HOLM TRUTHS

Down to earth advice for savers and investors from independent investment commentator Mary Holm

SPRING 2003

Life, limbs & livelihood

Life is not fair. But insurance is one way of making it a bit fairer.

In an insurance scheme, many people put money into a pool. Some don't get anything back. Others get back much more than they put in.

But those who do well out of insurance do so only because something bad has happened to them. Receiving insurance money helps to put things back into balance.

Most people would rather not be in a position to claim insurance – especially life insurance!

Still, if others are financially dependent on you, you'd better have a life policy. The same applies to two other types of insurance – which are also necessary for people without dependants if they are reliant on their work-related income:

- **Income protection, also called disability, loss of income or income replacement insurance.**

With this, you receive a percentage of your usual income or a regular dollar amount after you have been unable to work for, say, one, three or six months.

Usually, you can choose how long payments will continue if you can't work for a long period. It might be just a few years, or it might continue until you turn 65.

- **Lump sum total permanent disablement (TPD) insurance.**

Typically, this is not paid until you have been off work for six months and are unlikely to ever work again.

With both income protection and TPD insurance, some policies will pay if you can't do your particular job; others will pay only if you can't do any job similar to yours.

While all three types of insurance – life, income protection and TPD – are essential for many people, not everyone needs them.

How can you be sure you have necessary – but not unnecessary – cover?

TERM INSURANCE SUITS MOST PEOPLE

In this article we consider only term life insurance, not endowment or whole of life insurance.

Term insurance covers you for as long as you pay the premiums, then coverage stops. There is no savings element. It is the most suitable product for most people.

Do you need life insurance?

Whether you need life insurance is not always obvious. People with no dependent children – retired or not – often have no need for life insurance.

And, oddly perhaps, in some circumstances single parents with dependent children don't need it either. If they died, the children could live with the other parent and inherit enough assets to support them until adulthood.

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On the other hand, a non-employed caregiver may need life insurance. If they died, the family could use the insurance money to hire someone to look after the children or other dependants.

How much life insurance?

Think through your dependants' financial needs if you were to die tomorrow. Our table should help.

If you have a partner, it's a good idea to do the calculations together. The partner may be aware of current or future expenses that you won't think of.

Note that the amount of coverage you need will change over time. Review your needs when there's a change in your life, such as when a child is born or becomes financially independent, or when you take on a mortgage.

Note, too, that as you pay off a mortgage, you could gradually reduce your life cover.

Do you need income protection insurance?

If you are employed, your employer may continue to pay you over an extended period of illness. But it's foolish to assume that. Find out what your employer's sick leave policy is, and set up your insurance so payments begin soon after your sick pay ends.

For most self-employed people, income protection insurance is clearly needed.

There are, of course, Government-paid sickness and invalid benefits or, if you are an accident victim, ACC payments.

If you receive ACC payments, your income protection insurance payments will be reduced. It's the other way round with benefits. If you receive income from insurance or investments, your benefit will be reduced.

But that's not a good argument against insurance. Most disablements are caused by ill health, not accidents. So your Government entitlement is more likely to be a benefit – at just $337 a week after tax for a married couple – than the more generous ACC pension.

How much income protection insurance?

You might think you will need less income if you are unwell, as you won't participate in as many activities.

But you might actually need more income, to cover medical and other new expenses.

In any case, insurance companies set an upper limit on income protection insurance. Usually it's 75% of your pre-tax work-related income if the insurance payments are taxable, or 55% if the insurance payments are not taxable.

The limits are there because the insurance company doesn't want you to be better off ill than well. Who knows what silly behaviour you might otherwise get up to!

Basically, you need enough income protection insurance to cover your bills – not necessarily enough to pay off your mortgage and other debts.

Do you need lump-sum TPD insurance?

If you have extensive income protection insurance, you might think you don't need TPD cover as well.

However, it can be a great relief at a stressful time to receive a lump sum to cover additional medical expenses or any necessary changes to your home.

You may also want to pay off mortgages not covered by separate mortgage insurance and other debts, or put aside money for children's education.

If you would lose a company car, you may want to buy your own. And if you are diagnosed with an incurable disease, you may want to fund travel or a family reunion.

The only way to get TPD coverage is as an add-on to life insurance. And it can't be more than the amount payable on death.

So even those who don't need life insurance may decide to get some, so they can also get the TPD cover.

Note that a TPD payment, or investment income, won't affect any income protection payments you get.

How much TPD insurance?

Go through the items listed above, and any others you might want a lump sum for, and estimate amounts.

