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Disability Insurance Basics

We continually tell our clients and prospects that the most important thing they do for their families (at least financially) is provide an income. Without a steady and growing stream of income, all other financial goals are subject to failure. A few months ago we spoke about life insurance basics. This month we will focus on disability income insurance.

A disability income insurance policy could make the difference between financial security and financial hardship. The amount of individual disability income insurance you should buy depends on three things: how much income you'll need if you become disabled, how much money you can afford to spend on premiums, and how much insurance you'll be able to purchase under the insurance company's guidelines.

It's hard to know exactly how much income you'll need after you suffer a disability, but you'll probably need more than you think. Most of your fixed expenses won't change, and while you may save money on work-related expenses such as clothing, commuting and lunches out, you'll also spend more on other items.

Medical expenses will increase because you'll probably have to satisfy a deductible as well as an out-of-pocket maximum, which may increase your expenses immediately after your disability occurs. If you suffer a long-term disability and are forced to quit your job, your group medical insurance coverage may be terminated. If you work for a large enough employer, you may be able to continue coverage on your employer's plan through the government regulation known as COBRA, but you'll have to pay the premium yourself.

Living expenses will also increase because you may need to hire household help to take care of day-to-day activities that you can no longer do. Child-care expenses will continue if one of you is not working although your family income will decline. The healthy spouse may be forced to return to work if the other spouse is disabled.

You may already be covered by some disability income insurance through your employer. This may be short-term coverage, long-term coverage, or both. Short-term coverage pays a weekly benefit, usually after the first day of an accident or the eighth day of an illness, for a period of 13 or 26 weeks. Long-term coverage pays a monthly benefit that begins after the short-term period expires. The benefits are usually paid until age 65. You may be ineligible to buy any additional coverage, unless your employer's plan limits the maximum benefit to an amount that is less than 60 percent of your annual income. In many cases, income from bonuses or commissions is not covered by disability insurance.

You shouldn't depend on getting disability benefits from Social Security. Social Security pays benefits only under strict definitions of disability, making it very difficult to qualify. Also, benefits are limited and may not be adequate for your needs. Review the coverage available to you, take a look at the specifics of any group disability policies you already are covered by, then decide whether you need more disability coverage.

Once you've decided that you need to buy more disability income insurance, you should aim to cover a significant portion of the income that you will lose if you become disabled. However, you may not be able to buy as much coverage as you want. The insurance company determines the maximum amount of disability income insurance you can purchase, based on your income, health, age, and the amount of other disability benefits you're entitled to. Most companies will sell you insurance that replaces 50 to 70 percent of your monthly pretax earnings (of course, you can opt to buy less than this amount).

Disability income insurance is one of the most important protections you can buy. In a future article, we will discuss some of the features one should consider when buying such a policy.

On the Road to Retirement, Beware of These Five Risks

No investment strategy can guarantee success. All investing involves risk, including the possible loss of your contribution dollars.

There is no assurance that working with a financial professional will result in investment success.

On your journey to retirement, you'll likely face many risks that have the potential to throw you off course. Following are five common challenges retirement investors face. Take some time now to review and understand them before your journey takes an unplanned detour.

1. Traveling aimlessly

Setting out on an adventure without a definitive destination can be exciting, but probably not when it comes to saving for retirement. As you begin your retirement strategy, one of the first steps you'll need to take is identifying a goal. While some people prefer to establish one big lump-sum accumulation amount — for example, $1 million or more — others find that type of number daunting. They might focus on how much their savings will need to generate each month during retirement — say, the equivalent of $5,000 in today's dollars, for example. ("In today's dollars" refers to the fact that inflation will likely increase your future income needs. These examples are for illustrative purposes only. They are not meant as investment advice.)

Regardless of the approach you follow, setting a goal may help you better focus your investment strategy. In order to set a realistic target, you'll need to consider a number of factors — your desired lifestyle, pre-retirement income, health, Social Security benefits, any traditional pension benefits you or your spouse may be entitled to, and others. Examining your personal situation both now and in the future can help you determine how much you may need to accumulate.

2. Investing too conservatively...

Another key to determining how much you may need to save on a regular basis is targeting an appropriate rate of return, or how much your contribution dollars may earn on an ongoing basis. Afraid of losing money, some retirement investors choose only the most conservative investments, hoping to preserve their hard-earned assets. However, investing too conservatively can be risky, too. If your investment dollars do not earn enough, you may end up with a far different retirement lifestyle than you had originally planned.

