

*Work!*

## **Step 8 - Insure against financial risks economically**

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Insure against risks economically Step 8 of "10 Financial Planning Steps in the Right Direction"

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While value, affordability, risk exposure, and risk tolerance should affect insurance purchase decisions, insurance is often sold and purchased emotionally. Yet, insurance premium payments reduce personal funds that might otherwise be available for additional investments. Many people could spend all their net savings on insurance premiums and have nothing left to invest and to build an investment portfolio. The issue is where to set a rational rather than emotional balance between expected risk and return. Risk and return tradeoffs between insurance and investments Insurance affordability inevitably dictates that most people will bear some insurable risks without insurance coverage. Individuals may be more or less comfortable with this situation. Having a good understanding of one's risk exposure and risk tolerance is a good start. In general, individuals can significantly lower insurance premiums by focusing solely on buying catastrophic risk coverage and using self-insurance for more minor risks. For insurance you must have, shop around and chose high deductibles to reduce premium payments. Carefully evaluate the scope of coverage to assure that it is good quality catastrophic coverage. Then, invest the premium savings achieved through higher deductibles, rather than spending those savings. Over time, these premium savings and investment returns on them will build up your self-insurance asset pool. Catastrophic personal events can drain assets and destroy the best of investment plans. Property, liability, life, and disability insurance can be rational purchases, because of risk pooling with other risk adverse people. However, these types of insurance are not investments in and of themselves. Instead, they limit the financial impact of potential, but relatively unlikely, negative future events. The question comes down to finding good quality insurance at a competitive price and determining the tradeoff between money spent on premiums versus money retained and invested. Optimal investment planning focuses on enhancing expected risk-adjusted portfolio performance. An optimal investment plan assumes that the necessary labor-based net income will be earned over time to build up your investment assets. In addition, the plan reasonably assumes that your assets will appreciate over time, albeit with substantial and unpredictable price volatility. By adopting optimal investment practices, individuals increase the chances of financial success that can be attributed to investment returns. However, other risks are inherent in life planning, and there are no guarantees. Personal financial and investment plans may fall short of goals due to a long list of non-investment risks. These risks include inadequate savings, personal tragedy, and family misfortunes. Insurance can address some of the other financial risks that people face, which are not directly related to investment risk. Generally, these insurable risks are risks to one's future income stream or to one's future expenses. Such insurance is designed to replace lost income or pay higher expenses resulting from risks that do manifest themselves. Insurance-based annuity income guarantees are not investments Many investors rationally seek retirement income guarantees through annuities and related insurance products. When they purchase such insurance with their labor income and/or investment assets, they change the complexion of their portfolios. When they shift investment risk bearing to an entity providing a guarantee, they cease to be investors for that portion of their assets. Furthermore, they often must pay a high price to shift asset risk to the guaranteeing organization. Insurers intend to make a

risk-adjusted profit on the asset beyond the guarantees provided. Therefore, on average an individual can expect to receive less total value than he would likely have received had he kept the asset and retained the corresponding risk. However, there is one risk that individuals retain and cannot shift. This risk concerns whether the assets of the guaranteeing entity will be adequate to fulfill its future obligations. The sad, yet still ongoing saga of the 1991 collapse of Executive Life Insurance Company is a reminder of this nontransferable risk. Shifting risk and return to an insurance company can be rational, since the length of one's life span is uncertain and tolerances for risk vary from one individual to another. Risk pooling based upon longevity can benefit participants, if the price paid for the guarantee is not excessive. The total price of shifting asset risk in such arrangements is the key issue to individuals — in addition to the future risk of the insurance contract non-fulfillment. Combined insurance and investment products confuse personal financial planning decisions. In recent years, insurance firms have expanded their products and services from offering only pure insurance to selling hybrid products that combine insurance and investment characteristics. The industry also has garnered certain tax treatments that can make their products more appealing to persons with particular tax situations. Unfortunately, some of these hybrid insurance/investment products are characterized by inferior returns, high costs, unwanted tax implications, significant insured risk limitations, and other problems. Ultimately, the issue that the potential buyer must sort through is whether the purchase of separate insurance-only and investment-only products will yield better insurance risk reduction and/or superior risk-adjusted investment performance.