> ***"Death never takes the wise man by surprise; he is always ready to go."*** Fables of Jean de La Fontaine, 1621-95

LIFE INSURANCE CALCULATOR

A. Immediate Lump Sum Expenses

Outstanding bills	$
Funeral expenses (typically $5000)	$
Mortgage (zero if you have separate mortgage repayment insurance)	$
Other loans (eg finance company, credit cards)	$
Replacement of company car, if relevant	$
Emergency fund (maybe 6 months' income, to allow for several uses of this money)	$
Other	$
TOTAL A	**$**

B. Ongoing Expenses*

Children's education	$
Nannie/housekeeper or child care	$
Household expenses currently covered by your income (assume no mortgage or other debt payments, which will be paid off under A above)	$
Car replacement (budget for, say, one-fifth of a new or second-hand car each year)	$
Other	$
TOTAL B	**$**

* Multiply expected annual amount by:

2.9 if the spending will continue for 3 years	12.7 for 15 years
4.8 for 5 years	16.0 for 20 years
7.3 for 8 years	18.9 for 25 years
9.0 for 10 years	21.5 for 30 years

This assumes your family will invest the insurance money at 2.5% after tax and fees and inflation. The annual amount will go up with inflation.

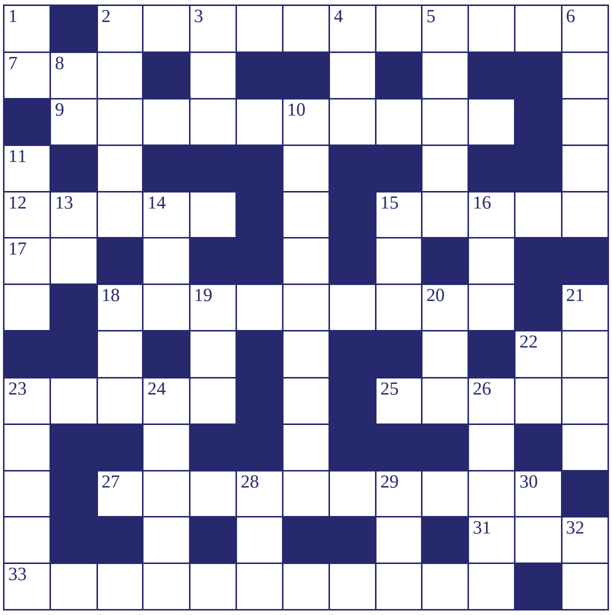
C. Subtractions

Other current life insurance	$
Assets that could be sold (such as a business, second car, boat, bach)	$
TOTAL C	**$**

D. Calculation

TOTAL A + TOTAL B	**$**
Subtract **TOTAL C**	Minus **$**
LIFE INSURANCE NEEDED NOW	**$**

FOR Insurance Tips *SEE PAGE 4*



Solution: Back page

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ACROSS
2. Closeness (11)
7. Vehicle (3)
9. Incapacity (10)
12. Worth (5)
15. Inquired (5)
17. Not he or she (2)
18. NZ's neighbour (9)
22. Proceed (2)
23. Clan (5)
25. Pen and _ _ _ _ _ (5)
27. Crept in too (anagram) (10)
31. In the present (3)
33. Take part (11)

DOWN
1. 2000+ years ago (initials) (2)
2. Ruffle (5)
3. Big extinct bird (3)
4. Sick (3)
5. Property taxes (5)
6. Return (5)
8. Not 1 Down (2)
10. Ruin canes (anagram) (9)
11. Keen (4)
13. In all email addresses (2)
14. Revenge (Maori) (3)
15. Everything (3)
16. NZ bird (3)
18. Muhammad _ _ _ (3)
19. Take to court (3)
20. Irish terrorists (initials) (3)
21. Maize (4)
22. Big US company (initials) (2)
23. A flower (5)
24. French hat (5)
26. Ring up (5)
28. Twitch (3)
29. A drink (3)
30. Not yes (2)
32. You and I (2)

GREAT DEBATE • GREAT DEBATE • GREAT DEBATE

AUSTRALIAN vs INTERNATIONAL SHARES

Suggest to New Zealanders that they should buy international shares, and many will invest in Australia but are reluctant to go further afield.

Arguably, though, they would be much better off in an international share fund. Australia may be the worst foreign country for New Zealanders to invest in. Is this correct?

The answer depends partly on your attitude to dividends. While Australian dividends aren't usually as high as NZ dividends, they are higher than in most other countries.

If you like receiving dividend income, Australia is attractive.

There are, however, tax considerations.

When New Zealanders receive dividends on overseas shares, they are taxable. But many of us don't pay tax on capital gains on shares – whether we hold shares directly or via a share fund not subject to that tax, such as an index fund or investment trust.

Taxwise, then, we are better off with shares in countries other than Australia. A bigger portion of their returns is likely to be non-taxable capital gains and a smaller portion taxable dividends.

Another big advantage of an international share investment – particularly via a share fund – is diversification, which reduces risk.

While the total value of New Zealand shares is only about 0.1% of all the world's shares, the total value of Australian shares is still a tiny proportion, at about 2%.

The New Zealand investor can certainly broaden their range of industries by crossing the Tasman. Still, an Australasian share portfolio will not cover as many industries as an international portfolio.

