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Part 3: Preparing For A Rainy Day

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The last two hurricane seasons have shown us the importance of a solid protection plan. We learned to prepare for the unexpected and take personal responsibility for ourselves and our loved ones. This week's "Fiscal Fitness" topic introduces the concept of risk management. Whether you are running a business or managing your household, you need protection against financial, medical or natural disaster.

The first major component in managing risk is having the necessary cash reserves to respond to unexpected needs, be it a reduction in family income or a major expense. Setting aside money for a rainy day significantly reduces stress levels and minimizes the use of credit cards. These funds should be liquid and safely invested so the principal is not subject to market risk.

There are two basic kinds of cash reserves:

1. Replacement fund, established to cover the cost of large items such as a new roof or the deductible on property and casualty losses.

2. Lifestyle emergency fund, which would provide the liquidity to pay for your basic expenses in the event that your income stops. The size of this fund depends on your specific financial situation, but should cover at least three months of basic expenses. If the loss of income is due to an illness or accident, your long-term disability insurance will usually kick in after the three months. If, on the other hand, you lost your job, this cash reserve allows you the time to find another job.

The second component of risk management is achieved through the use of insurance. Your insurance portfolio can help you safeguard the people and things that matter most to you and might include health, disability, auto, homeowners, excess liability (umbrella policy), life and long-term care. Although levels of coverage must be determined within the context of a comprehensive financial program, these are a few guidelines:

a) Your life insurance coverage should allow your family to maintain its present standard of living in the event of a premature death. When the proceeds are invested, they should generate the required annual income without touching the principal, even when considering the effects of inflation.

b) Monthly disability benefits are usually capped at 60-70 percent of your salary. For this reason, consider obtaining as much coverage as allowed by your employer or your insurance company.

The cost of an adequate risk management program may seem high and might require a reduction in your current spending and a more focused approach to cash management. But ultimately, it will provide you peace of mind, knowing that your family and your assets are safe.

Next week: When Is Enough, Enough?