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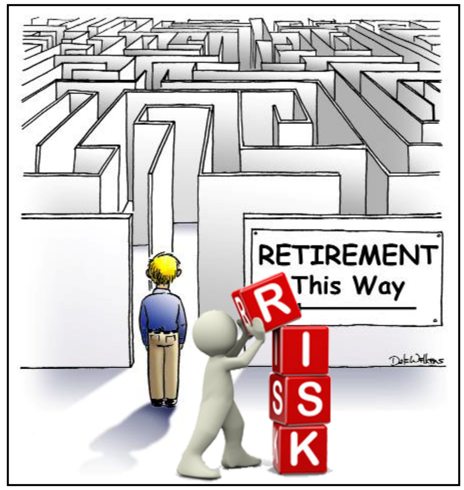
Winning the game of Risk

Navigating the Retirement Maze



"To be alive at all involves some risk."

-- Harold McMillan, former British Prime Minister

Most Baby Boomers can recall long evenings spent playing the board game of Risk, where the objective was global domination. The worst possible outcome was having your armies annihilated early on, and then having to wait around while the remaining players maneuvered for victory. Nowadays, we play the game of risk for real, where an adverse outcome can destroy our chances for an enjoyable lifestyle and retirement.

So how do we win at real-life Risk? We do it by not losing. More specifically, we approach it as a professional poker player would, by making sure that no single loss will ruin us financially. Thus, we need to identify those significant "lose the farm" adverse events that could occur, and develop a plan for diminishing their impact. It isn't a particularly difficult exercise, but an essential one for your financial health.

Defining risk

Life can be viewed as a continual series of risks. We begin taking risks as soon as we get out of bed in the morning, or even risk losing our job by not getting out of bed. But there are risks, and then there are RISKS. The latter are the potentially catastrophic ones that can result in a permanent financial impairment, and thus need to be managed accordingly.

The Merriam-Webster dictionary gives one definition of risk as "the possibility of loss or injury." As a financial planner, I define risk as the possibility of permanent financial loss. This can result from a disaster either in your personal life or your portfolio. You need to protect against both. From a planning perspective, we don't want to be vulnerable a single event that could wipe us out financially.

Managing major risks

When the occurrence of an unlikely event could permanently impair our financial security, we need a way to share this risk across a larger group. This is the essence of insurance. It's somewhat like a lottery, where many people lose a small amount (insurance premiums) so that no one person loses a life-altering amount. We're all familiar with the common types of insurance: life, auto, homeowner, health, and disability. Conscientious insurance agents make sure that the coverage afforded by each type of policy is adequate for a policy holder's particular situation. However, it is worth checking periodically to make sure that there are no significant coverage gaps.

A common deficiency I occasionally see is the absence of umbrella liability insurance, which increases the liability coverage of your auto and homeowners policies to $1 million or more. The cost of a negligence lawsuit – someone falling on the ice on your front walk, for example – can be quite high, so the several hundred dollar annual premium is a relative bargain. Don't skimp here. Another item to check is whether your homeowners insurance covers at least 80 percent of the replacement cost of your house. If it falls below that level, partial losses would only be covered at replacement cost minus depreciation.

Determining the appropriate amount of life insurance coverage can seem daunting. You need to consider what the negative financial impact would be on your family if they suddenly lost the services and income of you or your spouse. There are calculators on the Internet that can help you do this. Term life is the most economical way to get this coverage. Permanent life policies are appropriate for wealthy individuals looking for ways to tax shelter income, or people incapable of saving for retirement on their own.

Adequately insuring for the costs associated with long term illnesses is a topic that I covered back in my January and February 2013 columns on long term care insurance. It's a complex issue that continues to evolve, and the decision to purchase it depends upon a number of factors including family health history, financial assets, and types of coverage available. I'll be updating this subject in a future column.

Portfolio risk

For those of you who have visited my Web site, the quote that greets you on the home page reads: "The biggest risk is not meeting your financial goals." We've discussed how uninsured catastrophic losses can cause this. Maintaining your investment portfolio to achieve the needed returns while mitigating the effect of significant market losses is the other half of personal risk management.

Adequately addressing this topic requires more space than I have this month, so I'll save that for next month's column. As a parting thought, try not to get spooked out of the market just because your portfolio showed a loss last month. Numerous studies prove that individual investors are terrible at market timing, so structure your investments according to the timeframe in which you'll need to access funds, not by how CNBC influences your emotions.

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