

- *Client Information Summary* -

The Principles of Risk Management

The term **risk** has two definitions as it relates to personal financial management.

The definition of **investment risk** is *the degree of uncertainty of achieving an expected rate of return*. Client Information Summary (CIS) #107A—*Investment Planning Concerns and the Principles of Investment Management* provides a good explanation of investment risk.

The definition of risk that is explored in this Client Information Summary is *exposure to the chance of loss*. More specifically, we will identify those **risks** that can be insured, thus protecting ourselves from financial loss.

Chance of Loss

Let's start out by identifying the areas in which you may be exposed to the chance of loss. Perhaps the most obvious is **loss of property**. Property would include your house, cottage, car, or your personal belongings. Thus, one example of loss of property would be having your house burn down.

Another type of loss, one which we hear more and more about today, is the **loss of money** or **future earnings** resulting from your personal liability for; personal injury you caused to someone else (someone slipped on your front steps); destruction of another person's property (little Bobby smashed your neighbour's bay window); or an error in the discharge of professional responsibilities (as an accountant you made a mistake in working on an audit which resulted in a \$500,000 lawsuit!)

Another possible exposure is for medical expenses outside Canada (you are hospitalized in Florida for two weeks as a result of a car accident and get a bill for \$40,000). Each of these examples illustrates **losses** of money or future earnings. Fortunately, most of these "chances of loss" are insurable risks.

As catastrophic as some of these losses may seem, many people face the risk of a much greater loss each day, without blinking an eye. It's the potential loss of income caused by sickness or injury resulting in pro-longed disability or pre-mature death. Consider for a moment what your ability to earn income might be worth.

What Your Ability to Earn Income Might be Worth

While we don't always associate pre-mature death with loss of income, if the deceased was gainfully employed, the loss is very real. Aside from the emotional trauma, thankfully, loss of income as a result of loss of life is an insurable risk, with some exceptions and limitations. The magnitude of the financial loss can be very dramatic as the following chart illustrates.

<i>Years Left To Work</i>	<i>Monthly Income \$3,000</i>	<i>Monthly Income \$5,000</i>	<i>Monthly Income \$10,000</i>
10 Years	\$ 432,220	\$ 720,366	\$1,440,733
20 Years	\$1,072,011	\$1,786,685	\$3,573,369
30 Years	\$2,019,058	\$3,365,096	\$6,730,193

Assumes 4% inflationary increases each year.

No doubt the value of your home pales in comparison to the potential loss of your future ability to earn income.

The Chances of Becoming Disabled

What are your chances of actually suffering a loss of income as a result of a disability during your working career?

<i>Age</i>	<i>Number of Persons per 1,000 That will be disabled 90 Days or Longer Before Age 65</i>	<i>Average Duration</i>
30	505—1 out of 2	2.6 Years
40	446—4 out of 9	2.4 Years
50	342—1 out of 3	2.3 Years

Thus, with an understanding of our exposure to the *chance of loss*, we recommend strict adherence to the following:

Principles of Risk Management

1—Insure Your Income

If your earned income is necessary to attain financial independence, then transfer the risk of loss of income resulting from long-term disability to an insurance company (if possible).

If you are a professional or business owner and have expenses which would continue even if no income was coming in, then consideration should be given to transferring this responsibility to an insurance company by acquiring an office overhead/business overhead expense policy.

2—Insure Your Life

If loss of income through pre-mature death would pose a threat to your family's financial security, transfer the risk to an insurance company, by buying life insurance (if possible).

Consideration should also be given to the loss associated with the death of a spouse who doesn't work outside of the home. There may be large financial consequences in terms of loss of services that have to be replaced such as childcare. Also there could be loss of future pension benefits or even the loss of an inheritance that was being counted on as part of an overall financial independence strategy.

Although the risk may be minimal, insurance coverage on children should also be considered. The primary reason for this consideration would be if either parent were self employed or had compensation reliant on productivity. Someone in a salaried position would likely be marginally affected by considerable down time but, a non-salaried person would likely incur some income reduction. In this case, temporary coverage is recommended. Insurance coverage is also recommended if parents have concerns for a child's future insurability and/or could benefit from tax sheltering investment income. In this case, permanent coverage is recommended.

Properly arranged life insurance can help mitigate against these losses.

CIS #130R (*Types of Life Insurance and Their Proper Use*) provides an overview as to the various types of life insurance that are available, as well as some general considerations in selecting the type most appropriate to an individual's specific situation.

3—Insure Your Property

Insure against the possibility of major loss of property, such as, your home, cottage, cars and other prized personal possessions. Minor losses that can be reasonably self-insured should be. In particular, liability insurance is absolutely critical.

4—Insure Against Contingent Liabilities

It makes sense to eliminate catastrophic chances of loss that would impair your ability to attain or retain your financial independence. This can be accomplished through a combination of homeowner insurance, auto insurance, professional liability insurance (if applicable) and in some cases, excess liability insurance.

5—Insure Against Major Medical Expenses

As Canadians, one area of concern is when we are traveling outside of the Country. Private health insurance is available to provide this protection.

By adhering to these principals, you'll protect yourself and your family from the hardship that can result from all of these contingencies.