Insurance Ratios from Your Money Ratios

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I've already discussed Charles Farrell's book Your Money Ratios several times on this blog, including the all important Capital to Income Ratio and the Debt Ratios. He also gives advice on how much insurance to take out. I don't think his advice on this subject is quite as good for docs as on some of the other ratios. First, his life insurance ratio. I like that he relates it to your capital to income ratio. But in reality, it's all about a simple addition problem. Your portfolio, plus your life insurance, should equal the number you need to be financially independent (~25 X what you spend each year.) As expenses go down and as your portfolio value goes up, the amount of life insurance needed should go down. It has little to do with your income. It's all about your expenses. Here's his chart:

Age	Capital to Income Ratio	Life Insurance to Income Ratio
25	0.1	12
30	0.6	9.4
35	1.4	7.1
40	2.4	5.2
45	3.7	3.7
50	5.2	2.4
55	7.1	1.4
60	9.4	0.6
65	12	0.1

You notice that the ratios are inverses of each other. That's an important relationship to understand. I just don't like how he uses income instead of expenses. It's easier to use income for a rule of thumb, but it's so much less accurate. His disability ratios suffer from the same problem. He says you should have disability insurance sufficient to replace 60% of your income until you turn 60, then 40% until you turn 65, then zero. In reality, you need enough disability insurance to pay all your expenses AND allow you to save for retirement. If your spouse is a doc, that might be zero disability insurance. It just takes more thought about your individual circumstances than "buy as much disability insurance as you can" to decide how much to own, especially when a good policy might cost you over 3% of your gross income. Although I like the idea of ratios that he uses in the book, I think he's pushed it a little too far here. This decision has to be more individualized. I hope this is from laziness or ignorance on his part, and not just from the fact that he makes big commissions off disability insurance.

His stance on long-term care insurance is much more nuanced, as it should be. He suggests not buying it until age 55, then calculating your "insurance gap" to determine how much to buy. Insurance gap is the cost of long-term care minus the amount of income your portfolio generates. For example, if your portfolio generates $50,000 a year, and long-term care costs $80,000 a year, you need to buy sufficient insurance to cover $30,000 of expenses. That's a pretty good general rule.

People generally fall into three categories for long-term care. The first category has little to no assets. If they get really ill, they spend what they have left, then Medicaid pays for long-term care. The second category has a lot of assets. These are people with no "insurance gap." If they get sick, they pay out of their large retirement stash. I hope most docs make it into this category. Most docs I know don’t plan on living off less than the cost of long-term care in retirement. The third category are those with sufficient assets that they don’t want to spend them all down, but not enough to be sure they have enough to pay for long-term care. These are the folks that need to buy the insurance. It gets a little more complicated if you’re married, so Farrell suggests you double the costs of long term care, calculate your gap, then get a policy on each spouse for half of the gap. That seems like a solid compromise. I say save enough money so that by 55 or 60 you simply don’t need LTC insurance. In my state, LTC (nursing home, private room) averages $65,000 a year. I plan on living on more income than that in retirement.