Artemis FINANCIAL ADVISORS

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Should You Purchase Disability Insurance?

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One of the biggest gaps in most individuals' financial plans is protection against the financial consequences of becoming disabled and not being able to work for a considerable time. Few people are aware that the risk of becoming disabled before age 65 is significantly higher than the chance of dying before age 65. Irrespective, surveys repeatedly show that financial advisors are not adequately educating their clients on disability risks and helping them put in place an adequate risk management plan. In this note, we seek to arm you with enough information to decide whether you are at risk and need to take action.

What's at Stake?

For most working Americans, their ability to work and their future stream of earned income is their most valuable asset*, by far*. As the chart indicates, the present value of an earnings stream of $250k for 20 years, including retirement contributions and adjusted for a 3% annual cost of living increase, is $4.9 million. For someone earning $500k annually, the present value is $9.8 million. In short, a long-term or permanent disability can have a devastating financial impact on a family.

Figure 1. Major Disability Cost: Lost Earnings & Retirement Contributions

Annual Earnings	Years Disabled (prior to retirement)		
	10	**20**	**30**
$100k	$1.1M	$2.0M	$2.7M
$250k	$2.7M	$4.9M	$6.9M
$500k	$5.3M	$9.8M	$13.7M

Figures are the PV of annual earnings and retirement contributions over indicated time frames assuming 3% inflation. Retirement contributions assumed to be 15% of employee's salary plus a 5% match, and earn 5% annually.

How Common is the Risk?

Contrary to popular perception, injuries are not the major cause of disability; accidents account for only around 10% of disabilities. Chronic illnesses such as arthritis and connective tissue disorders are the largest source of disabilities (22%), followed by cancer (14%), strokes and heart attacks (10%), and a variety of other diseases.

The good news is that while the probability of a short-term disability is relatively high, the odds of a long-term disability are low.[1] The best data I was able to find is that if you are a 35-year-old male, you have about a 25% chance of experiencing a disability before age 65 that will keep you out of work for 90 days or more. If you are a white-collar 35-year-old male, eat a balanced diet, have no chronic conditions and do not smoke, your odds may drop to 15%. For a 55-year-old white-collar male, the odds decrease to around 10%.

1. Ron Lieber, "The Odds of a Disability are Themselves Odd", *The New York Times*, February 6, 2010

Moreover, the odds of that disability affecting you for a very long time (5 years or more) are very small. For a 35-year-old white-collar male with a disability, the chance of it being very long-term is 27% (and 44% for a 55-year-old). So, for a healthy 35-year-old male, there is about a 4.0% chance overall (.15x.27) of being disabled more than 5 years before age 65, and for a 55-year-old, there is a 4.4% chance.

Yet, low odds of occurrence and high financial consequences is the perfect formula for insurance. In the case of disability, the financial consequences can be devastating. For all of the above reasons, I believe disability insurance can be a very important risk management tool that ought to be considered by those who have a sizeable income stream ahead of them and lack a strong safety net such as a spouse earning a high income, an inherited trust, or other resources.

How Much Does Insurance Help?

Recent statistics indicate that only about 40% of working Americans have long-term disability income insurance through their employer, and only a very small minority – 6 percent of women and 8 percent of men – have purchased disability insurance individually.

Standard employer-based policies cover the insured up to normal retirement age of 65. Usually, the policy will provide a benefit equal to a percentage of the insured's current expected base salary (most typically 60%) exclusive of bonus income, up to a specified monthly maximum (e.g., $10,000 per month). To the extent that the employer pays the premiums, any disability benefits received are taxable to the insured. Therefore, for a high-income earner the actual after-tax monthly benefit may only represent 20%-40% of his/her prior total after-tax compensation, all during a time in which healthcare and other care-related expenditures will almost surely increase.

Individual policies can fill the gap between what the group policy will pay and the individual's current total earnings (including bonus income and even retirement contributions). Moreover, since the individual is paying the premium, those added benefits are not taxed when received. Individual policies are also portable (i.e. they stay with you even if you leave your current job). However, they don't come cheap. For instance, a policy with a 90-day elimination period for a 43–year-old, with a monthly benefit of $7,000 and so-called "own-occupation" protection, can cost $3,000-$4,000 annually, depending on options selected.

Bottom Line

As with any insurance purchase decision, it is important to determine how much financial risk you are able to retain and how much might be transferred to insurance. For most high income earners, a short-term disability (less than 90 days) is typically manageable from a financial perspective and is, indeed, one of the reasons why most all financial planners recommend keeping some emergency liquid savings. But a long-term disability is rarely manageable and can force immense changes to lifestyles and financial security. Disability insurance can mitigate those impacts.

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