confusion, it’s time to apply Occam’s Razor. So back away from the laptop. Set aside the smartphone app. Let’s try to make life insurance “Occam simple.”

If you want to optimize the economic benefits of life insurance in your financial plans:

1. Apply for the maximum life insurance benefit available.
2. Buy as much life insurance as you can afford.
3. Keep the largest benefit in force until death.

That’s it. Sure, there might be a lot of details to be worked out (it’s one of the reasons life insurance professionals exist). But as a basic model for life insurance, these are workable assumptions. And although William of Ockham might not think it’s necessary, here is a brief explanation why.

### In This Issue...

**MAKING LIFE INSURANCE  
“OCCAM SIMPLE”**

Page 1

**“TAKE THE ECONOMISTS....  
PLEASE!”**

Page 3

**DEFERRED COMPENSATION  
IN COLLEGE FOOTBALL**

Page 4

**THE REVERSE MORTGAGE:  
USING HOME EQUITY IN  
RETIREMENT**

Page 5

\* The title of this newsletter should in no way be construed that the strategies/information in these articles are guaranteed to be successful. The reader should discuss any financial strategies presented in this newsletter with a licensed financial professional.

## Apply for the maximum life insurance benefit available.

Life insurance exists because people have an economic value that will be lost or diminished when they die, particularly if they die unexpectedly. A life insurance benefit is a lump-sum payment that attempts to replace that economic value. So if life insurance is seen as a desirable component in your financial plans, there are several reasons why it makes sense to apply for as much as possible.

The anticipation of all parties – the insured, the beneficiaries, and the insurance company – is that a claim is not an imminent event; everyone expects death to occur sometime *in the future*. Right away, this means an attempt to insure based on *current needs* cannot be accurate. The only practical way to secure sufficient *future* value is to ask the insurance company for the maximum amount it will offer today, including any guaranteed future purchase options.

The practicality of applying for maximum life insurance can be illustrated by a parallel example of a wrongful death settlement. If someone died due to the negligence of an impaired driver, would a surviving spouse and/or children petition a court for just enough to meet current needs, or for an amount equaling the maximum projected financial value of the victim? We would consider it right and just to award the family the maximum.

A financial settlement in a wrongful death is a de facto life insurance payment. Isn't it equally right and just to apply for the same level of protection from an insurance company that a family would seek from a judge? Don't minimize your economic value. Better to let the insurance company calculate it, instead of relying on your complex – and inaccurate – estimation of needs.

There is another practical reason to apply for maximum benefits: Approval of most life insurance policies is conditional on the health of the insured, and the general trend for health is downward over one's lifetime. Applying for as much life insurance as possible (including options to obtain additional coverage at a later date without proof of insurability) takes into account the fact that every approval may be the last one.

## Buy as much life insurance as you can afford

Just because an insurance company says you're worth \$20 million doesn't mean you'll have the resources to pay for the coverage. Many households, particularly those looking at life insurance for the first time, are going to find that the amount of life insurance an insurance company might offer could exceed their budget. But if you understand the financial principles behind maximum insurability, you'll want to lay claim to the biggest benefit you can afford *today*.

At this juncture, many life insurance discussions veer into the contentious waters of "term versus permanent" insurance. You don't have to go there.

What you want is the maximum benefit now, with options to reconfigure the program later, typically through conversion privileges and future purchase options. For those with budget constraints, term insurance usually is the most cost-effective way to initially secure the highest insurance benefit. It is true that term life insurance is designed (and priced) to expire before the insured is likely to die. It is also true that in order to keep an insurance benefit until death, term policyowners will eventually

change to policies with higher premiums, typically some form of cash-value life insurance. But even though all parties in a life insurance transaction expect death will occur *later*, the biggest financial risk is that it might happen *today*.

## Keep the largest benefit in force until death.

Among insurance instruments, life insurance is unique in that the likelihood of the event occurring is 100 percent. A house may never burn down, a car may never be damaged by an accident, a worker may never become disabled, but everyone dies. This reality creates a unique financial equation: for a guaranteed price, a guaranteed event will result in a guaranteed payment. And, under almost all circumstances, this transaction will be profitable: the final insurance benefit paid to beneficiaries will exceed premiums paid.

When integrated with the other pieces in a financial plan, there are all sorts of ways the financial certainty of life insurance can be used to improve one's overall financial performance. A guaranteed life insurance benefit<sup>1</sup> can be a permission slip to spend other assets, provide a tax-free inheritance, prevent valued assets from being sold to meet estate or tax obligations, supplement retirement income<sup>2</sup>, defray long-term care expenses, and more.