What's more, the Aussie share market tends to perform similarly to New Zealand's. When our market is doing well or badly, Australia's market quite likely is too. It's better to be in many sharemarkets. When some fall, others are likely to rise.

Australia does, however, have attractions for certain investors.

Realistically, the only way for most people to make a diversified

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AUSTRALIAN SHARE PROS	AUSTRALIAN SHARE CONS
✓ Higher dividends for income	✗ Higher dividends, which are taxed
✓ Easier to buy individual shares	✗ Fewer industries
✓ Familiarity, more information	✗ Single economy risk
✓ Good if retiring in Australia	✗ Sharemarket moves like NZ market

INTERNATIONAL SHARE PROS	INTERNATIONAL SHARE CONS
✓ Lower dividends, which are taxed	✗ Lower dividends for income
✓ Wider range of industries	✗ Less information available
✓ Many economies	

> ***"Work is the price you pay for money."***
> Anonymous

(*AUSTRALIAN* vs *INTERNATIONAL SHARES, CONTINUED*)

investment in world shares is through a share fund.

If you prefer to buy individual shares – which is wise only if you have enough money to buy a wide range – it's easier to buy Australian than international.

There's more information about Australian companies in our news media, including Aussie share tables in many newspapers. And Australian corporate laws and practices are more like ours.

Some Australian companies are listed on the NZ stock exchange. And, if you buy shares on the internet, several New Zealand brokers offer Australian shares but not other international shares.

Finally, if you are planning to retire in Australia – as quite a few New Zealanders do – investing in Australian shares enables you to build up wealth in that country before moving there.

For people who like dividend income and direct share investment then, and especially for those who will retire in Australia, holding Aussie shares makes sense.

For most others, the tax advantages and superior diversification of an international share fund – especially one that doesn't pay tax on capital gains – make it the best way to venture offshore.

WRITER AND PUBLISHER

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Insurance Tips

• Watch for inflation

Inflation can slash the value of insurance over the years. Check your coverage every four or five years.

Under most life and TPD policies, premiums and payouts can be adjusted each year for inflation.

With most income protection policies, once you are not working and the payments start, they will rise with inflation. Some also adjust your coverage each year while you are still working.

Take care with this. Your coverage may rise faster than your income. If you make a claim, the company will still pay only up to its 55% or 75% limit. You may be paying for cover you can't get.

On the other hand, if your coverage is not adjusted while you are working, watch that it doesn't fall behind your needs.

• Getting together

Joining a new workplace or association? Ask if they can give you cover for life, TPD and medical insurance. It's usually a good deal.

Sometimes an employer makes a contribution to your insurance costs.

Even if they don't, premiums are lower than if you bought insurance independently. It's cheaper per person to run group insurance, and employees or association members tend to be better-than-average risks for an insurance company.

Another advantage: if you start a new job, you may be able to obtain insurance without a medical examination, which may be required for individual coverage. And medical cover may start immediately, rather than your having to wait for, say, three months.

When you leave your job, you may be able to continue coverage – although you will then pay higher individual rates. This is particularly helpful if you have developed a medical problem that might otherwise limit your chances of getting insurance.

• Which insurance company?

It's safer to stick with large well-established companies. You want to be sure they can pay when you claim.

To assist with judging this, compare ratings, which are done by Standard & Poors or AM Best.

An S&P rating of AAA to A is "secure", and BBB is "adequate". An AM Best rating of A++ to B+ is "very good" or better. B or B- is "adequate".

Everything else being equal, go with the cheapest company.

But make sure they seem likely to stay the cheapest. Ask if there is any guarantee period during which they won't raise your premiums, and how often they will raise your premiums as you get older.

• Income protection and tax

In some income protection schemes, your premiums are tax deductible and payments you receive are taxable. In others, the premiums are not deductible and the payments are not taxable – so you don't need as much cover.

It's not clear which is better. But if you choose the first type, make sure that you do deduct your premiums. If you wouldn't otherwise file a tax return, this may be a hassle and you may be better to choose the second type.

• A bad bet

Don't bother with life insurance that pays out only if you have an accident.

Only a tiny proportion of people die in accidents. And why would your dependants need more money if you die one way than if you die another way?

Get the coverage you need regardless of the cause of your death.

Holm Truths Crossword Solution

B		F	A	M	I	L	I	A	R	I	T	Y
C	A	R		O			L		A			I
	D	I	S	A	B	I	L	I	T	Y		E
A		L				N			E			L
V	A	L	U	E		S		A	S	K	E	D
I	T		T			U		L		E		
D		A	U	S	T	R	A	L	I	A		C
		L		U		A			R		G	O
T	R	I	B	E		N		P	A	P	E	R
U			E			C				H		N
L		P	R	O	T	E	C	T	I	O	N	
I			E		I			E		N	O	W
P	A	R	T	I	C	I	P	A	T	E		E