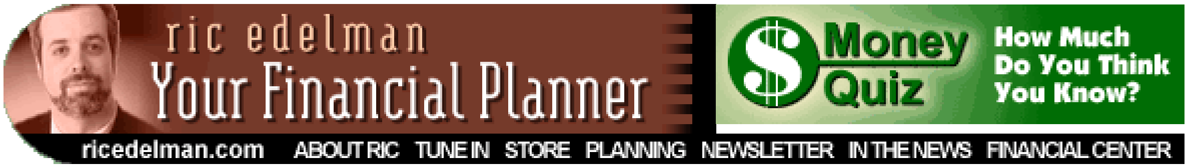

Why You Need Disability Insurance

By Ric Edelman
From The Truth About Money.

Your largest asset is not your house, your health, or your company pension.

For almost everyone who is still working, your largest asset is *your ability to produce an income*. Thus, the most important type of insurance is *disability income insurance* (DI). You need it more than any other kind of insurance — more than life, health, homeowners, or auto insurance. In fact, in my firm's planning practice, we typically are far more concerned that our clients own disability coverage than life coverage.

Although everybody who earns a living needs disability insurance, less than 15% of all workers in the U.S. have it. There are two reasons why:

Reason #1: "It won't happen to me"

I bet you think "bad stuff" only happens to the other guy. Well, to the other guy, you're the other guy. Consider this: 48% of all mortgage foreclosures in this country are caused by disability. When somebody gets injured or ill, they can't work. They then lose their job and thus their income. With no income, they can't make their mortgage payment and the bank forecloses. If you thought people lose their homes because they're deadbeats, alcohol or drug abusers, criminals, or compulsive gamblers, think again. They're good, honest people who merely suffer a disability.

Although only 15% of workers have DI coverage, virtually all home-owners have insurance on their homes. I'll bet you do, too. Yet has any house on your street ever burned down? Unlikely, because the odds of that happening are only one in 1,200.

Yet your odds of suffering a disability before age 65, one that lasts 90 days or more, is an incredible 1 in 8. So if you think it won't happen to you, maybe — just maybe — it might.

In fact, as Figure 11-1 shows, actuaries can predict with remarkable accuracy the probability that a disability will occur. For example, take any five people who are age 45. Statistically, it is 95% certain that at least one of those five people will suffer a long-term disability prior to age 65. Those are pretty awesome odds, and I certainly would not want to bet against them — yet that's exactly what you're doing if you do not have disability insurance.

The Air Bag Phenomenon

Interestingly, the reason you are so likely to suffer a disability is exactly because you are so *unlikely* to die. Since 1960, the frequency of death from the four leading causes have sharply *decreased*, while the frequency of disability has sharply *increased*. I call this the Air Bag Phenomenon.

If you live in a major metropolitan area, you'd agree that there are 10 rush hours every week, one each weekday morning and evening. How often do you hear of a traffic accident in those rush hours?

Every time, of course.

But in how many do you hear that a driver was killed in a rush hour accident? That's much less common. Since fatalities are unusual, most of us don't give those accidents a second thought, other than to complain that someone made us late. But the truth is that someone is getting hurt in those accidents. After all, you're not likely to avoid injury after sustaining a collision at 55 mph.

And that's my point: Due to the advent of airbags, many people now survive auto accidents who 10 years ago would have been killed. But this does not mean accident victims just walk away from the scene. Rather, it simply means they go to the emergency room instead of the morgue.

Indeed, a study by the University of Pittsburgh showed that people protected by an airbag who are involved in a high-speed, head-on collision often suffer a variety of injuries caused not by the collision, but by the airbag itself — including burns to the chest and face, loss of hearing and vision, and broken forearms. Airbags also fail to prevent legs from being broken. And research from the University of Florida revealed that many drivers whose lives were saved by airbags suffer injuries that are not readily apparent to rescue workers, such as lacerations to the liver. Thus, airbags do not assure that you will survive injury-free if you are in an accident.