## And here come the "Yeah, buts..."

These three statements are life insurance in a nutshell. Working out the details that proceed from these life insurance assumptions will vary based on individual circumstances, but these principles are reliable guidelines for making productive life insurance decisions. At this point, someone, somewhere, interrupts with, "Yeah, but..." followed by something like:

*"I only need a specified amount of life insurance as collateral for a bank loan."*

*"If I live a long time, the historical returns from other financial products might be higher."*

*"This doesn't apply to me. I'm not married, and I don't have kids."*

*"Buying as much life insurance as possible would make me worth more dead than alive."*

As Seinfeld would say, "Yada, yada, yada." It is possible the details of a specific situation could result in a life insurance decision that seems to contradict the three principles listed above. And there may be some omissions in this explanation of life insurance that a tax expert, actuary, or financial compliance officer would say ought to be included, either as clarifying details, or disclaimers. But remember, the idea of Occam's Razor is to identify essentials that can be used as the basis for practical decisions. In a way, this article is also an intellectual "trimming" as well, an attempt to present some essential concepts without cluttering the discussion with too many details.

The Occam simple takeaway from this discussion:

## Does your current life insurance program reflect these three principles? ❖

<sup>1</sup>All life insurance policy guarantees are subject to the timely payment of all required premiums and the claims paying ability of the issuing insurance company.

<sup>2</sup>Policy benefits are reduced by any outstanding loan or loan interest and/or withdrawals. Dividends, if any, are affected by policy loans and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses, or is surrendered, any outstanding loans considered gain in the policy may be subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first, subject to ordinary income taxes. If the policy owner is under 59 ½, any taxable withdrawal may also be subject to a 10% federal tax penalty.



There are times when you have to wonder if the jokes about economists really aren't jokes. For example, this supposedly humorous observation might actually be true:

**First Law of Economists: For every economist, there exists an equal and opposite economist.**

**Second Law of Economists: They're both wrong.**

It's sort of unnerving how accurately these postulates describe two prevailing opinions regarding current economic conditions, and the proposed solutions.

Right now, there's the group of economists saying people need to spend more to get the economy going. Simultaneously, there's another group of economists declaring people need to save more or they won't be able to retire. Then, there's the ironic twist, where actions intended to stimulate spending appear to increase saving.

**You Must Spend!**

For almost as long as there have been economists, a standard response to an economic slowdown has been to lower interest rates. Theoretically, lower interest rates make borrowing more attractive and saving less attractive. Increased borrowing promotes consumption, which results in a growing economy.

But what happens when interest rates have been lowered to zero and people still aren't spending enough? If you're an economist, you stick with your model and go negative; in several countries today, banks and depositors incur fees for holding cash reserves. When the saving isn't just discouraged, but actually punished, banks will be forced to lend and people will be forced to spend. Right?

Wrong.

An August 8, 2016, *Wall Street Journal* article "Are Negative Rates Backfiring?" reports that efforts by European and Japanese economists to stimulate their sluggish economies with negative interest rates appear to be missing the mark. The results "have left some economists scratching their heads. Instead of opening their wallets, many consumers and businesses are squirreling away more money."

In fact, in economies where interest rates are either close to zero, or negative, borrowing and spending has remained depressed while the saving rate in several countries has increased.

Apparently, the economists are so committed to their models they can't comprehend the thought processes of non-economists. No matter how sophisticated the explanation, individuals and businesses remain wary of a counter-intuitive concept like negative interest rates. Encouraging spending by punishing saving is akin to urging people to buy more food by fining them for owning a refrigerator. The analogy is accurate, but doesn't make sense. And this cognitive dissonance leads to a distrust of the policy makers who are supposedly "managing" the economy, making consumers more cautious about spending, even if money is available.

