5 insurance mistakes and how to avoid them

BY SARAH MAX, FIDELITY INTERACTIVE CONTENT SERVICES — 11/04/11

Don't get tripped up by these common errors when shopping for life insurance a critical piece of your financial safety net.

If life insurance has been low on your list of financial priorities, you're not alone. Some 30% of U.S. households have no life insurance whatsoever, and half admit to not having enough, according to research and consulting firm LIMRA.

While budget constraints account for some of this gap, the morbid nature of the product might also be to blame. Unlike, say, saving for retirement or college, thinking through the financial implications of death doesn't exactly evoke warm and fuzzy feelings.

But better to confront your own mortality than leave your family a legacy of financial hardship. And, look at the bright side: "Prices are near all-time lows," says Robert Bland, CEO of Life Quotes, a national life insurance brokerage. "You've got intense price competition, and the industry is realizing that people are living longer." In fact, a healthy 40-year-old man could lock in a $1 million, 20-year term policy for about $640 a year, according to Life Quotes.

Taking stock of your insurance needs and shopping for a policy isn't rocket science. Still, it's easy to get tripped up by the dollars and details. Here are five common blunders to avoid.

Mistake No. 1: Counting on rules of thumb

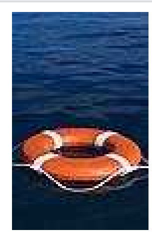
A better way: Do an inventory of what you need and what you have.

A common rule of thumb is to buy insurance equal to 10 times your annual salary, but that guesstimate can result in not having enough or, conversely, buying too much, says Dan Mathews, a fee-only certified financial planner with Stepp & Rothwell in Overland Park, Kan. It can also lead you to overlook hidden costs, such as replacing employer-provided health insurance, as well as big-ticket items, such as college for your kids or retirement for your non-working spouse. An online life insurance planning tool such as Bankrate's can help you come up with a more detailed estimate.

For most families, a term life policy is usually the go-to type of policy, and for good reason. "It's the cheapest insurance to fit the bill," says Michelle Fait, a fee-only planner with Satori Financial in Seattle. As the name suggests, it offers a fixed premium for anywhere from 10 to 30 years depending on the term you choose. If you have kids, you'll want a policy that doesn't expire until they finish college. If your spouse relies on you for some or all of the household income, the term may be tied to when your mortgage is paid off or when you plan to retire.

A step-by-step guide to buying life insurance

These simple steps will help you figure out how much coverage you need and find the right policy for you.



Mistake No. 2: Buying permanent insurance at all costs

A better way: Cover your bases with term.

If your insurance needs go beyond your working years – for example, you want to cover estate taxes – a permanent policy may be appropriate, says Brett Wollam, senior vice president of marketing for Fidelity Investments Life Insurance. These policies, which come in the form of whole life, variable life and universal life, don't expire and typically include a cash value component. When matched properly with a family's needs, such a policy can be an important addition to an overall financial plan.

But because these plans come in many different varieties – and are substantially more expensive than term insurance – you should consult a fee-only financial planner (who doesn't make commissions on life insurance products) before going this route. "First and foremost you need to make sure you have enough insurance to cover your needs," says Mathews, who warns against letting the allure of low-risk returns often promised by whole life policies detract from the main goal of getting the right amount of coverage.

Mistake No. 3: Relying on employer-provided insurance

A better way: Lock in a policy you can take with you.

Group life insurance is a common offering in company benefit packages. These policies, which typically cover from one to five years of salary, offer some financial cushion, but it's best not to include them in the equation. "If you lose your job you likely won't have that insurance," says Tom Ewanich, vice president and actuary with Fidelity Investments Life Insurance.

Some firms offer supplemental policies at the employees' expense, typically subject to a health exam. Before you go this route, make sure the policy is portable, meaning you can take it with you when you leave the job, and see how the plans price out. As a rule, these policies are often more expensive than what you'd find on the open market, says Mathews. One exception: If you have a pre-existing condition that makes it tough to qualify for an individual policy consider stocking up on insurance when you start a new job. "Some companies have a no-questions-asked period where new employees can buy supplemental insurance that isn't tied to a health assessment," says Fait, the Seattle planner.

Mistake No. 4: Not insuring a non-working spouse

A better way: Put a dollar value on his or her contributions.

At its core, life insurance is designed to replace income. That said, the death of a non-working spouse can still be a financial hardship, Ewanich says. It can result in substantially higher child care costs and home maintenance costs. "It can (also) have an impact on the wage earner's ability to earn money," he says.

To find the right number, calculate what it would cost to pay someone to help care for the children, manage the household and deal with all the other tasks that fall on the shoulders of a stay-at-home spouse.

Mistake No. 5: Fibbing on the insurance application

A better way: Be honest from the get-go.

It probably goes without saying, but your individual health – as determined by everything from your weight and blood pressure to medical history and prescription drugs – will greatly influence premiums. A 40-year-old male smoker, for example, can expect to pay about $3,900 a year for a 20-year, $1 million term life policy, according to Life Quotes. That's about six times what his healthy non-smoking counterpart would pay.

If your health is less than stellar it's particularly important to shop around, says Life Quote's Bland, because different carriers are willing to take on different types of risk. Initially, you'll be quoted based on the information you provide on the application, but because all of this information is verified via a medical clearinghouse and health exam, fudging the numbers will get you nowhere.

In fact, during the underwriting process you may be better off providing more information than necessary. "If you have something in your health history, explain it," Bland says. "You'll likely have a better outcome if you give this information up front."

Once you've done your homework and secured the coverage you need, don't just set it and forget it. Experts recommend reassessing your coverage when you change jobs, buy a new home, have another child, get divorced or get remarried. Even if the dollar amount of coverage you need doesn't change, some of the fine print could be affected.

The most obvious example is divorce. "If you don't update your policy to remove your ex-spouse, he or she will remain the beneficiary," Mathews notes.