



What if we told you that nobody needs insurance? You might be surprised to hear this from an insurance advisor, but that's exactly our philosophy. The fact is, life will go on without insurance. Unlike the need for food, shelter, and other essentials, people do not die or become sick or injured because they did not buy a specific insurance policy. So, no, nobody needs insurance.

Why You Might Buy Insurance

So why would you buy insurance?, The decision to buy insurance is a personal one that reflects an individual's values and priorities. It is a decision based on desire more than need. You may wish to create security and peace of mind, to mitigate perceived risk, to shelter loved ones from financial hardship, or to simply build capital for the next generation.

For a high-income or high-net-worth individual, the decision to purchase insurance becomes an investment choice, one that is compared with alternative avenues for allocating capital or income. Perspectives may change based on financial decisions and structure. For example, you may not feel you have liabilities because you reorganized your affairs for estate and tax planning (and subsequent removal of certain tax liabilities), but the original liabilities didn't actually go away. You simply limited the growth of those liabilities. Insurance can provide protection even in those circumstances.

Determining Insurance Cost

Whether you wish to purchase insurance as an individual or for a business, the process always starts with a cost/benefit analysis. You can either perform this analysis yourself or have someone else do it for you. This is where, I believe, we can provide value since the best service we can provide is meaningful information that allows you to make a fully informed decision based on facts.

I don't believe that it is possible to measure the subjective value of insurance. Each person will have a different risk tolerance level based on personal preference and values, and one of our first steps is to determine your natural tolerance to risk. We'll help you identify and understand your ability to deal with unexpected change. Some people thrive when they are faced with uncertainty, while others are anxious. Both reactions are acceptable, and our job is to make sure that our recommendations match your need for security.

Methods Used to Measure Insurance Policy Performance

"What is the cost to meet my unmet need?" you might ask. As insurance advisors, we'll help you understand how to evaluate the cost, so you can make an informed decision.

Space to Breathe



Two methods that most insurance advisors use to measure insurance policy performance include the Simple Cash Flow Comparison and the Net Present Value (NPV).

SIMPLE CASH FLOW COMPARISON - The simplest expression of the cost of insurance is the premium stream. This approach doesn't take into account the time value of money. Consider a typical mortgage, for example. When you pay more than the required interest on your mortgage, you will pay down the mortgage over time; if you pay interest only, the cost would be lower but the mortgage would never get paid off. Insurance works in a similar manner: Higher premiums paid for life may be a better value than a lower initial premium that increases over time. Additionally, some insurance policies allow you to pay extra to accrue a cash value, as well as pay for the insurance coverage. This results in increased coverage over time and potentially creates positive cash flow in the future. Because of these differences, using Total Outlay as the measure of cost or performance is ineffective and inaccurate.

NET PRESENT VALUE (NPV) - One way to deal with an uneven cash flow is to use what's called a Net Present Value (NPV) calculation. This determines the amount of a single lump sum that can be invested at interest to fund all future premiums or cash flows. The challenge with this approach is that the NPV of a cash flow will vary dramatically based on the discounting rate used, and the decision on the discount rate is a subject of debate. A low discount rate will mute the impact of the time value of money, while a high discount rate will magnify the differences. NPV also only provides one value based on the specific time period used in the analysis, and it is cumbersome to provide NPVs for all periods of the analysis. When using NPV, it is crucial to use a discount rate that is relevant to your situation. The Net Present Value method is more sophisticated than the Simple Cash Flow method, but it is still inadequate as a performance measurer.

We do not recommend Simple Cash Flow Comparison or Net Present Value to measure insurance policy performance.

Two methods that we recommend for measuring insurance policy performance are Internal Rate of Return (IRR) and Effective Rate of Return (ERR).