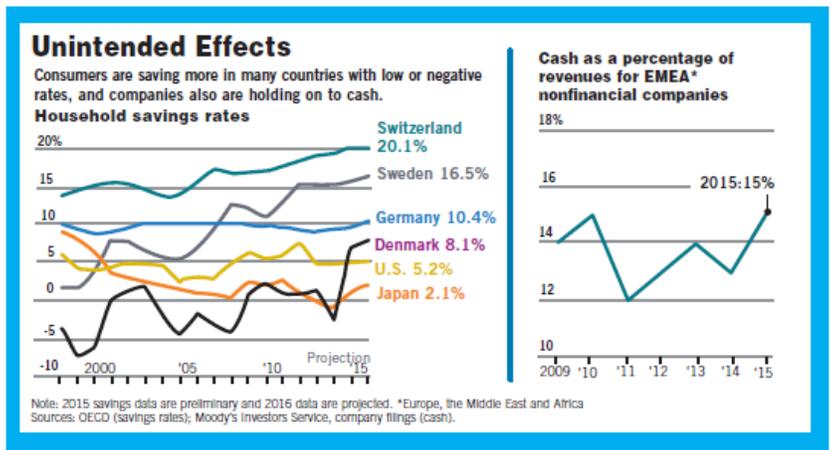
Along with the disinclination to spend, negative interest rates mean those who are committed to saving for retirement have to save even more to meet their financial targets. Heike Hofmann, a 54-year-old German fruit stand owner, told the *WSJ* that negative interest rates seem like "madness," and "I now need to save more than before to have enough to retire." Lasse Bohman, a 63-year old newsstand worker from Stockholm, echoed those sentiments, saying negative interest rates make him want to save more for retirement rather than spend. "I am just going to keep on putting money in the bank," he said, or "put it under the mattress at home."

**You Must Save!**

On the other end of the befuddled-economist spectrum, there is an April 19, 2016, *Atlantic* article by Derek Thompson that asks "Why Don't Americans Save More?" Noting that American saving rates, across all classes, were quite high as recently as the 1980s, Thompson presents five reasons why Americans have stopped saving like they should. Among them:

- **Government policies have made it easy not to save money, and...**
- **American culture has become uniquely addicted to conspicuous consumption.**

Thompson elaborates on these conclusions, noting that retirement plans like 401(k)s are "leaky," i.e., it's too easy to withdraw money before retirement. He cites studies showing that for every \$1 contributed to these plans, 40 cents flows out in the form of premature withdrawals. The flexibility allowed by these plans makes it too easy to spend savings, and sabotages retirement accumulation.



Thompson also suggests that the ethnic and cultural diversity in the US compels people to present themselves as wealthy – even if they have to go in debt – because wealth is a cross-cultural measure of status and acceptance. Thompson believes this is a partial explanation for another paradox that befuddles economists: “American middle-class households pay fewer taxes and save less money than those in many other rich countries.”

But when Americans spend – conspicuously or otherwise – isn’t that what economists want?

### Let Us Take Over

**“An economist is someone who doesn’t know what he’s talking about - and makes you feel it’s your fault.”**

There’s an obvious irony here: When economists want people to spend, they save. And when they want them to save, people spend. But wait, there’s more: It’s your fault their plans didn’t work.

When economic theories misfire in the real world, the experts often attribute it to “user error.” Or user ignorance. Regarding negative interest rates, University of Michigan economist Miles Kimball told the *WSJ* the problem is economists haven’t properly communicated the concept. “They should say this is a normal tool of policy,” he says, and then people wouldn’t freak out. Because once an economist tells you everything is going to be okay, you can take it to the bank, right? (Bad economist pun. Sorry.)

But maybe it’s not enough to improve the message. The populace may be so economically dense that Thompson believes it may be time to forgo explanation and persuasion. The economists need to take control:

**“In a world obsessed with the wizardry of behavioral nudges, perhaps policymakers should consider putting away the magic wand and just do the paternalistic thing: Force people to save more, by expanding Social Security or by creating new forced savings policies. It should be harder for Americans to not have financial security when they retire.**

**Maybe the only way to make people richer in the long run is to take their money away from them.”**

It’s a funny statement, in the way that “funny” can mean a bit odd or curious. But it doesn’t sound like he’s joking.

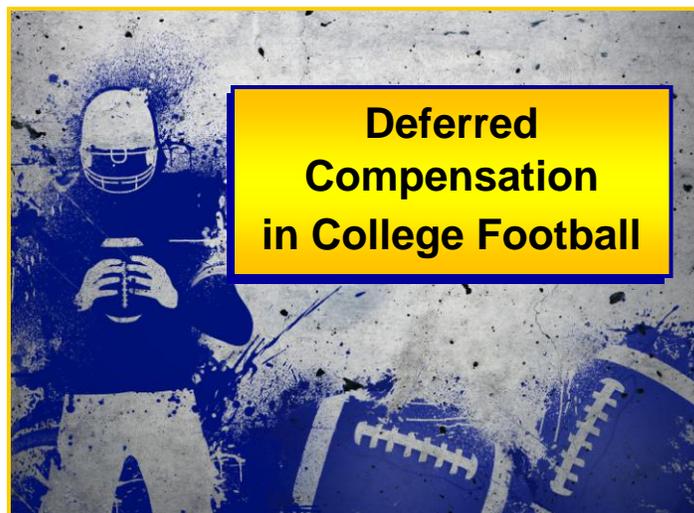
### Who are Your Economists?

