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Playing Moneyball with Life Insurance

"Inherently, the 'Moneyball' approach works because it takes advantage of the behavioral quirks of other people."

Uncovering hidden value can give you a competitive edge. This was the message in Michael Lewis' 2003 best-seller, "**Moneyball: The Art of Winning an Unfair Game**," and the 2011 movie of the same name starring Brad Pitt.

In Moneyball, Lewis detailed the strategies used by Billy Beane, the general manager of the Oakland A's, to compete against major-league baseball teams with deeper pockets who could afford to pay top dollar for the best players. Using a revolutionary set of metrics, Beane identified players whose value was "hidden," then signed them for much less than all-star free agents or high-profile draft picks.

For example, Beane found that on-base percentage, instead of batting average, was a better predictor of offensive production. A player who hit .270 but also walked a lot was just as valuable as an all-star who batted .330, but rarely got a base on balls. The all-star commanded a big salary, while the .270 hitter could be had for much less.

Beane's approach was met with skepticism from his peers; old-school general managers said Beane's statistical models contradicted decades of accumulated baseball knowledge. But in the late '90s and early '00s the A's were consistently competitive and profitable, largely due to Beane's commitment to statistical analysis to evaluate and price talent.

Some baseball people still resist Beane's "analytics," but today, teams in every professional sport use sophisticated statistical studies to shape their rosters and determine strategies. Often, these deep studies uncover new insights that change the game, such as the emphasis on three-point shooting in basketball, or the increase in passing in football.

Moneyball in Personal Finance?

In a November 2015 commentary, Jason Hull, CFP, explains the critical element in hidden value:

"Inherently, the 'Moneyball' approach works because it takes advantage of the behavioral quirks of other people."

In Beane's case, his competitors continued to rely on traditional stats and the subjective assessments of their scouts. Even after Beane's methods produced consistent results, many remained unconvinced; it was, "Don't confuse me with your facts. I know what I know."

Behavioral finance studies regularly uncover quirks in consumers' money decisions. For perceptive consumers, these inefficient or irrational behaviors can be Moneyball opportunities to gain a financial edge.

Here's an example: Hold onto your life insurance policies.

Persistency and Life Insurance

One approach to life insurance sees it as a necessary cost that should be eliminated as soon as possible. You buy only enough to meet the perceived

In This Issue…

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needs of today, then drop it as soon as you think you can get by without it. Using this model, many consumers discontinue their life insurance coverage well before the policies are designed to end; they might buy a 20-year term policy, but drop it after 8 years, or surrender a whole life policy before their death.

At first hearing, this strategy might seem plausible, especially since many people ascribe to it. But it overlooks the economic fundamentals of life insurance.

Insurance, in any form, diffuses the risk of an unfortunate incident happening to one person by spreading the financial cost across a larger group. For insurance to work, the premiums have to be low enough to be seen as affordable, but also high enough to ensure that all claims can be paid. Actuaries, similar to Billy Beane, use statistical analysis to build pricing models for life insurance. Then, like professional sports teams, insurance companies compete in the marketplace, using their unique pricing formulas to attract policyholders.

While each life insurance company has its own pricing models, these models are built on four primary components.

Mortality. The statistical probability of when a death will occur.

Earnings. The return the insurance company receives on its invested capital reserves.

Expenses. The costs incurred by the company to acquire business and administer benefits.

Persistency. How long policyowners can be expected to pay premiums.

The Moneyball factor in this mix is **persistency**. A life insurance company must ensure that the premiums collected will be sufficient to pay any anticipated claims. In a term policy, this means the likelihood of a claim occurring during the term, whether it's 10, 20 or 30 years. With a whole life policy, the premium coincides with the assumption that the likelihood of a death claim is 100 percent (because the policy will be in force for one's "whole life"). Through regular audits, state regulators compel insurance companies to repeatedly prove their ability to pay all potential claims.

But some policyholders will not hold their policies to maturity – i.e., they do not persist in paying premiums. When they surrender a policy early, the insurance company retains the collected reserves. Since a benefit no longer has to be paid, these reserves improve the insurance company's profits.

Where's the "hidden value" in persistency? A 2014 white paper by Daniel Gottlieb and Kent Smetters, "Lapse-Based Insurance," explains:

"Life insurance companies earn substantial profits on clients that lapse their policies and lose money on those that keep their policies. Insurers, however, do not earn extra-ordinary profits. Rather, lapsing policyholders cross-subsidize households who keep their coverage."

