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Life Expectancy an Important Retirement-Planning Tool

BY PETER KLEIN

As our knowledge of the universe advances, scientists have become aware of certain unities found within life. For example, every mammal, no matter what size, is issued roughly the same number of heart beats in a lifetime, about 1.5 billion. This same rule applies to metabolism. Shrews that live less than a year will have a heart and metabolism rate of almost 100 times as fast as that of a human. Alternately, elephants live almost as long as humans since larger animals' hearts beat more slowly and use energy more efficiently than smaller animals.

Humans, however, no longer fit this model. We now live longer than our size would dictate. Our ability to harness technology and science to treat disease and control our environment has had an enormous impact on the length and quality of our life.

With the aging of the baby boomers, more Americans will reach retirement age over the next two decades than at any other time in our history. These same boomers will inherit significant advances in medical care, which will

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Fraternal Benefit Societies: What Independent Agents Should Know

BY MICHAEL MURILLO

When a client signs their insurance paperwork, they're receiving more than just a policy. They're receiving your expertise, your level of service, and your empathy to help them achieve important financial goals.

But do they receive prescription drug discounts? How about breakfasts, picnics, or an evening at the theater? Will they get detection and test kits for their home? Will you send them an oak seedling so they can plant a tree in their neighborhood? Those might sound like unusual benefits that are unrelated to your business, but for fraternal benefit societies, they can be an important addition to a client's overall financial package. Independent agents have the opportunity, if they choose, to work with several dozen existing fraternals, many of which are more than 100 years old. There are many things you need to know about these groups, however, in order to determine if you should take advantage of their opportunities in addition to the business you do with other companies.

What is a fraternal benefit society?

Fraternals were developed in the 1800s as a way for people — many of them immigrants who were new to the United States — to work alongside those with common ethnic, religious, and other backgrounds. The nonprofit organizations provide "mutual aid" to individuals and families. That includes insurance against death, disability, and illness

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impact the length and vitality of their retirement years. This translates into greater financial requirements. It's incumbent upon every individual to plan for their retirement, addressing crucial factors such as mortality and morbidity risk and long-term inf ation risk, and it is your responsibility as a financial advisor to do so by taking into account these factors.

Morbidity and mortality risk and squaring the curve

As people age, the likelihood increases that they will be battling chronic illnesses. Before the advent of modern medicine, the typical person deteriorated and died on a rather severe downward curve, their lives abruptly ending either from infection or organ failure. Today, people live longer and enjoy a morbidity curve that is f attening and drawn out, which graphically results in a longer, f atter line that equates to a squaring of the curve. Advances in medicine and preventive care, including diet and regular exercise, have allowed humans to persevere even though they may suffer from one or more chronic illnesses, such as arthritis, heart disease, and diabetes.

Many decades ago, there was considerable difference in the lifespan of the rich versus the poor. Advances in technology and medicine have leveled the playing field. Today, most people have access to state-of-the-art medical care. Consequently, there is less appreciable difference in the lifespan of a billionaire versus the lifespan of a middle income person with access to health care. According to a March 2008 New York Times article, people in the most aff uent group could expect to live 2.8 years longer than people in the most deprived group, but by 1998-2000, the difference in life expectancy had increased to 4.5 years. The challenge is, how do people with more modest means meet the future financial obligations of expanded retirement years?

Medical underwriting and life expectancy estimates

Historically, human life expectancy has largely been the central focus of life insurance companies and their actuaries. But in recent years, we have witnessed the development of a secondary market for life insurance policies involving clients age 65 years and older who no longer need insurance. Once these policies are sold, they are referred to as life settlements. Valuing a life insurance policy requires that the buyer determine the life expectancy of the insured. In this case, life expectancy is based on an estimate of medical mortality while ignoring the risk of accidental death. Companies that specialize in assigning life expectancies (LEs) have evolved; they are referred to as medical underwriters. Individually, the LEs assigned are entirely precise. No one can predict the exact year that a person will die from natural causes. However, based on a group of 200 or more individuals, medical underwriting firms believe that they can

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statistically predict the mortality of individuals with an accuracy of plus or minus 10 percent.

The concept of LE has far broader applications than simply the pricing of life settlements. Knowing a client's LE is critical to addressing the risk of outliving their savings. You can use this information to optimize the financial performance of a client's investment while at the same time satisfying the issue of suitability. Furthermore, it's relevant in managing and planning your clients' retirement options and financial planning strategies. What the later years may mean for your clients may well determine their investment strategies and asset allocations today.

Limitations of conventional investment concepts

If conventional investment strategies are employed, many new retirees will outlive their savings. The typical financial planner would base their client's allocation of investments on the "Rule of 110." Simply put, this rule dictates that you take the client's age and subtract it from 110 to gauge the allocation between higher-risk, higher-return investments, such as stocks, and lower-risk lower-return investments such as bonds. Complicating this rule is that the actual individual deployment of funds needs to be based on suitability, which is composed of three broad measures: the client's investment objective, financial needs, and level of sophistication. Alternatively, a typical withdrawal strategy tends to follow the simple rule of 4 percent of assets a year.

