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Published in *The Chartiers Valley Source*
OCTOBER 2007

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Big Ed and His Lousy Life Insurance Policy

While defined-contribution retirement plans like 401ks are becoming far more common than defined-benefit pension plans, many workers still participate in pension plans. And as they near retirement, a very important decision awaits – which pension payout option to select?

While some retirees with pension plans have the option to select a “lump-sum” payout and roll it into an IRA to avoid current taxation, for the purpose of this article, we’ll look at those people who must select between a monthly payout for the duration of their life or a joint and survivor payout to provide security for their spouse.

Let’s talk about Big Ed. After many years at the Amalgamated Business Corporation (ABC), Big Ed will retire soon and his ABC pension benefit will be as follows:

$3,000 per month for his life only (single life payout) or
$2,600 per month for life (for his life), with 50 percent ($1,300 per month) for his wife Karen for the rest of her life (joint and survivor) should he die first.

Big Ed loves his wife, and he wants her to be financially secure should he pass away first. So he’s inclined to take option two. But what he doesn’t realize is that by taking option two, he’s essentially buying into an extremely poor life insurance policy. Let’s look more closely.

Life Insurance Option #1- ABC Life Policy
Big Ed might have thought he was absolutely done buying life insurance. He had it all those years when the kids were little, and now that he was retiring, it’s not needed. But without even realizing it, Big Ed is now going to buy a “life insurance policy” from ABC, which is exactly the definition of a joint and survivor pension.

The problem is that it’s a lousy policy. What would Big Ed have said if an insurance salesman showed up at his door offering a policy with these features:

1) $400 premium for life – no option for paying it up more quickly
2) Builds no cash value – pays no dividends
3) Can’t ever change the beneficiary – even if Karen dies first
4) If Karen does die first, Big Ed still pays the $400 premium for the rest of his life
5) Kids never see a penny of his pension after his death

Life Insurance Option #2- PRIVATE Life Policy

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But luckily, Big Ed realizes that this is a poor option, and instead consults with a financial advisor who explains that a privately purchased policy may offer certain advantages, assuming that Big Ed is in good health and is insurable. Opting for a private policy is often a good option, but might not be for everybody. So Big Ed and his advisor consider the following:

1) He needs a policy large enough so that the proceeds could generate at least $1,300 per month, the same amount that Karen would have received
from the ABC survivor option.
2) The size of the policy, Big Ed's age, health and smoking status will determine the premium.
3) The premium may be "quick paid," based on the performance of the policy and/or Big Ed paying in a larger premium or a lump sum up front.
4) If Karen dies first, Big Ed may choose to keep the policy active and name his children as the beneficiaries. He may also cancel the policy and put any cash value in his pocket. By doing so, he in effect "gets a raise," since he'll no longer be paying insurance premiums.

Certainly, any pension-maximization strategy is not without risks. First, if a private policy is selected over a joint and survivor pension option, it is imperative that the policy remain in force and not lapse, otherwise the surviving spouse would be left without any "pension" income.

Annual reviews must be conducted to ensure the policy's viability. In some instances, the selection of a single life-only pension could jeopardize medical benefits of the surviving spouse. Finally, the life insurance proceeds must be sufficient enough to at least equal what the joint and survivor option would have generated.

Caveats aside, persons retiring within the next five years and covered under a pension plan would be well advised to begin to understand their pension choices and consider the option of pursuing a private policy as an alternative to the pension policy, which could represent the most expensive and least flexible life insurance policy they'd ever imagine buying.

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