That's the Moneyball insight: Persistency profits cross-subsidize those who keep their coverage. Or, to put it more plainly, the people who surrender life insurance early make it more profitable for those who keep it.

In term life insurance policies with level premiums, policyholders overpay relative to the annual cost of insurance during the policy's early years, then underpay toward the end of the term. In a 20-year level term policy, the cross-over from overpaying to underpaying typically occurs in the eighth or ninth year. If a policy is surrendered in the eighth year, it means the owner ***overpaid for the entire period the coverage was in effect,*** which further improves the insurance company's profit.

In policies that accumulate cash values, persistency profits are included in the dividends[1] paid to existing policyholders. And these dividends include persistency profits from surrendered term insurance as well as cash value policies.

Every company has different persistency statistics and methods to account for its value in their pricing models. In general, persistency profits are a "reward" to long-time policyholders, which means the longer you hold the policy, the greater the benefits. For this reason, even consumer advocates who are strongly in the "life-insurance-as-an-expense camp" caution against surrendering cash value policies that have been in force for a long time.

There are plenty of compelling reasons to keep a life insurance policy instead of surrendering it before maturity. When integrated with other pieces of your personal finances, life insurance can do more than protect against the financial loss of a premature death. It can provide supplemental[2] income, allow the spend-down of other assets, guarantee[3] an inheritance, fund charitable causes, help with long-term care and end-of-life expenses, and more.

If you understand the possibilities with life insurance, persistency is a Moneyball factor that gives you an economic advantage. Consumers who surrender policies early literally give their premiums to consumers who keep their policies in force. ❖

1 Dividends are not guaranteed. They are declared annually by the insurance company's Board of Directors.

2 Policy benefits are reduced by any outstanding loan interest and/or withdrawals. Dividends, if any, are affected by policy loans and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses, or is surrendered, any outstanding loans considered gain in the policy may be subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first, subject to ordinary income taxes. If the policy owner is under 59½, any taxable withdrawal may also be subject to a 10% federal tax penalty.

3 All whole insurance policy guarantees are subject to the timely payment of all required premium and the claims paying ability of the issuing insurance company. Policy loans and withdrawals affect the guarantees by reducing the policy's death benefit and cash values.

Insight:

High Income Doesn't Equal Financial Savvy

(It just means you may not be ruined by your ignorance)

Most of us don't respond well to scolding. There's something about a condescending attitude connected to a wagging finger that just rubs us the wrong way. But scolders can't help themselves, especially if they think they're right. Which is why Karen Hube of *Barron's* is compelled to tell us:

Americans are lousy at personal finance.

Yawn. You've heard it all before, right? A good chunk of the population doesn't save, can't come up with $1,000 for an emergency and will never be able to retire, blah, blah, blah.

But that's not you, is it? After all, you earn a good income, contribute to a retirement plan, and have a great credit score. You're not the typical American household.

Well great. But it does not follow that you're good at personal finance. Hube contends there is "an almost universal lack of financial literacy among Americans" – even among those with high incomes. Hube quotes Spuds Powell, the managing director of a Los Angeles wealth management firm:

"This is a much bigger problem than most people are aware of. I'm constantly amazed at how common it is for clients, even sophisticated ones, to be lacking in financial literacy."

> ***"The number of inferior strategies is infinite."***
> **– Jack Bogle**

Making a lot of money is not proof that you are managing it well.

It's natural to think there's a correlation between high income and better financial management. But in truth, the only thing that distinguishes high-earners from the rest of the financially illiterate is their ability to pay for their mistakes.

And this illiteracy is not about obscure tax issues or unique investment opportunities. Rather it is ignorance regarding some of the most fundamental issues of personal finance. Like debt, particularly student loan debt.

The Student Loan Crisis

You've probably heard that there's a student loan crisis in the United States; too many borrowers are in default or financially hamstrung by their educational debt. The problem is big enough to be a drag on the economy, and the US government, which holds the majority of student loan debt, has looked at options to sell off these loans, even at a discount, just to get rid of them.

