

3 MY FINANCIAL RISKS, NEEDS AND OBJECTIVES

3.1 WHAT ARE THE RISKS?

When you invest your package you should keep your household risks in mind. Always make provision for these household and individual risks. Keep up your existing provision and ensure that you make provision for all risks, if you can afford to do so. Some risks (and possible provision for these) are:

- loss of income as a result of
 - death (a life policy, group insurance)
 - disease (medical insurance)
 - disability (disability insurance)
- loss of property
 - death/fire (mortgage – short-term insurance, life policy)
 - motor vehicle (short-term insurance)
 - contents of your house (short-term insurance)
- personal liability as a result of
 - home ownership (if you hit your neighbour in the eye with your fishing-rod – short-term insurance)
 - ownership of a motor vehicle (if you injure a pedestrian while driving – short-term insurance)
 - malpractices (insurance that covers liability)
- business risks (business insurance is discussed in section 4.3)
- estate duty (life policy or trust with donations and loans – see section 6.3)
- costs of winding up your estate (any investment)

- retirement (long-term investments with capital growth)
- estate planning (see section 6.3)
- too many debts because of 'living it up' (use borrowed money to provide for your needs and acquire assets that offer capital growth)
- inflation (investments with capital growth; adapt policies for inflation)
- income tax (use the legal instrument of tax avoidance where possible)
- frequent changes in legislation (be informed and consult a knowledgeable broker)
- interest rate changes: interest rates may drop but you are depending on your income from interest for your survival (invest for a fixed term of, say, two years)
- market risk: overseas markets may fluctuate and cause the prices of local unit trusts to drop (invest in money market funds)
- business risk: the industry in which you have invested may be very sensitive to a recession (invest in money market funds)
- financial risk (don't finance your business with 95% borrowed money – the cost of interest is high and therefore your repayments will be very high)
- fluctuations in exchange rates: people who invest in foreign countries will be exposed to this risk, as well as those who import or export (adapt your strategies to changes)
- national risks, for example investments in countries that are politically unstable
- health risks (health planning is a prerequisite for retirement planning)

SELF-INSURANCE IS DANGEROUS

Although monthly short-term insurance premiums are regarded as part of the household budget, the general public do not accept these payments without protest. It upsets people to see how their premiums are increased every year whether they had claims or not.

People also find it unacceptable to be forced to increase their short-term insurance cover every year. If they don't, they are underinsured and will be entitled only to part of a claim. (This is called the principle of average.) In addition, policyholders' monthly premiums are increased when they have submitted a claim.

WE HAVE NOTHING BUT EXPENSES

Before a motor vehicle can be insured the engine number must be stamped per-

manently on all the windows and an alarm and/or a gear lock installed. A house must have burglar bars, a dog or two, an alarm system linked to a reaction unit, as well as safety gates and fences.

All these regulations cost people a lot of money before they can successfully submit an application for short-term insurance and later a possible claim for damage. Short-term insurance premiums of R300 or more are common. This insurance offers cover against the detrimental effects of risks like fire, theft or a car accident.

Why do we have to spend such a lot of money on short-term insurance when we don't get any return on our money? Couldn't this money be invested in unit trusts or kept in a savings account?

These days questions like these are often raised in the hope that somebody will be able to answer them.

WHAT IS AN EMERGENCY FUND?

When you establish an emergency fund, money is invested so that the accumulated amount will be available in a crisis situation. The owner of the emergency fund must be disciplined and deposit a premium in the fund every month. He has full control over the utilisation of the fund. The aim of such a fund is to make your own provision for possible future damage.

Assumptions if an emergency fund is to be successful:

- A financial disaster such as car theft or a car accident will never occur to you and your house won't burn down.
- When such a disaster does occur the fund will be large enough to cover the damage.
- It is unlikely that more than one disaster will occur within a short period.
- No disaster will occur in the first ten years. This will allow the fund sufficient time to grow because of compound interest.
- You will pay many small claims yourself and won't use the money in the fund.