Jokes aside, how do you make sense of what often appears to be contradictory or indecipherable economic information? Are there better times to save or spend? Are there financial products or strategies for different circumstances? How do you know?



**One last joke:**  
**An economist is a man who, when he finds something works in practice, wonders if it works in theory.**

With all the funny economic ideas floating around, you need to work with professionals who can articulate principles and strategies that make sense and deliver predictably positive results. You want specialists who use good practices to shape their theories, instead of the other way around. ❖



A popular sports meme says **“Football is life. Everything else is just details.”** Based on recent news, a variation might be **“Football is life (insurance). Check out the details.”**

A Freedom of Information Act request regarding the compensation agreement for University of Michigan football coach Jim Harbaugh revealed the university is adding \$14 million to the second-year coach’s compensation package with a series of loans to purchase life insurance. This is in addition to Harbaugh’s current annual salary of \$5 million.

Some details:

- A \$2 million loan was made June 3, 2016, coinciding with the establishment of the life insurance policy. If Harbaugh is still the head coach on December 6<sup>th</sup>, each year from 2016 through 2021, Michigan extends additional \$2 million loans to cover the annual premium payment.
- As long as the policy remains in-force, Harbaugh is not required to repay the loans. When he dies, some of the insurance proceeds will repay the university, with the rest passed to Harbaugh’s beneficiaries.
- Harbaugh is the owner of the policy, which gives him the right to take withdrawals or loans from the policy.
- If Harbaugh should die during the period when Michigan is paying for the policy, the agreement guarantees that the coach’s family will receive no less than 150 percent of the premium that has been paid, with the net payout growing by \$6 million in 2016 and \$3 million each successive year.
- If Harbaugh decides to leave the school or is fired, the university will stop the loans. If the insurance policy is canceled for any reason after that point, Harbaugh must pay back the money Michigan loaned him.

A source at U-M told ESPN that, while it might seem unusual for a football coach, the agreement with Harbaugh “is a commonplace form of deferred compensation in the corporate world.” The publicized details support this assertion, and highlight the advantages for both the coach and the university.

The FOIA documents didn’t provide specifics regarding the policy, but since Harbaugh is 52, and by all accounts in good health, a \$2 million annual premium will fund a substantial life insurance benefit, immediately increasing financial security for his wife and six children. (ESPN’s Darren Revell tweeted that

“while Michigan hasn't disclosed Harbaugh's life insurance policy, based on premiums, it's worth at least \$35 million,” while a *Detroit Free Press* report calculated the insurance benefit to be “at least \$20 million.”)

Besides securing financial protection for his family, Harbaugh receives several tax advantages. Since the premium payments are considered loans, the coach does not have to report this additional compensation as taxable income. Cash values in the policy can usually be accessed on a tax-favored basis, either as withdrawals or policy loans. Finally, current tax law also allows his heirs to receive the future insurance benefits tax-free.

With the assurance the loans will be repaid, either if the policy is cancelled or when Harbaugh dies, the university has minimal financial risk. It has also given the coach some compelling reasons to stay at Michigan for the duration of his contract. Since Harbaugh has changed coaching jobs four times in the past 10 years, some expressed concern at his hiring that he might again bolt for greener pastures after a few seasons. This type of agreement, sometimes referred to as “golden handcuffs,” provides substantial incentive for Harbaugh to fulfill his contract.

### Is Deferred Compensation Worth a Look in Your Organization?

Deferred compensation agreements using life insurance can be an attractive way to reward and retain key employees. Unlike qualified plans, such as 401(k)s, the terms of these individual deferred compensation agreements, such as ownership, beneficiaries, and control of cash values, can be customized to match the unique circumstances of both the employer and employee. ❖

## The Reverse Mortgage: Using Home Equity in Retirement



One of the dilemmas of home ownership in retirement is whether to keep the home as a residence or sell it to provide additional retirement income. On one hand, a home owned free and clear in a desirable location may allow for a higher standard of living at an affordable price. On the other hand, selling the same property and down-sizing might mean greater net cash flow.