INTERNAL RATE OF RETURN (IRR) - A less traditional method used to measure the efficiency of life insurance is to calculate the Internal Rate of Return (IRR) at an assumed date of maturity. This method provides a benchmark that is not reliant on discount rates. Actual date of death is the only variable that changes the IRR of level death benefit policies with fixed premiums. There is additional variability for policies that have a variable premium, where the death benefit and premiums can vary based on investment returns earned by the cash value within the insurance policy.

IRR calculations treat the policy premiums as cash outflows and the death benefit as a cash inflow. It then determines what rate of return those premiums would need to generate if they were invested elsewhere, so that they would accumulate to an amount equal to the policy death benefit. This rate of return is then compared to other investment opportunities to determine the relative effectiveness of life insurance as a financial instrument.

Space to Breathe



Most life insurance policies have pre-determined premium levels and premium payment periods; however, the date when the death benefit will be paid is unknown. A common practice is to assume that this event will occur when someone reaches their life expectancy. Permanent life insurance pays the full coverage amount of the policy regardless of when death occurs—a major advantage over other capital accumulation strategies. Should death occur in the first year, a life insurance policy would pay a full target amount, while the alternate investment approach would only provide the deposits plus any accumulated investment return. This approach to measuring performance is meaningful and a preferred approach over the other methods previously described, but is not perfect.

EFFECTIVE RATE OF RETURN (ERR) – The shortcoming with the IRR calculation is that it does not account for an earlier death and the value of the instant capital created over and above the accumulated investment account. Since a traditional IRR calculation does not account for an early payout possibility of the target accumulation amount, it's helpful to use a truer comparison calculation that includes an adjustment for the insured payout difference. If it's assumed that term life insurance can be purchased each year to cover the shortfall, it becomes possible to remove the financial risk of an early death. To account for the annual insurance purchase, we simply subtract the cost of that insurance from the alternative investment accumulation account value—this will give a more accurate picture of the true return on the premium investment in the permanent policy, and is, therefore, our preferred method of measuring insurance policy performance.

Calculating ERR

To calculate the ERR at any point in time, we follow these four steps:

1. Add any new deposits to the investment accumulation fund
2. Calculate the amount of term life insurance required to make up the difference for that year based on the shortfall from our target accumulation amount (should death occur in that year)
3. Deduct the cost of minimum cost term insurance coverage from the accumulation fund
4. Add the investment returns on the remaining accumulation fund to the balance

The ERR calculation solves for the investment return required each year in step 4 in order to achieve the target accumulation amount at a point in time (e.g., life expectancy).

Enhancing ERRs

There are a number of ways to enhance the ERR of your insurance coverage. You can:

1. Reduce the net cost or cash flow required to support the desired coverage
2. Increase the death benefit of your coverage over time without a proportionate increase in the cost of the underlying insurance
3. Take advantage of tax benefits created by life insurance to enhance the economic benefit of the coverage

Space to Breathe



COVE CONTINUITY
ADVISORS INC

Measuring Insurance Policy Performance

The Cove Continuity Method

We can help you determine whether insurance is best for your situation. No hard sells. No pressure tactics. We conduct insurance analysis and present best options.

We also use the ERR and IRR methods exclusively, differentiating ourselves from other advisors who mostly use Net Present Value. At Cove Continuity, we start with IRR, and then we introduce the ERR method to provide more accuracy.

In the case of policy performance, we prefer to use ERR.

We use IRR when we compare insurance policies.

We use ERR when we compare insurance to an alternative investment.

Measuring and optimizing ERR is a complex process. It requires testing various approaches through modelling and analysis. It is important to talk to an insurance advisor who has a good working knowledge of this type of modelling. At Cove Continuity, we have an extensive depth of experience and knowledge to provide these analyses.

We can advise on advanced insurance planning strategies and available products, and we have strong relationships with all of Canada's insurance providers to insure that no stone has been left unturned in finding your ideal insurance solution.

Cove Continuity Advisors Inc.

604.924.9152

info@coveadvisors.com

coveadvisors.com

Space to Breathe