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FINANCIAL PLANNING 2.0

Second in a series **By SCOTT BURNS and LAURENCE J. KOTLIKOFF**

In his day, Andrew Carnegie was the world's richest man. He was also one of the most humble and generous people to ever walk the Earth. He attributed much of his success to others. Following his dictum – "The man who dies rich dies disgraced" – he donated his entire estate to charity.

Carnegie was particularly passionate about education and educators. In 1918, he endowed the Teachers Insurance Annuity Association, now known as TIAA-CREF, to help ensure the financial well-being of our nation's teachers.

Over the years, TIAA-CREF has done a fine job fulfilling its mission, not just for teachers, but also for the general public it now serves. It does high-quality research and delivers low-cost investment management.

But we've got a complaint.

The one area the nonprofit has fallen short is financial advice. Here the company seems more concerned with marketing.

Case in point: TIAA-CREF has not one, but two, life insurance calculators on its Web site.

The Simple Life Insurance Calculator has five questions.

The Detailed Life Insurance Needs Calculator has 20 questions.

Both ask you how much of the insured's earnings needs to be replaced and for how long. They both advise using a 75 percent income replacement rate if the household has no mortgage. They advise a higher rate if it does.

Both calculators solicit your mortgage balance and college and emergency funding needs. The Detailed Calculator also asks about household demographics, assets, taxes, inflation and the rate of return on one's assets.

Neither asks about the surviving spouse's or partner's current earnings, future earnings or retirement date. This is a remarkable omission: The fundamental goal of life insurance is maintaining the household's living standard.

You can't understand insurance needs without knowing the living standard that needs to be protected. And you can't calculate the household's living standard without knowing about all its economic resources, including those of the surviving spouse.

The calculators also ignore child, mother, father, widow and widower Social Security survivor benefits – another huge omission. There's nothing about the survivor's planning horizon, housing plans, pension benefits, retirement accounts or a host of other factors that can make a major difference when you're determining your life insurance needs.

Big difference

Does it matter? Yes.

Take the Middles – a middle-age, middle-class California married couple with two children.

Both parents are 40. The kids are 7 and 10. Mr. Middle earns $75,000 per year. Mrs. Middle earns $50,000. The couple has $75,000 in regular assets and owns a $300,000 home with a $125,000 20-year mortgage with monthly payments of $1,250.

Property taxes, homeowner's insurance, and maintenance total $6,000 per year. The couple plans to spend $25,000 in today's dollars on college tuition and other expenses for each child for four years.

Each spouse will retire at age 65 and begin collecting Social Security benefits in that year. Both spouses have experienced 4 percent wage growth since they started work at age 22. The couple expect inflation to run at 3 percent annually and to earn a 6 percent nominal rate of return on savings.

Using an 80 percent lost-earnings replacement rate assumption, TIAA-CREF's Simple Calculator tells Mr. and Mrs. Middle to buy a whopping $1.825 million and $1.325 million in life insurance, respectively. The Detailed Calculator tells them to buy a bit less: Mr. Middle, $1.054 million; Mrs. Middle, $777,790.

If the couple were to follow TIAA-CREF's Detailed Calculator's recommendations, they'd pay close to $3,000 in premiums, or 2.3 percent of their combined annual earnings. If the couple follows the Simple Calculator's advice, they'll end up spending over $5,000, or 4.0 percent of their earnings. This is a lot of money to pay for insurance they don't need.

Smoother technique

In the first article of this series, we explained the theory of consumption smoothing, a method of calculating and maintaining your sustainable lifetime standard of living. Using ESPlanner, Mr. Kotlikoff's company's financial planning program, people adjust the amount they save over their lifetimes.

According to ESPlanner, Mr. Middle needs $485,000 in coverage and Mrs. Middle needs $129,000 to smooth their consumption. This will ensure survivors with the same living standard, assuming they live to age 95.

If you're beginning to think that TIAA-CREF is some kind of villain, don't. It's simply following common industry practice. Virtually all of the many life insurance calculators share a common trait: They systematically inflate life insurance needs because of the calculation methods they use.

This series is about finding the best financial planning tools available. We're using ESPlanner for comparison purposes, but we're not suggesting that every reader run out and pay $149 for software, which Mr. Kotlikoff profits from. What we do recommend is that financial planners and serious investors should realize the limitations of some of the traditional tools in the marketplace.

We point to TIAA-CREF because it provides two calculators, not one. There aren't two answers to the question of how much life insurance a household needs. So if TIAA-CREF believes that $1.825 million is the right amount of life insurance holdings for the husband in our stylized household, why does it offer its Detailed Calculator, which tells Mr. Middle to purchase only $1.054 million in life insurance?

Alternatively, if TIAA-CREF believes that $1.054 million is the right coverage for Mr. Middle, why does it provide the Simple Calculator that will lead him to dramatically overinsure?

We think there is a clear answer: Marketing.

As with most financial institutions, the primary goal is selling insurance policies. Whether the amount of insurance is appropriate is secondary.

When we called TIAA-CREF senior vice president Bret Benham for comment, he said, "Our site clearly states that the simple life insurance calculator is intended to provide customers with a rough approximation of the amount of life insurance needed if death occurred today, but we recognize that the actual amount required to help meet dependents' needs may be higher or lower than the amounts shown."

An $800,000 difference, on their own calculators, is a pretty good demonstration of "rough."

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