WHY ESTABLISH AN EMERGENCY FUND?

There are various reasons that people establish emergency funds to self-insure their houses, furniture (contents of their homes) and cars:

- They don't receive any return on their insurance premiums.
- They are 'throwing away' their money.
- They are under economic pressure.
- The household budget does not balance.
- They have an overdraft to repay.
- The premiums are too high.
- They personally never submit claims.
- As soon as a claim is submitted the premiums are increased.
- They are unemployed.
- The premium covers all the furniture but thieves steal only TVs, video recorders, technical equipment, firearms and jewellery.
- Premiums are increased by 15% per year.

TYPES OF EMERGENCY FUND

- People could cancel all their short-term insurance and deposit the premiums in an emergency fund (savings account).
- They could self-insure part of their property but leave fire insurance and/or limited motor vehicle insurance in the hands of the short-term insurer. Limited motor vehicle insurance means that the person only has insurance against damage to somebody else's car.
- It is possible to establish a mutual fund with friends or family. Each year joint premiums and compound interest will increase the amount in the fund. The members of the fund should draw up a written document with special conditions for the payment of claims. It would be advisable to consult an attorney before you establish such a fund.

DISADVANTAGES OF AN EMERGENCY FUND

There are many disadvantages:

- The interest is taxable.
- The value of the fund is eroded by inflation (depending on the type of investment).
- After-tax interest in the emergency fund will prevent rapid growth.
- Should the house be destroyed by fire within the first year, you may be sequestrated but still have to pay the mortgage bond.

- You will have to save for almost a decade to replace the furniture of an average household.
- You may be involved in an accident with a luxury car and as a result lose all your possessions.
- Two or three accidents (risk situations) can occur in the same year.
- It will take a lifetime to save enough money to replace a house that has burned down (should this be accompanied by various car accidents and thefts, you will die impoverished and unable to leave anything to your heirs).
- Possessions accumulated over thirty or forty years could be lost at any time.
- This kind of fund causes stress and you will not have peace of mind when you go on holiday.
- The risks of an emergency fund are higher than that of even the most risky share.
- No emergency fund can pay for the types of theft that occur near squatter camps. What will happen if there is also a fire in your house or a serious car accident?
- Monthly payments in the emergency fund must be increased every year to keep up with inflation.
- Within a day of being established the emergency fund will have to be large enough to cover the loss of a house, furniture and a car.
- Political unrest is now a greater reality than ever before and considerable damage has already been caused to private property.
- Friends or family members may die and this may cause problems among fund members.
- Members of the fund may be sequestered.
- People may get divorced and one of the spouses may make a claim against the emergency fund. The other spouse may also refuse to make further payments because he or she does not want to continue to insure the other's assets.
- If people also have business property, this will be even more risky to insure because of the higher risk of fire, for example.
- Making provision for your own insurance is just as risky as paying the premiums of your medical aid scheme into an emergency fund to cover medical expenses (on your own or with friends or family).

SUMMARY

Establishing an emergency fund is far too risky. It's very dangerous financial management for you to risk all your possessions just to save on premiums. Never try to make provision for self-insurance via an emergency fund.

3.2 WHAT ARE MY FINANCIAL NEEDS?

The financial needs that arise from certain risks can be identified from the discussion above. After you have determined the extent of a specific risk you must determine how often the risk may occur. As the risks increase and decrease your financial needs will do the same. Financial needs are also determined by your goals for the future (see section 3.3 below for a detailed discussion).

There are various types of financial need. All of them have their own characteristics, which will largely determine the type of financial product (ie investment) that should be bought (invested in) to satisfy that specific need. A single product could also satisfy a combination of financial needs.