So while airbags have been very good news for the life insurance industry (as the number of highway fatalities has dropped), it has been bad news for the health and auto insurance industries (which pay the medical expenses of accident survivors).

Indeed, medical advances can be felt far beyond the highway. A generation or two ago, a worker who suffered a heart attack on the factory floor would have died. Today, paramedics and emergency medical technicians arrive in minutes, ready to stabilize and transport the patient to the hospital — by helicopter, if necessary. Throughout much of the country, EMTs are able to install pacemakers *right at the scene*.

And there's more. Has your liver gone bad? No problem. We'll give you a new one. Clogged arteries? We'll predict the stroke before it occurs, give you a quadruple bypass, and you'll be back on the tennis court in six weeks. Failed kidneys? We'll hook you up to a machine that will take over the job.

Modern medicine can do many things. Above all else, it can *keep you alive*. But that doesn't mean you'll never miss a day of work.

Quite the contrary. In a study of more than 2,000 severely ill patients from five medical centers around the country, the *Journal of the American Medical Association* reported that nearly a third of the families lost most of their life savings as a result of the patient's illness. The study found that although 96% of patients had some form of medical insurance, 31% still lost their savings.

"Home care and disability costs may now be more devastating to patients and their families than the costs incurred in the hospital," said the study. These expenses include the unreimbursed costs of home care, health aides, special transportation, and related medical costs. In addition, 29% of the families studied lost a major source of income, either because the patient no longer could work, or because another family member had to quit a job in order to care for the patient.

So if you think a disability won't happen to you, or if you think it won't result in a financial burden, think again.

Reason #2: "It's Too Expensive"

Without question, DI coverage is expensive. Annual premiums can be 1% to 3% of your annual salary. And that's why many people ultimately reject DI insurance. "I can't afford it," they say.

Turn this argument around. The reason you need to buy disability insurance is exactly why you don't want to buy it.

Have you ever seen one of those insurance commercials on late-night TV? "For just two dollars a week... you cannot be turned down... veterans only..." and other nonsense. These policies are only two bucks a week because the insurance companies know they're not going to pay a claim!

If you look at the fine print, you'll see that the benefits for the first several years often are limited to a return of the premiums you've paid, minus administrative costs. Since most buyers of this awful coverage are a gizzillion years old, the carriers know the buyers will die before they qualify for a claim. Thus, the carriers collect $2 a month, for which they do nothing in return. That's why coverage is so cheap. For the carrier, that $2 premium is virtually pure profit!

This is the main thesis of the insurance world. A policy is cheap when the insurance company knows it is unlikely to pay a claim. But policies are expensive when there is higher probability that you will file a claim. Therefore, the more expensive the policy, the more you need the protection.

Think Like the Seller

It might help if you examine the situation from the insurance company's point of view. If only one house in 1,200 is likely to burn down and each house is valued at $250,000, then how much does an insurer need to charge each of the 1,200 homeowners to be able to pay the claim for the one house that burns down? The answer is:

$$\frac{\textbf{1 Claim of \$250,000}}{\textbf{1,200 Homes}} = \textbf{\$208/Per Home}$$

Toss in administrative expenses, profits, and payouts for other forms of damage, such as lightning, theft, and flood, and the typical homeowner's insurance bill is about $350. Thus, from the insurer's perspective, the cost of a policy is directly related to the likelihood and cost of a claim. This explains why homeowner's insurance is cheap, and why DI coverage is expensive.

The Cost of Disability vs. The Cost of Death

Look at Figure 11-3. Mike, a 35-year-old male nonsmoker in good health, buys a $250,000 life insurance policy. If Mike were to die, the insurance company would owe his survivors $250,000.

On the other hand, if Mike bought a $2,000 disability income policy and suffered a disability, the insurance company would owe him $2,000 per month — for as many as 30 years. That would be as much as $720,000 in claims!

That's why disability insurance is expensive — and why you need it.

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