3. ...Or too aggressively

On the other hand, retirement investors striving for the highest possible returns might select investments that are too risky for their overall situations. Although you might consider investing at least some of your retirement portfolio in more aggressive investments to potentially outpace inflation, the amount you invest in such higher-risk vehicles should be based on a number of factors. Appropriate investments for your retirement savings mix are those that take into consideration your total savings goal, your time horizon (or how much time you have until retirement), and your ability to withstand changes in your account's value. Would you be able to sleep at night if your portfolio lost 10%, 15%, even 20% of its overall value over a short time period? These are the types of scenarios you must consider when choosing an investment mix.

4. Giving in to temptation

On the road to retirement, you will likely face many financial challenges as well — the unplanned need for a new car, an unexpected home repair, an unforeseen medical expense are just some examples.

During these trying times, your retirement savings may loom as a potential source of emergency funding. But think twice before tapping your retirement savings assets, particularly if your money is in an employer-sponsored retirement plan or an IRA. Consider that:

- Any dollars you remove from your portfolio will no longer be working for your future
- You may have to pay regular income taxes on distribution amounts that represent tax-deferred investment dollars and earnings
- If you're under age 59½, you may have to pay an additional penalty tax of 10% to 25% (depending on the type of plan and other factors; some exceptions apply)

For these reasons, it's best to carefully consider all of your options before using money earmarked for retirement.

5. Prioritizing college saving over retirement

Many well-meaning parents may feel that saving for their children's college education should be a higher priority than saving for their own retirement. "We can continue working, if needed," or "our home will fund our retirement," they may think. However, these can be very risky trains of thought. While no parent wants his or her children to take on a heavy debt burden to pay for education, loans are a common and realistic college-funding option — not so for retirement. If saving for both college and retirement seems impossible, consider speaking with a financial professional who can help you explore the variety of tools and options.

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Life Insurance with a Refund

The cost and availability of life insurance depend on factors such as age, health, and the type and amount of insurance purchased. Optional riders are available for an additional fee and are subject to contractual terms, conditions, and limitations as outlined in the prospectus and may not benefit all investors.

The return of premium, as well as any other guarantees related to life insurance, are contingent on the claims-paying ability and financial strength of the issuer.

All investing involves risk, including the possible loss of principal, and there is no guarantee that any investment strategy will be successful. There is no assurance that working with a financial professional will improve investment results.

Comparatively speaking, of all the different types of life insurance available, term is usually the least expensive. Generally, term life insurance provides protection for a stated or defined period of time, usually from one year to 30 years. If you die during the coverage term, your beneficiary receives the death benefit from the policy. But what if you outlive the term? With return of premium (ROP) life insurance, you receive the return of all your premium payments at the end of the policy term if certain conditions are met.

What is ROP?

Variations may apply, but generally ROP is term life insurance coverage for a specific number of years (term). The face amount of the policy, or death benefit, is paid to your beneficiaries if you die during the term. But unlike straight term, if you live longer than the term, all of your premiums are returned to you with ROP as long as the policy was in good standing and in force at the end of the term. Some insurers even pay back a prorated portion of your premium if you cancel the ROP term insurance before the end of the term. Also, the premium returned generally is not considered ordinary income, so you won't have to pay income taxes on the money you receive from the insurance company. (Please consult your tax adviser.)

Some particulars

Unlike permanent cash value life insurance, ROP premiums generally do not earn interest or appreciate in value. Also, the premium returned usually does not include the return of added premium charges for substandard coverage (extra premium charged for poor health) or costs for certain policy riders (extra premium you pay for benefits added to the basic term policy, such as a disability rider).

The cost of ROP can be significantly greater than straight term insurance, depending on the issuer, age of the insured, amount of coverage (death benefit), and length of the term. But ROP almost always costs less than permanent life insurance with the same death benefit. While straight term insurance can be purchased for terms as short as one year, most ROP insurance is sold for terms of 10 years or longer.

Is ROP right for you?

Before you buy life insurance, you should know how much insurance you need. Your need for insurance is based on numerous factors, some of which include your current age and income, your marital status, the number of incomes in your household, your number of dependents, your long-term financial goals, the amount of your outstanding debt, your existing life insurance, and your other assets. You should also consider your overall financial, estate, and tax planning goals as part of your insurance needs evaluation.

Term insurance is appropriate for situations when there is a high need for insurance but not much cash flow to pay for it. For example, a young family with limited cash resources may have a great need for survivor income to provide for living expenses and education needs. Also, term insurance may be appropriate to cover needs for a limited period of time, such as coverage during your working years, your children's college years, or for the duration of a loan or mortgage.