The resolutions to this dilemma are not limited to staying in the home or selling it. In some circumstances, it may be possible to continue living in the same house while also drawing an income from the accumulated equity through an arrangement known as a reverse mortgage.

A reverse mortgage (also known as a home equity conversion mortgage, or HECM) is a home equity loan for older homeowners that does not require monthly payments. Instead, the loan is due only when borrower sells the home, moves out or dies. Repayment is often made by the sale of the property, with any excess equity remaining either with the borrower or heirs.

The very first reverse mortgage was written in 1961 by Nelson Haynes, a banker in Portland, Maine, to allow the widowed wife of his high school football coach to stay in her home after losing her husband. Over the next five decades, the arrangement has become formalized, and today, most reverse mortgages are transacted under guidelines issued by the U.S. Federal Housing Administration. Among the standard provisions:

- 🏠 A homeowner seeking a reverse mortgage must be 62 or older.
- 🏠 The home must be used as a primary residence.
- 🏠 The home must either be owned outright or have a low mortgage balance that can be paid off with proceeds from the reverse mortgage.
- 🏠 There are no restrictions for how the money from a reverse mortgage can be used.
- 🏠 Depending on the terms of the reverse mortgage, funds can be received as a lump sum, a fixed monthly payment, a line of credit, or a combination of the above.
- 🏠 2015 FHA guidelines require reverse mortgage applicants to undergo a financial assessment that includes an income assessment, credit check, and third-party consultation.

Since the lender will not receive any payments of interest or principal until some point in the future, the amount available for loan is a percentage of the home's equity. This percentage is calculated in consideration of several factors, including the borrower's age, the loan interest rate, and the anticipated future value of the property. Generally, the older you are and the more valuable your home, the more money you can get.

With no required mortgage payments, interest on the loan accrues each month. This increasing balance can eventually grow to exceed the value of the home, particularly if the home's value declines, or the borrower remains in the home for a long time. However, at the end of the mortgage the borrower (or the borrower's estate) is generally not required to repay a balance in excess of the sale value of the home.

### Considerations and Caveats

Just because you're a retiree with substantial equity in a home doesn't mean you should take out a reverse mortgage. Steven Sass, from the Center for Retirement Research at Boston College, says a reverse mortgage makes sense for people who:

- Don't plan to move.
- Can afford the cost of maintaining their home.
- Want to access the equity in their home to supplement their income or have money available for a rainy day.

There are many ways a reverse mortgage could enhance retirement. The equity could provide additional income, consolidate other debt and increase cash flow, serve as a reserve

fund for medical expenses or travel. But any consideration of a reverse mortgage also must address other potentially challenging factors.

Whether a borrower can reasonably expect to continue living in the home is a critical consideration. Could failing health, or changing social connections to friends and family prompt a move? If the borrower is married, or being cared for by an adult child, would the death of the borrower mean an eviction for a survivor due to the sale of the house to satisfy the reverse mortgage balance?

Besides the human issues, there are also “carry costs” to consider. Even if the home is owned free and clear, there are still taxes, insurance, maintenance, and the possibility of major repairs to consider. One of the stipulations of a reverse mortgage is that the property must remain in good condition, so a future sale can repay the debt.

### Spending the Equity and Keeping the House

There may be opportunities to integrate a reverse mortgage with other pieces of your financial program such that the retiree can spend the equity, yet still leave the house to his/her estate. From a tax and investment perspective, drawing additional retirement income from a reverse mortgage might be preferable to liquidating assets that would incur capital gains or income taxes. These “unspent” assets can be held in reserve to repay the reverse mortgage when the borrower moves or dies, restoring the home to the estate. Another variation of the same strategy is coordinating a permanent life insurance policy with a reverse mortgage. At the borrower’s death, proceeds from a life insurance policy could be used to repay the outstanding debt.

Even if you’re not ready to retire, this discussion may prompt you to consider how you intend to use your home equity. Do you want to increase your equity or pay off an existing mortgage before retirement? Is there an advantage to positioning a reverse mortgage as a “last asset,” one that can be accessed later in retirement when the payout would be highest? These are questions that can only be evaluated in the context of your other financial assets and unique circumstances. ❖

**The next time you meet with your financial professionals...**

... why not ask them how they see a reverse mortgage working in your retirement plans?

It could be the starting point for expanding your retirement options.

NOTE: Reverse mortgages should not be used for the purchase of securities or insurance products.

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