Twelve Steps to a Life of Financial Peace

Step 6: Setting the Foundation – Managing Risk

"Take calculated risks. That is quite different from being rash."
George S. Patten (1885 - 1945)

Picture this. You are on a hill rolling a snowball upwards. You started with a snowball about the size of your head. Your goal is to get to the top of the hill with a snowball large enough to make a very large base for a huge snowman. You stop about half way up to check your progress. Great, you are on track and feeling really good. So, you have it made, right? It appears that way, but there are a few things that could happen to keep you from your goal. Suppose you fall and break both of your legs, so you cannot push it any more. What if you fall down and the snow ball starts rolling down hill rapidly. How about if someone much bigger than you comes and steals your snowball, or smashes it to pieces.

The top of the hill is your financial independence. The snowball is your savings and investment plan. And you are … well you. Unfortunately, some people work really hard to build a financial future just to have it taken away by an unexpected event. Financial risks are a fact of life. There are only three things you can do about a risk.

First, you can **avoid risk**. This strategy might work for certain limited risks, but for the most part, it is unrealistic. In order to avoid risk, you will have to remove all of the possible events, which could cause the loss. So, for example, you could avoid the risk of death by automobile accident by never riding in a car. However, you would still have the risk of death by some other cause.

Another possibility is to **assume risk**. This means that you determine that you are in a position to cover the risk from your own financial resources. Unless you are a very wealthy person, this method of covering risk will also have limited application. For example, you could possibly assume some of the risk of medical expenses by accepting a higher deductible to get a lower premium. You determine that the cost savings is worth the risk and you can quantify the total amount of risk and decide that you can accept it. It would be more difficult to assume the risk of having your house burn down.

Most financial risks cannot be avoided and are too large to assume. There has to be a **transfer of risk**. In order to transfer risk, you have to find another person or company with deeper pockets than you. Usually, this means entering into a contract with an insurance company. The insurance company has enough people facing the same risks that they can pool them and predict their losses fairly accurately. Therefore, they can make a profit on the premiums and provide for the transfer of risks for each individual.

There are many types of risks of financial loss that we all face. One serious risk, which many people overlook or underrate, is the loss of income from a disability. This loss is far more likely for most people than the loss of life. The question you must ask yourself is: what will happen if you are unable to work for an extended period of time? There is often short-term protection, which will cover for thirty to ninety days, available from the employer. Long-term disability coverage begins after the policy's waiting period (usually 90 days).

Long-term disability income insurance is available through many employers at an additional cost. It can also be purchased privately. It is important that you understand the waiting period (period before benefits begin), maximum length of benefits, amount of monthly benefits, and whether or not there is a cost of living adjustment on benefits.

One of the most important risks to those you might leave behind is, of course, the loss of life. Life insurance is the only viable way to transfer this risk from the ones you care about who are depending on you. The question is; how much do you need and what kind? There are two broad categories of life insurance: term and permanent. Term is the best solution for most people who need pure insurance coverage for a limited amount of time. You should select the length of guaranteed coverage, which will last long enough to ensure that your financial responsibilities will be met before it expires. For example, if your youngest child is sixteen years old and you expect to be financially independent within ten years, a ten-year level term policy should be adequate. Make sure the insurance company you chose is highly rated, not just the cheapest premium. You should consider permanent insurance, if it is not likely that your obligations will end or that you will realize financial independence. Another use of permanent insurance is for estate planning purposes.

One of the most common mistakes we find in our financial planning practice is that people are not adequately protected from liability. You should fully understand the coverage you have and its limitations. There are types of losses, which may not be covered by your homeowners' or automobile policies. An umbrella policy fills in these gaps and increases the amount of coverage as well. Most people with any significant net worth or income should have this type of coverage.

Most people take their health insurance for granted, because it is often provided by an employer. However, it is important that you understand the limitations and options of these policies. It also might make sense to shop individual policies and compare them to your employer group plan.

Finally, there is long-term care coverage for the risks we face of an extended illness, which requires that we spend time in an institution not covered by our insurance or Medicare. Anyone over fifty years old should begin to explore this coverage.

The scope of this article is far to general to cover all of the intricate details of these risks and their coverage. If you are not technically qualified to evaluate them, you should get help. Make sure you work with someone who has the attitude of a consultant, rather than a salesman. In the meantime, keep pushing the snowball uphill and make sure you enjoy the journey!

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