Do not ignore insurable risks that could destroy your best laid financial plans

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Summary: A previous financial article, “The Solution - ONLY follow financial strategies that are scientific, passive, diversified, savings focused, risk controlled, low cost, and tax efficient,” suggested that investors are much better off with a well-considered financial plan. A stable set of financial beliefs can help you to keep focused and on track throughout your life. This follow-up article discusses the additional need for your personal financial plan to consider insurable risks that might be covered by cost-effective insurance products. A personal financial plan is not complete without needed insurance. Individuals and families are unpredictably vulnerable to disease, disability, and death. Other factors beyond their control can interfere with their ability to be fully employed or to be employed at all. Assets can be damaged or destroyed. Legal actions, and financial predators can drain assets. As you use your favorite personal finance software to develop a workable lifetime financial plan, you should also consider where you might be vulnerable to other risks that would disrupt your financial planning. Some of these risks could be ameliorated through insurance. Insurance may provide cost-effective risk pooling benefits in some circumstances. However, in other situations, the net present value of insurance premiums may be too high to warrant carrying the insurance, despite the risks. (See: Insure against financial risks economically)Buying appropriate and economical insurance is not simple. The menu of insurance choices is complex, and insurance product complexity has increased over time. Constantly shifting games are played between insurance providers and insurance consumers. As we should expect them to do, insurance companies pursue higher profits and work to limit their risk exposure through actuarial analysis and (usually) careful risk underwriting practices to avoid clients who would potentially be more costly. At the same time, many consumers are aware of their particular risk exposures and may succeed in concealing them when purchasing insurance. This is known as "adverse selection." The very clients that want to buy certain types of insurance are the ones that insurance companies seek to avoid. Insurance is a minefield of moral hazards on both sides. From an economic standpoint, this means that insurance will never be a bargain. Rates must be set by the insurance company to make a profit from the mix of people who make it into the insurance pool, including those with personal knowledge of adverse conditions that the insurance company lacks. You should always make a reasonable effort to assess rationally your own personal probabilities and financial tradeoffs before you buy an insurance policy. Nevertheless, you must realize that you will always "overpay" for insurance unless you happen to suffer some unfortunate event that is covered by the insurance contract, and your claim actually gets paid. Unlike investments, which can be purchased directly from many investment funds without a broker, you need an insurance agent or broker to buy insurance. After you have rationally assessed your need for particular kinds of insurance, finding a broker or agent who is honest and knowledgeable is the next step in the process. Similar to the process of selecting a financial advisor, you need to interview several insurance agents and brokers and choose one based on their knowledge and competence. (For screening ideas, see these article categories on the selection and payment of financial advisors: Selecting an Advisor and Payment of Advisors) You always need to keep in mind that insurance agents and brokers will be paid commissions by insurance companies to sell their products to you. Often the most profitable insurance products with the highest sales commissions are the insurance products that would tend to benefit you the least from the standpoint of cost-effective risk amelioration. The insurance companies love your premiums, but not your claims. Insurance agents and brokers love making the sale, because the great majority of the sales commissions they receive will be paid within the first year after you sign the insurance contract. This front-loaded sales agent compensation is one of the reasons that many insurance products have cancellation fees that expire over time.There is a very heavy and calculated emotional side to the insurance sales and marketing process. Therefore, be very aware of insurance sales tactics. If the sales conversation focuses on your particular needs and risk exposures and you are offered a range of options that seem to meet your needs, this is a good sign. Your needs should drive the insurance product selection and the insurance product should directly address the risk exposures that you already knew you had. However, if the sales process moves to emotionalism and anecdotal stories of families saved by insurance coverage, realize that this story telling is often part of the sales training process of insurance salespeople. However, after you have put down your Kleenex, you still need to pick up a sharp pencil and calculator, before you sign any insurance contract. Insurance products like investments usually turn out better, when purchased rationally rather than emotionally.Properly chosen, insurance products should directly address the underlying financial exposures associated with insurable risks. However, many of the cautions offered above and elsewhere by *The Skilled Investor* about investment risk bearing and the cost-effectiveness of investments also apply to insurance products. In particular, you should be careful when you evaluate insurance products that are not solely insurance products. Hybrid insurance products may combine both insurance and investment characteristics. While they are sold as the best of both worlds, often they are not the best of either. Whenever possible, buy insurance only products rather than insurance and investment hybrids.When purchasing insurance, you need to be clear whether you have an income-related or asset-related financial exposure. Your personal finance software should model both your gross and net human capital to help you gauge and project your financial exposure associated with employment related income. Human capital diminishes with age, so insurance coverage requirements linked to earned income logically would decline with age.As you age, the balance of insurable exposures tends to shift from earned income risks to asset related risks. Your personal finance software should model your potential investment portfolio growth, investment returns, and asset withdrawal rates across your lifecycle and through your retirement plan. The adequacy of retirement investment assets can depend upon your unpredictable longevity, unpredictable investment returns, and other risks. For example, through annuities, which are a hybrid insurance and investment products, you could benefit from insurance risk pooling and insure against your longevity risk. However, annuity costs typically are quite high. You should be very sure that you understand all terms of an annuity contract and that you know your non-annuity alternatives, before you sign any annuity contract.Finally, there is no free lunch when you purchase insurance contracts. You trade your future investment portfolio assets and make premium payments in exchange for the assurances of insurance companies. You may pay premiums and may never need to make a claim. However, if you do suffer an insured event, then you certainly want your insurance company to be in business and solvent, when that unfortunate event happens. Therefore, you should check the financial ratings of the insurance company that is offering to sell you an insurance contract -- BEFORE you sign the contract. Do not take this ratings review process lightly. If your insurance company is not around when you need it, you will be out of luck. If your insurance company is still around, but it is having financial troubles at the time, then so will you. Any competent insurance agent or broker should have printed ratings information available for the insurance products that he or she suggests you buy. If not, this is a big red flag. While your agent or broker should provide financial ratings information, here are links to the major ratings services for your background: A.M.

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