

Risk management

Property insurance
Liability insurance
Move your car before mowing

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We're in for one wild and crazy ride

☐ "Insurance is probably the least exciting topic in personal finance, but it is extremely important as well."

Daniel Franklin, author of *So You Graduated College...A Financial Guide to Life After Graduation*

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Definitions of risk

- ☐ In investing we see that **risk** is the possibility that actual returns will deviate from expected returns
 - Investing is a "speculative risk" => potential for **gain or loss** – stock price could rise or fall
- ☐ But here **risk** refers to "**pure risk**" => no possible gain, only possible loss
 - Fires, accidents, theft, illness
- ☐ Insurance protects against pure loss

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Risk management

- Process of identifying and evaluating situations involving **pure risk** in order to find different ways to handle it
 - Insuring against the risk is only one way and not always the best way

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Three personality types

- Risk-taker or risk-lover => a person not upset by risk, may actually enjoy it
- Risk-neutral => a person that neither fears nor enjoys risk
- Risk-averse => a person who tries to avoid risk
 - **Needs insurance!!**

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Steps to risk management

1. Gather info to identify risk exposure and potential losses
2. Estimate potential losses in dollars
3. Decide on the best ways to handle risk and losses
4. Administer the risk-management program
5. Reevaluate and tweak the program

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Where are you vulnerable?

- Car => stolen or you can be in an accident
 - Your car is wrecked or you hurt someone
- House => fire, flood, somebody slips on your sidewalk, your dog bites somebody
 - Your home is destroyed or you hurt someone
- Personal possessions => stolen or destroyed
 - Theft and fire

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Estimating size and chance of loss

- How likely is a loss and how severe could it be?
 - Do you live in a high crime area?
 - Is your house made of straw? Or sticks? Or bricks?
 - Is there a big bad wolf living in your neighborhood?
 - Are you a conservative driver or a maniac?
 - Average driver involved in one accident every seven years
 - Fender bender to catastrophic collision
- Estimating the maximum size of a potential loss is important

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Three ways to handle risk

- Avoid the risk
 - Don't skydive or smoke in bed
 - Often not practical – you want to live your life and you will drive and own house and jewelry
- Just live with risk
 - OK if max loss is not too severe
 - But make this a conscious decision
- Control the risk
 - Fire alarms, smoker detectors, good padlocks

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Two more ways to handle risk

Transfer the risk

- With an insurance policy, you transfer the risk to an insurance company who reimburses you for a loss

Reduce the risk to an acceptable level

- Buying insurance to cover only some of the loss
- **You eat tolerable losses but insure against catastrophic losses**

Risk management => transferring and reducing the risk

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Two key points to risk management

Never risk a lot to save a little

- **Don't NOT** get insurance on a potentially big loss just to save a few dollars
- It's stupid and not worth it

Never risk more than you can afford to lose

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Let's buy some insurance

Means of transferring and reducing risk

You (and thousands of other policy holders) pay premiums to a company

Premiums go into a pool

- Compensates a few for their losses
- Provides a profit for insurance company

Insurance policy is **contract** between insured (you) and an insurance company to cover your loss

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What loss?

- To be covered, a loss must be fortuitous and financial
 - Fortuitous => unexpected in terms of timing and magnitude
 - Lightning striking your house is fortuitous
 - Value of your stock portfolio falling 25% is not
 - Reasonable to expect stock prices to fall
 - Financial => loss must be objectively measurable
 - Replacement of your stolen car + temporary rental is covered
 - Psychic pain of losing your classic '53 Corvette is not

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Reducing your cost of insurance

- Reduce your insurance premiums by
 - Maxing out your deductible (initial portion of a loss that must be paid by you)
 - True for car insurance and property insurance
 - Purpose of insurance is to protect you against large, infrequent, unpredictable losses and not small, frequent ones
 - With a higher deductible, you save on the premiums and so can afford to buy higher policy limits**

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Double agents

- Two kinds of insurance agents
 - Independent agent
 - Represents two or more different insurance companies
 - Profits by commission
 - Tries to match you with the company and policy that best fits your needs
 - Exclusive agent
 - Represents only one insurance company
 - Employee of that company
 - Charges lower commission - being paid by company, too
- Allstate, State Farm, GEICO, Progressive, etc.