So, it's a little bit surprising to read the following headline from a January 2018 report by Urban Wire:

"Affluent Households Owe the Most Student Debt"

Referencing a recent Survey of Consumer Finances for 2016, the study found that "most outstanding student debt is held by people with relatively high incomes." Specifically, the top 25 percent of households by income ($81,140 or above in 2016), held about half of all outstanding education debt. The top 10 percent, those with incomes of $144,720 or higher, held 24 percent of the debt. These numbers reflected both young adults who borrowed for their own education, as well as parents or grandparents who borrowed to help children or grandchildren.

The authors of the report acknowledge these numbers "do not mean that most student loan borrowers are less well off than those without student debt... (but) most outstanding student debt is held by people with relatively high incomes."

If you think there is a positive correlation between income and financial literacy, you might also conclude that student loans are a savvy strategy. That's a tough position to justify.

Student loans are arguably one of the least desirable borrowing options, notwithstanding the typically low interest rates. Educational debt is very speculative; most students enter college with vague educational goals, and no assurance that the career that follows will produce enough income to make borrowing a profitable proposition. Further, student loans have few options for relief. They generally cannot be discharged in bankruptcy, forgiveness options limit employment choices, and other provisions, like forbearance, only prolong the financial agony instead of alleviating it.

Despite low interest rates, the large amount of debt and the corresponding monthly payments are a burden, even for graduates who earn substantial incomes; many of the financial milestones of adulthood, such as marriage, buying a home, or saving for retirement, are either delayed or foregone because of too much debt.

The fact that high-income families hold the most student-loan debt is not indicative of their financial literacy.

So why do so many wealthy American households use student loans? A plausible explanation: high-income households simply have enough money to absorb the consequences of their financial ignorance.

But as more students accumulate larger debts, even the institutions which directly benefit from student loans are recognizing that students need to be better educated about personal finance, and debt in particular.

Even Harvard Is Now Teaching Personal Finance

Here's the opening sentence from a May 2019 *Wall Street Journal* article:

"Elite universities haven't typically focused on personal finance. That is starting to change, thanks in part to rising debt levels for young Americans and growing anxiety about their economic futures."

The article details personal finance workshops offered this spring to students at both Harvard and Princeton. When asked why there might be a need for instruction in financial basics, a postdoctoral research associate who participated in the Princeton's Financial Literacy Day, said,

“We’re a generation that’s really shaped by some really poor macroeconomic decisions and it’s harder for us to think that there’s sort of exogenous progress in our lives and our livelihoods,”

Translation: Our generation is living with the repercussions of the poor economic decisions of our elders, and it’s hard to see how we will make financial progress in the future.

It might be normal for children to dismiss the wisdom of their parents, and blame them for their issues, but when prestigious universities feel the need to instruct their students on the ABCs of personal finance, it doesn’t suggest these future high earners – or their parents – have high financial intelligence.

Still Yawning? You Could Be Missing Out

Maybe you or your kids aren’t burdened by student loan debt. Even so, your financial literacy might be lacking. There’s a dieting maxim that says, “Everyone underestimates how fat they are, and how much they eat.” The same distortion can occur with our money: We overestimate how much we have, and how much we know. When it comes to self-assessment, we all have blind spots.

You may also be comfortable paying for your inefficiencies. But what are you missing by not getting smarter with your personal finances? What if you knew cost-efficient borrowing and repayment strategies, and how they could improve your monthly cash flow? Or how a different approach to risk management might allow your savings to produce better income in retirement? Boosting your financial literacy could yield substantial benefits. ❖

Even if you think you’re doing fine, why not ask your financial professionals? A little knowledge might help you do a lot better.

Dynamic Principles… for a Good Year

An April 17, 2019, commentary in the *Wall Street Journal* featured a 2015 study from sociologists at Cornell and Washington University in St. Louis that sifted 44 years of income data for the US population. Among its findings:

- **12 percent** of the U.S. population will have at least one year where their income places them **in the top 1%** of all households.
- **39 percent** will have at least one year of income in the **top 5%.**
- **56 percent** will have at least one year of income in the **top 10%.**
- **73 percent** will have at least one year of income in the **top 20%.**

Economists often use the top 20 percent as a demarcation for the upper middle class. These findings suggest that three-fourths of American households will, for at least one year during their working lifetimes, be members of the upper middle class. Which sort of supports the idea of income mobility, that “moving up” is possible.

