Risk Management

At its root, risk is the exposure to and uncertainty of loss. Risk is inherent in nearly everything we do on a daily basis. Loss of one’s health or life, or the loss of property can have both personal and financial impacts. A cornerstone of a strong financial plan is in managing this risk.

There are several ways to approach risk. To illustrate the approaches towards risk, we can look at an example of the risks associated with owning an in-ground swimming pool. There are innate risks with owning a pool including serious liability potential. The first approach towards risk is to retain the risk. Essentially, you are doing nothing about the risks associated with the pool. Alternatively, one can avoid the risk altogether by eliminating the source of risk entirely. You can elect to get rid of the pool, and by doing so, you have eliminated the associated risks. Risk can also be managed through reduction. In this approach, you acknowledge the risks present and take steps to reduce the frequency or severity of the loss. With this approach, you might fence off the pool in order to reduce risk.

A final approach to risk management is by transferring costs associated with the risk loss to another party. This is generally done with insurance. A basic premise of insurance is, in exchange for a premium payment, the insurance company will assume the costs associated with the loss and compensate you accordingly if losses are incurred.

It is also possible to manage risk with a combination of these techniques. For example, you may retain a portion of the risk of loss by accepting a high deductible but also reduce the remaining loss through insurance.

Your approach to risk will likely be dependent upon the level of frequency and degree of severity associated with the potential loss. To help determine how to handle risk, one should assess potential severity and the frequency of the potential loss. High financial impact, high frequency activities are generally best handled by avoiding that activity entirely (risk avoidance). High impact, low frequency events are good candidates for risk transfer (insurance). Low severity, high frequency events generally are best managed through risk reduction. Low impact, low frequency events may be retained.

Risk is the possibility of loss, including loss that can be financially devastating. As part of the comprehensive financial plan, it is prudent to review and plan for personal, property and liability risks. This includes a thorough review of your home or renter’s policy, auto insurance, health and long-term care policies, as well as life and disability policies.

*Adam Smit is the President of Adam Smit Investment Management LLC. He is a registered principal of LPL Financial. His practice emphasizes an investment philosophy of investing in quality while holding for the long-term. Securities offered through LPL Financial. Member FINRA/SIPC.*