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Elements of Financial Planning, Part 2: Risk Management

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Managing risk is a very important part of every financial plan. There are many types of risk addressed in a well-drafted plan - risk caused by stock market declines, economic instability, death, disability, loss of income and damage to assets like a car or house. These unforeseen events can have devastating financial implications to finances and alter the anticipated outcome of a financial plan. While risk is impossible to avoid, it can be managed appropriately.

The most common way to manage risk is through insurance, otherwise known as risk transfer. Insurance should be used to transfer risk with a low likelihood but high financial consequence. In a well drafted plan, all forms of insurance should be considered, reviewed and implemented where appropriate.

Most Americans with financial means carry health insurance; however, there are many caveats to the policy that can affect its benefit. In drafting the plan, it's important to consider the deductible amounts, coverage limits, co pays, and networks of doctors available. For small business owners, health insurance can be a major cost to the bottom line. For relatively healthy small business owners, transferring only major risk by increasing deductibles may be a good alternative to reducing costs.

Disability insurance is often overlooked, though disability can cause major financial hardship. If the primary income earner in a family is unable to complete their work duties, the financial loss can be devastating. Depending on an individual's age, the risk of disability is greater than the risk of death and often times creates the same financial loss to the family . Guaranteeing an appropriate level of income through disability insurance is important.

The premature death of a family member can also have a major financial impact to survivors and loved ones. It is important to insure the economic void that would be created in the event of death. Calculating the present value of future earnings that would otherwise be lost is a prudent first step. Term policies are the least expensive and typically cover the income earner over their years of employment and potential lost earnings.

There are other types of life insurance that are permanent in nature, such as whole life, universal and variable. These types of insurance often carry a high internal cash value and have much higher premiums. Many insurance professionals will position high cash value insurance as a means to protect survivors in addition to building up a tax free cash value that can be tapped for retirement income. In reality, the amount of liquidity available under this strategy is limited as the policy requires a substantial amount of cash value to cover insurance costs and to remain in-force. As a result, reduced liquidity and limited income available, may make the strategy becomes less attractive relative to buying term and investing the premiums saved. However, permanent insurance is excellent for wealth transfer techniques which we discuss under estate planning.

Asset protection covers loss from creditors or damage to assets such as a car or house. Property and casualty insurance is the first step in designing a well constructed asset protection plan. Auto and home coverage will offer replacement coverage in addition to liability coverage from creditors. Many high net worth individuals are under-insured for liability and frivolous lawsuits. Umbrella coverage is an important and relatively inexpensive step. Beyond this level of planning, high net worth individuals may consider Asset Protection Trusts or offshore accounts. Both of these entities will offer more protection from creditors but come with the downside of some loss of control of the asset.

Many insurance companies offer coverage for stock market declines on a portfolio in the form of annuities. Annuities are an investment portfolio with an insurance wrapper. They typically guarantee a level of retirement income and/or death benefit. However, Annuities are generally very expensive, carrying costs roughly 3 – 4 times the typical professionally managed portfolio. In addition, most of the coverage offers peace of mind but no real economic benefit. For example, most of the living benefits are structured in such a way that the insurance companies have almost no chance of paying a claim to the customer. The death benefits premiums are typically far more expensive than traditional life insurance for the same benefit. They also have large income and estate tax consequences that are limited in a traditional diversified portfolio. The best risk management strategy for market declines may be a well diversified portfolio that is tax efficient and avoids unnecessary costs.

A customized, well-designed financial plan brings clarity and direction to financial choices clients make everyday. One of the most important elements of a financial plan is risk management through insurance. Though it is important to manage risks like stock market declines, economic instability, disability, loss of income, and damage to assets, it is never possible to avoid it altogether. The peace of mind offered by a well-constructed financial plan is invaluable to help clients navigate periods of market volatility.

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