But wait, there’s more…

Only 0.6 percent will stay in the top 1% for 10 consecutive years.

This counterpoint leads to a very profound statement about personal finance:

“The reality is that most Americans will experience periods of both economic insecurity and relative affluence.”

Income mobility isn’t a one-way elevator. Not only do Americans move up, they also move down. But how many of us make financial plans with this reality in mind, especially when our elevator is going up?

The Necessity of Dynamic Principles

In any planning process, we often assume static conditions for some variables. In personal finance, we might project that our health, income, living arrangements and other factors will remain the same, or progress in a consistent manner.

Deep down, we know these variables will change. But in pretending these factors are static, we can be seduced by an illusion of stability, that our static assumptions about life are reality. This is especially true in periods of relative affluence, when our income is stable or steadily increasing.

In these moments, there is a natural tendency to adjust to our good fortune, even though it may be fleeting, by upgrading our lifestyle. We get a nicer car, take a longer vacation, buy a bigger house. And why shouldn’t we? If we’ve met our pre-determined (and static) saving objectives, doesn’t that mean we can enjoy the extra?

Maybe not. Remember the reality: Americans will experience both periods of economic insecurity and relative affluence. When outcomes vary from the plan – for better or worse – there should be some adjustments.

Dynamic Responses to a Good Year

Considering the possibility of economic insecurity during a good year might be perceived as buzzkill; just when things are going great, someone reminds you it might rain on your parade.

If you see it that way, it may be because the static projections you used as a baseline have become your reality. But your financial life is not static, and never will be. If you're having a good year, here are a few dynamic principles you might consider.

- ✓ **Over-save.** Suppose your static personal accumulation plan assumes saving 15% of income each year. If income exceeds expectations, it might be better to save 20, 25, 30% – or more. Because if your income takes a hit in the future, one of the first casualties might be the ability to save. Over-saving in good years limits the financial damage from bad ones.
- ✓ **Secure your good fortune.** If you over-save, you don't have to take as much risk. Ten thousand dollars earning 1% per year is more than $5,000 earning 5%, and it will take 17 years for $5,000 to grow large enough to surpass it. A good year is a great opportunity to make your savings more secure.
- ✓ **Enjoy it. (But pay cash.)** Some delayed gratification is necessary. But too much delayed gratification, especially in a good year, can be de-motivating. How can you balance the prudence of over-saving with the pleasure of spending?

Here's an idea: If you're willing to pay cash, buy it. If you're not, be cautious. Take the purchase of a new car. In a good year, $800 monthly payments for the car you've always wanted might seem doable, even though it's double your current $400/mo. But what about next year, or the year after, when things might not be so flush?

To answer that question, reframe the transaction. If the car costs $40,000, and you have the funds, are you willing to pay cash? If so, buy it. But if the large expenditure makes you uneasy because it makes too deep a dent in your long-term accumulations, maybe it's better to hold off. Almost every luxury can be financed, but **what you're willing to pay cash to enjoy can be an effective psychological measuring stick** for how much you can comfortably spend. ❖

It may be the right time for some dynamic change.

The Duty of Every American: Archiving Tax Records

Once a year, every American household is required to prepare a detailed financial report, documenting income and expenses, and declaring their profit or loss. This report is an income tax return.

The Transition to Professional Assistance, Tax Software, and E-Filing

Theoretically, you can prepare any tax return with an IRS instruction booklet, a pencil and a calculator. But if the people who enact tax rules can't keep them without computer assistance, there's no way you should try to.

As a 2020 presidential candidate, Vermont senator Bernie Sanders recently released for public scrutiny his tax returns from the previous 10 years. The oldest return, from 2009, was apparently self-prepared, and in reviewing it, professional tax preparers found several errors by the 77-year-old senator. Three mistakes reduced the senator's reported taxes, while one unnecessarily increased them. Had the return been prepared properly, Sanders would have owed $4,479 more than he paid.

No one has implied that Mr. Sanders cheated on his taxes; a spokesperson for Sanders said, "any inadvertent errors were…promptly addressed." And the *Wall Street Journal* noted that Sanders's 2010 return "was created by a paid tax preparer using software."

Bottom line: unless your financial life consists of nothing more than a single W-2, you can't complete your returns without professional assistance or a tax-preparation program. When it comes to taxes, you simply can't remain analog in a digital world.