Whether to consider ROP term insurance usually revolves around a few issues. Does the added cost of ROP fit into your budget? It's great to know you can get your money back if you outlive the term of your life insurance coverage, but there is a cost for that benefit. Also, if you die during the term of insurance coverage, your beneficiaries will receive the same death benefit from the ROP policy as they will from the less-expensive straight term.

Some financial professionals recommend that the best way to provide for your life insurance needs is to "buy term and invest the difference." This suggestion is based on the premise that you know how long you will need life insurance protection (until your mortgage is paid off, for example), and that you'll be able to get a better return on your savings from other investments. The same rationale may apply to ROP term insurance. Since your premiums do not earn interest while with the issuer, they likely will not keep up with inflation. So you may want to consider paying the lower premiums for straight term insurance and investing the difference to potentially accumulate more savings.

When choosing between these two alternatives, you may want to think about the amount of coverage you need, the amount of money you can afford to spend, and the length of time you need the coverage to continue. Your insurance professional can help you by providing information on straight term and ROP term life insurance, including their respective premium costs.

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When should I submit college financial aid forms?

For the 2019-2020 school year, the federal government's financial aid form, the FAFSA, can be filed as early as October 1, 2018. It relies on current asset information and two-year-old income information from your 2017 tax return, which means you'll have the income data you need when you sit down to complete the form. This is a relatively new process. A few years ago, parents had to wait until after January 1 to file the FAFSA and use tax data for the year that had just ended, which forced them to scramble to complete their tax return in order to complete the FAFSA.

If you have a new or returning college student, it's a good idea to file the FAFSA as early as possible in the fall because some aid programs operate on a first-come, first-served basis. The deadline for filing the FAFSA is typically March or April and will vary by college. But don't wait until then. It's a good idea to submit any college aid forms as early as possible, too.

The FAFSA is a prerequisite for federal student loans, grants, and work-study. In addition, colleges typically require the FAFSA before distributing their own need-based aid and, in some cases, merit-based aid. Even in cases when you don't expect your child to qualify for need-based aid, there may be another reason to submit the FAFSA. All students attending college at least half-time are eligible for federal unsubsidized Direct Loans regardless of financial need. ("Unsubsidized" means the borrower, rather than the government, pays the interest that accrues during school, the grace period after graduation, and any deferment periods.) So if you want your child to have some "skin in the game" with a small loan, you'll need to file the FAFSA. (Loan amounts are capped each year: $5,500 freshman year, $6,500 sophomore year, and $7,500 junior and senior years.) What if you file the FAFSA but then change your mind about taking out a loan? Don't worry, you aren't locked in. Your child can always decline the loan after it's offered.

The FAFSA is available online at fafsa.ed.gov. In order to file it, you'll need to create an FSA ID if you haven't done so already (follow the online instructions). You'll need to resubmit the FAFSA each year, but fortunately you can use the built-in IRS Data Retrieval Tool to have your tax data electronically imported, which saves time and minimizes errors.

What's so great about a college net price calculator?

If you're saving for a child's college education, at some point you'll want to familiarize yourself with a college net price calculator, which is an invaluable tool for estimating financial aid and measuring a college's affordability. Available on every college website, a net price calculator gives families an estimate of how much grant aid a student might expect at a particular college based on his or her personal financial and academic profile and the college's specific criteria for awarding grant aid. A college's sticker price minus grant aid equals a family's "net" price, hence the name.

The idea behind a net price calculator is to give families who are researching colleges a more accurate picture of what their out-of-pocket costs are likely to be, rather than having them rely on a college's published sticker price. The figures quoted by a net price calculator aren't guarantees of grant aid, but the estimates are meant to be close, so running the numbers is an excellent way for parents to see what their net price might be at different colleges.

Keep in mind that each college has a different sticker price and formula for determining how much grant aid it distributes, so every calculator result will be different. For example, after entering identical financial and family information on three separate net price calculators, you might find that College A has a net price of $25,000 per year, College B has a net price of $30,000, and College C is $40,000.

A net price calculator typically asks for the following information: parent income and assets, student income and assets, and the number of children in the family, including how many will be in college at the same time. (Generally, the more children in college at the same time, the more grant aid.) It may also ask more detailed questions, such as a student's class rank and/or test scores, how much money parents have saved in employer retirement plans in the most recent tax year, current home equity, and how much parents expect to pay in health-care costs in the coming year.

A net price calculator typically takes about 10-15 minutes to complete and is time well spent. Typing "net price calculator" in the search bar of a college's website should direct you to it.