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Homeowner's insurance Combines into one policy

Property insurance

- Damage to the dwelling
- Loss of personal property and dwelling contents
- Expenses due to loss of dwelling
 - Food, temporary lodging, hotel room, etc.

Liability insurance

- Homeowner's no-fault medical payments
 - Injuries suffered by visitors regardless of who is at fault
- Homeowner's no-fault property damage
 - Visitor's personal property damaged at your house

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Damage to the dwelling

You will most likely be **required** to have insurance on the dwelling

Required by whom??? Your mortgage provider

- Bank or S&L "owns" your house until you pay off the mortgage
- They don't want to lose if it burns down
- So they require you to take out a policy for the replacement value of the house

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But you rent

Renter's insurance

- Same deal as homeowner's except
 - Doesn't cover damage to the dwelling
 - Covers only personal property and personal liability

As a renter you have a **choice** to get property and liability insurance or not

- Remember, don't risk a lot to save a few bucks

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Insuring personal property

You've got a video camera, two PC's, a 100 inch plasma HDTV, a new dining set, two watches, two iPods, 8 pairs of designer jeans, a digital camera, a turbo cappuccino maker

Take inventory in all rooms, item-by-item

- Use your video camera on a walk-through
- **Take pictures** and put them in safe-deposit box

May need **extra rider** on policy in case standard limits are inadequate for your expensive taste

- \$15 a year may give you extra \$1,000 jewelry coverage – **know your policy's limits**

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What's that dining set worth?

Can insure your property in 3 ways

- Purchase price
 - What you paid for it
- Actual cost
 - Purchase price minus depreciation
 - Not as good for you if it's destroyed or stolen
- Replacement cost
 - Best but most expensive

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Liability insurance

Standard coverage

- \$100,000 of personal liability coverage
- \$1,000 of no-fault medical expense coverage
- \$250 of no-fault property damage
 - Your dog ruins a visitor's leather jacket

Fairly cheap to raise these limits and they do represent possible big losses

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Car insurance

- Combines liability and property insurance into a single-package policy
- 4 types of coverage
 - **Liability insurance**
 - **Medical payments insurance**
 - Uninsured and underinsured motorist coverage
 - Physical damage insurance

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Liability insurance

- Required in all states**
- Covers you when you are responsible for losses incurred by others
 - Bodily injury and property liability
 - Policies quote coverage with three numbers
 - 100,300,100** (multiples of \$1,000)
 - **\$100,000 max liability per person's bodily injury**
 - **\$300,000 max total liability for all people in accident**
 - **\$100,000 max property damage liability**
- As a new college grad 50/100/50 could be adequate since you won't have a lot of assets
 - I wouldn't do this – but I'm risk-averse

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Medical payments insurance

- Required in all states**
- Covers injury to you and your passengers regardless of who's at fault
- Also covers members of your family if they're injured in someone else's car
- Most states have a no-fault system
 - You and your passengers collect from **your** insurance company
 - If you weren't at fault, your company seeks reimbursement from the other driver's company

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Uninsured motorist insurance

- Not required - optional**
- Protects you if you're in an accident with a driver who is at fault but who has no insurance
 - Also protects against hit-and-run accidents
- Relatively cheap
 - Maybe \$40 per year for \$100,000 coverage

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Collision insurance

- Not required - optional**
 - Get it but with high deductible
- Covers damage you do to your own car
 - You rear-end another car damaging your own
 - You back into your son's basketball hoop on the side of your driveway because you had parked the car at an angle in the garage because your son had left junk in the garage
 - Not worth reporting to insurance due to deductible

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Comprehensive insurance

- Not required – optional**
 - Get it but with high deductible
- Covers damage to your car *not caused by collision*
 - Scraping the rear fender with your lawn mower because you were too bleepin' lazy to move the car
 - Your daughter scraping the front fender with her bicycle even though you thought the car was safe in the garage

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Save on car insurance

- Shop around
 - Coverage is standard but premiums vary greatly
 - Can save hundreds by comparison shopping
- Buy highest liability limits (250,500,100)
- Select very high deductibles
- Move your car out of the way before cutting your grass

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