Most Americans already know this. The IRS reports that 56% of filers use a paid preparer, and 36% use tax-return software. And for the 2018 tax year, the IRS anticipated that 90% of all taxpayers would file their returns electronically.

Return Is Done? Your Record-Keeping Has Just Begun

It's not enough to use professional help and/or technology to prepare the return. IRS rules include the archiving of supporting documentation for periods ranging from one year to a lifetime. And while most Americans have made the transition to electronic tax return preparation, a much smaller number have effectively organized their supporting documentation, in either hard-copy or electronic form.

Yet at some point in the future, you may need to retrieve this information, perhaps to respond to an audit request, or more likely, as a reference point for another taxable event (such as as determining your cost basis in the sale of a home or an investment).

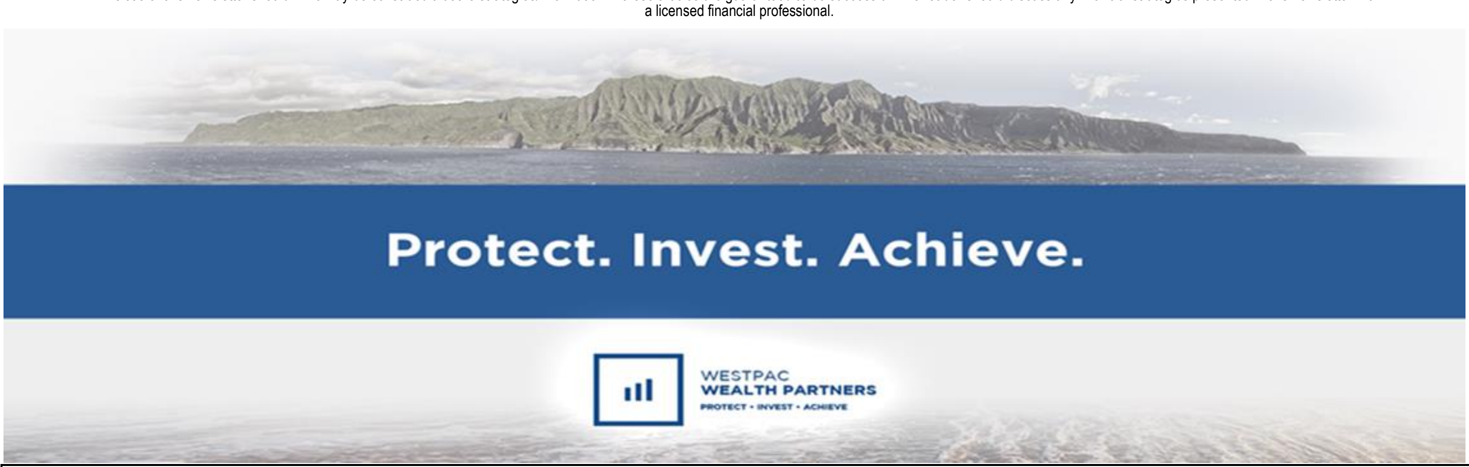
Today, your supporting data may exist in an electronic or paper format, on a disk or in a folder, stored online or stuffed in a file cabinet. How can individual taxpayers effectively assemble these disparate pieces? The same way they prepare their returns: with professional assistance, software, and electronic filing.

Digital Vault + Professional Help = You Can Do This!

Unless you have a natural inclination toward organizing, often the best place to start your archiving is with a financial professional. A financial professional knows what to save, and most likely has a system, including software, in which to categorize and store it. Many financial professionals – such as CPAs, investment advisors, insurance agents, and brokers – offer their clients a digital vault for the storage of important documents, often on a complimentary basis. (As an example, consider The Living Balance Sheet®* from Authorized Users affiliated with Guardian Life Insurance Company.)

Using a digital vault under the guidance of a financial professional gives you the tools and assistance to make organization doable instead of so overwhelming that you never get started. You may be able to delegate the scanning of paper documents into digital files, and authorizations for real-time updates to existing accounts can make maintenance almost automatic. ❖

Organization has systemic benefits; it makes you more efficient, better prepared, less stressed. The tools and professionals that prepare your tax returns can help you develop a system for archiving these records. Take advantage of these resources. When it comes to taxes, you can't afford to remain disorganized, or analog.



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