**Risk Management in Perspective**

*The Financial Planning Context*

In order to meet our lifestyle financial goal such as children’s education, overseas travel and comfortable retirement, it is necessary to construct an investment strategy. This process we refer to as *wealth creation*.

In order to protect our ability to maintain the required level of funding in the event of our premature death, inability to earn income or major illness, a risk management strategy is required. This is an integral part of *wealth preservation*.

The only way to effectively safeguard against these financial planning risks is through insurance. However, the dilemma facing the planner is that every Rand contributed to insurance represents a reduction of one Rand in the amount that we have available for funding purposes. Using the farming analogy, if you comprehensively insure all your crops against all possible contingencies, then there is little if any prospect of financial reward if you achieve a successful harvest.

If we assume that you maintain a contribution of R 8,000 per month towards a retirement fund in present value (real) terms and your insurance premiums are R 4,000 per month, then logic tells us that the opportunity cost of your insurance cover will be a one third depletion of your retirement capital.

*Understanding Risk*

Of course, nobody can do without risk cover, but we need to ensure that it is used appropriately and cost effectively. This is best illustrated in terms of the following Risk Management Matrix:

Severity of Loss

Frequency of Occurrence

**Self-Fund**

**Reserve**

**Avoid**

**Insure**

Consider the analogy of a motor car. It would be nonsensical to provide insurance to cover fuel costs. Imagine how much more fuel would be consumed and how such premiums would become unaffordable. Consumption expenditure should therefore be *self-funded*.

Replacement of tyres is a less frequent, albeit costlier event. It is entirely manageable through the creation of *reserves*.

For contingencies such as theft and major accidents, risk transfer through *insurance* is essential.

Certain risks with severe economic consequences can be mitigated by *avoiding* inappropriate conduct, such as obeying speed limits and not driving under the influence of alcohol.

*Understanding Insurance*

*Life Insurance* would be required in the event of your premature death. The proceeds would fund the repayment of creditors, estate duties and costs, the provision of funds for the sale of business interests and to the extent required, the support and maintenance of your family.

*Disability Cover* is essential if, as a result of illness or injury, you are unable to earn income. As far as liabilities and capital needs are concerned, lump sum benefits are appropriate, whereas living expenses are normally funded through an income replacement plan.

*Trauma Cover* is very useful in the event of the diagnosis of a specified illness such as cancer, coronary artery disease. Frequently there are unforeseen costs associated with such conditions, including the modification of your home or assisted care.

*Health Insurance* costs represent an increasing proportion of a household budget. Both medical schemes and supplementary insurance cover may be utilized. The regulatory environment has interfered with traditional risk pooling and underwriting processes and the selection of correct options requires the involvement of a specialist in the field.

*Our Advice Process*

The first step in the process is to determine the quantum of cover required. Existing cover would be taken into account, including the proceeds of any group scheme arrangements concluded by your employer.

The *Qualitative Assessment* focuses on the minimum specifications of the cover required, both in terms of your own requirements and our minimum product specifications. For example, disability cover should relate to your own occupation rather than any occupation, loss of income cover would need to be inflation-linked and critical illness cover should cover a specified minimum range of conditions.

The *Quantitative Assessment* would compare different means of funding cover. Term assurance may be more cost effective than whole life cover if the need is of a short to medium term duration. Both premiums and cover may be linked to a percentage rate or to inflation. Escalating premiums would initially be cheaper but in the longer term they could be far more expensive. We would run scenarios for different life expectancies to facilitate informed decision making.

The selected Insurer would need to offer a product that complies with the minimum product specifications and have both competitive premiums and acceptable administration standards.

*The Periodic Review Processes*

At each annual review of your financial plan, your need for risk cover would be reviewed in the light of your changing circumstances. As you move through the various life stages, the underlying needs and hence quantum of cover would change.

Many of our clients have accumulated significant amounts of cover over the years from a myriad of different sources. There may be opportunities to consolidate or reduce cover. Contrary to popular belief, insurance premiums on replacement policies may be lower notwithstanding your current enhanced age. Similarly, certain benefit structures may over time have become archaic. In many situations, especially on or after retirement, one may discard superfluous cover and thereby unlock significant cash values which represent a high proportion of the sums insured.

Nevertheless, we would be very circumspect before proposing changes without a thorough analysis of your existing policies and an assurance of your current insurability.

At PKF Wealth, we believe that an integral part of the financial planner’s arsenal is an understanding of the risk management process and specifically the ability to clearly define, quantify and appropriately insure risk.

In the words of John F Kennedy, “There are risks and costs to action. But they are far less than the long range risks of comfortable inaction.”