Time and investment risk

Generally speaking, the longer the time horizon, the more risk is involved in a financial plan. Investors are rewarded with a higher return in stocks because over the long term, stocks have significantly outperformed other investment securities, although there have been many short-term periods in which they have underperformed or posted negative returns. Consequently, there is more risk in owning stocks if one has a short time horizon. Time exerts a different effect when analyzing the risk of owning fixed-income securities, such as bonds. More risk is associated with holding a bond long term than holding it short term because of the uncertainty of future inf ation and interest rate levels.

If one were to lock in a rate of 6 percent for a bond that matured in one year, an upward move in inf ation or interest rates would have a less adverse effect on the price of that bond than a 6 percent bond that matured in 30 years.

Inf ation risk

Retirees face an entirely different zone of inf ation risk than working couples. If you exclude from the consumer price index electronics, such as computers and f at screen TVs, whose prices have been declining, you discover a core inf ation rate that is considerably higher. Moreover, retirees face inf ation rates weighted to a greater degree by medical costs, which have been rising at a far higher rate of 12 percent or more per year. An adjusted inf ation rate as low as 6 percent would mean that goods and services would double in cost every 12 years. For a retiree on a fixed income, such stratification of inf ation would be devastating. Given these factors, most simplified investment strategies are likely to fall short in meeting a couple's retirement needs.

Incorporating LEs in retirement planning

Gaining a better understanding of a client's life expectancy and epidemiology can better assist financial planners in custom-tailoring a client's retirement plan, asset allocation strategy, and withdrawal expectations. A 70-year-old retiree, depending upon their genetic makeup and general health, could easily live another 25 years. Advances in medicine will contribute to a greater stratification of life spans. A retiree with a life expectancy of an additional 30 years can tolerate more risk in their investment strategy and needs to achieve higher returns since they are at greater risk of outliving their savings. Knowing a client's life expectancy allows financial advisors to develop a more precisely tailored investment and retirement plan. During the last decade, there has been a substantial increase in the depth and breadth of investment products. Across all investment product categories, we have seen the development of a broad array of products.

How much of a client's assets should be allocated to generating guaranteed income and how much should be allocated to long-term investments, such as stocks and bonds, is the first part of a threefold assessment.

The process begins with a review of a client's assets, including life insurance policies. A life insurance policy review can help determine the best options for a client. In some cases, they can be sold to more efficiently allocate a client's assets toward guaranteed-cash-f ow products while eliminating premium expenses. The combination of selling a negative-cash-f ow asset while using the proceeds to generate positive cash f ow creates a swing factor in funds f ow that can dramatically change a client's ability to manage their future financial needs.

Knowing a client's life expectancy can help a financial advisor determine if an annuity makes sense. Consequently, annuity contracts are more attractive for people whose health, living habits, and family mortality experience suggest that they are destined to live longer than the average person.

Basic daily expenses can best be secured by using annuities in combination with Social Security payments. Annuities, a guaranteed cash f ow investment set of products, can also be used to meet basic needs, allowing an investor to take a less conservative approach to investing the remaining assets. Additionally, annuities can be made judgment-proof, although this will depend on which state the client lives in and how long they own the annuity. For someone dependent upon investment income from a sum of money, this could be an important feature. Moreover, tax-deferred annuities can bypass probate proceedings and go directly to named beneficiaries without any cost or delay.

The last step in the process is to invest the remaining funds to address the risk of longevity and inf ation. This means allocating more of those assets toward higher-growth, higher-risk investment products that are designed to produce superior long-term returns.

Peter Klein is director of life settlements for Capitas Financial. He can be reached at peter.klein@capitasfinancial.com.

Obtaining a Life Expectancy Report

The typical "clients" of a medical underwriting company are life settlement brokers, providers, and institutional investors. A life expectancy report is designed to meet the needs of these particular institutions, so they are not prepared in a format that is necessarily user-friendly to the investment advisor community. However, financial advisors and estate planners can get a life expectancy report for applicants by contracting with one of many medical underwriters.

A life expectancy report is typically obtained through an advisor who has an account with one or more of these medical underwriting companies. These companies require the following information:

- Completed preliminary application that includes an advisor appointment letter and executed HIPAA release form
- List of all attending physicians including specialists.
- Medical family history
- Attending physicians' reports (APSs)

Some of these APS reports can be in excess of 500 pages. Given the confidential nature of the information and the laws surrounding HIPAA records, medical underwriting firms require that agents follow strict submission protocols to secure medical records. Some of the firms have established secure Web sites for the uploading of records.

A typical life expectancy report requires 7 to 8 business days to prepare at a cost of about $250 per report.