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Insurance: A Tax on People who are Bad at Math?

I recently read a Facebook conversation about health insurance where one person said, “I’m better off saving the $1000/month premiums and paying for my own medical bills if they ever come up”. And the other person said, “Bah! Recipe for bankruptcy! You need full insurance!”. Which person was right?

Years earlier, I was talking to a friend who had just bought her husband a Rolex watch as an anniversary present. As part of buying the watch, she also bought an insurance policy which would buy them a new Rolex if it was stolen. Was this policy a good idea too?

What about collision insurance on your car? And life insurance?

Insurance of all types – car, house, jewelry, health, life – is a crazy field swayed by lots of marketing, fear, and doubt. In fact, I’d bet most insurance is bought partly on fear and without doing any actual math on whether it’s a good deal. If you’re an average consumer, you spend several thousand dollars per year on insurance. Maybe there’s a way we can cut that down and let you keep some money for yourself!

The first thing to understand about insurance companies is that they are making money off of you – lots of it. They do this by employing a team of brilliant mathematicians called Actuaries who analyze detailed mountains of statistics about the average behavior of people like you, and thus how much money they expect to pay out to you in claims. They then strategically set your premiums to a level where on average, they can pay your claims, pay their employees, and still make a large profit for their shareholders. So they have, of course, rigged the odds against you. So when buying insurance, you will most likely pay in more than you get out of it.

This seems obvious, but some people still need a little reminder, because I keep hearing things like, “I need dental insurance, so I don’t have to pay the $300 every time I take my kid to the dentist!”. That’s a mindset that is imagining that insurance actually SAVES you money on average, which it does not – otherwise the insurance companies would all lose money – which they do not!

Once you understand this, you realize there are only three possible reasons to get insurance in any particular area.

- You’re forced to do it (car insurance laws, house insurance required by your mortgage bank)

- You can't afford the consequences (A burned-down house or a year in the intensive care unit at $20,000 per day)
- You are riskier than the insurance company thinks you are (you engage in drunken car racing or competitive eating events on the weekends).Or on a more serious note – if you are **planning or expecting a baby**, or have any known upcoming or chronic health conditions.. these are good times to plan in advance and set yourself up with a much lower-deductible plan. The US is an unusually expensive place to have a baby in a hospital, and even I wouldn't advise risking paying for this out of your own pocket. The cost will range from $3,000 to $1 million+, depending on complications you cannot predict in advance.

That covers the main categories of insurance. But what about things that you can't afford but are really unlikely? Do you get kidnapping insurance on yourself to cover up to a $3 million ransom? Identity theft insurance? Insurance on your kids? Extended warranties from Best Buy on your new laptop?

Stop! It's all a trick.

Luckily there is a solution: Get almost none of it. Especially if you already have a healthy 'Stash of savings built up and could thus afford any unexpected expenses.

Since you'll be driving only affordable used cars with no bank loans, get only liability insurance. Since you will be keeping yourself healthy for life, get only a "catastrophic" type of health plan where you pay ALL your own bills unless the cost exceeds $5-10k in a given year. Since you will be building up savings and cutting your living expenses, and you are very unlikely to die in the next few years, you may not need any form of life insurance.

My wife and I have never carried life insurance on ourselves, and we consider it a compliment to each other: "I believe you would do Just Fine if I wasn't around, because you're a capable and independent person". Get the highest deductible on your house insurance that the mortgage company will allow. Or if you have no mortgage, the highest you are comfortable forking over after an incredibly unlikely event (I usually set mine at about $10k).

Then for the insurance lines that you are keeping, do a nice afternoon of shopping around – I did this last January and sliced about $300 per year off of my remaining home and car insurance. The winners for me ended up being subsidiaries of Geico, although different people will find their results vary with different insurance companies, strangely enough.

Then put all the savings from these premiums into growing your nest egg, realizing that you are now getting paid to be your own insurance company.

It sounds risky if you let the fear creep in. But it should actually feel deeply satisfying and safe. By not buying into a product where the odds are stacked against you, you are STATISTICALLY likely to win. We can't predict the future, but we do have one tool that lets us turn the unknown to our advantage, and that is statistics. They are my best friend when it comes to becoming wealthy, and they should be yours too.

The savings of thousands per year will add up alongside all your other newfound riches from frugality, and you'll soon find that none of these potential expenses will scare you. Over the past 10 years, I've saved about $40,000 in insurance premiums compared to the average level of spending, and now that $40k is sitting alongside my other employees, producing $2800 of passive income each year, and already more than big enough to cover replacing a crashed car or paying any possible deductibles on medical bills.

And after 10 years of relatively exciting living, I haven't even had to dip into it once. Now I see why insurance companies make so much money!