Financial needs are made up mainly of income and capital needs. Income needs exist or develop during your lifetime, as well as in cases of unemployment, disability or disease. Capital needs exist or develop primarily after your death in the form of mortgage debts, estate duty and the costs of winding up your estate. Your needs could be

- temporary (three months, two years)
- permanent (estate duty)
- future (debts after your death)
- increasing (provision for retirement must beat inflation)
- decreasing (a mortgage bond which is decreasing)
- constant (food, clothing)

Pay special attention to financial needs that may arise because of death, disability or retirement. Find out how you can combine provision for these needs – ask a broker to help you. Remember, the better you know your own financial situation, the more your broker can help you.

3.3 MY PERSONAL FINANCIAL OBJECTIVES

STEP 1

Before you can determine your objectives, in other words where you want to go

to (point B), you should first know exactly where you are (point A, that is to say your current financial situation). You require at least the following particulars before you can make any investment (particularly your package):

- family details such as names
- ages
- marital status
- matrimonial property dispensation
- financial statements
- fixed assets
- moveable assets
- cash
- other investments such as policies (obtain details from all the institutions where you have policies)
- death and disability benefits
- pension benefits
- group benefits
- possible inheritances
- current and potential sources of income

Be sure that you know your own risk profile (how much risk you are prepared to take, for what return and from what type of investment). Your view of the political and economic situation in the country is also important.

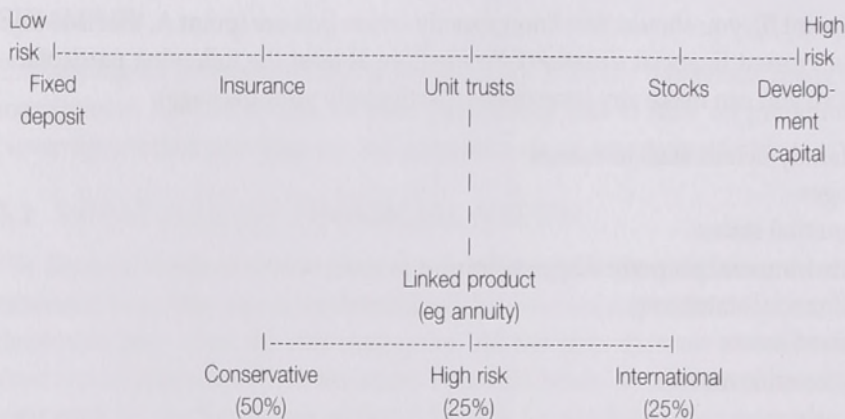
Investment strategies at different ages during the lifecycle will be discussed in chapter 5. As you will see, younger people tend to make more risky investments and older people less risky investments.

Low risk (non-risky investment)

Age	60 plus	Average risk
	50-60	
	40-50	
	30-40	
	20-30	

High risk (very risky investments)

In the same way as we classify our investment products as risky and non-risky, we should spread our risks within a specific product. Let's use unit trusts as an example.



For example, you could invest in a linked product and spread the risk by making your investment in three parts: conservative (50%), high risk (25%) and international investments (25%). If you follow this strategy changes in the interest rate and the economic and political situation won't have such a negative effect on your investments because you haven't invested all your money in high-risk shares. Should the stock exchange fall, 75% of your investment will be quite well protected. A lower risk usually means a lower return.

STEP 2

Compare your current financial situation with the financial needs you have identified. The financial needs that you haven't made provision for in the short, medium or long term will now become your short-term, medium-term or long-term objectives.

Some of your financial needs could be

- your children's studies – costs and debts
- bank overdraft
- credit card
- large accounts (such as Edgars and Woolworths)
- a short-term loan from a family member
- a knee operation that is long overdue
- the amount you owe on your car
- a mortgage
- insufficient resources to live on

- insufficient provision for retirement

STEP 3

Determine your own short-term, medium-term and long-term objectives. These are the objectives you should keep in mind when you are investing your package. Of course, immediate objectives should be attained before you set and attain your short-term, medium-term and long-term objectives.

Immediate objectives
Pay all your debts <ul style="list-style-type: none"> • study debts • bank overdraft • credit card • clothing and other accounts • loan – member of the family • car • mortgage
Short-term objectives
<ul style="list-style-type: none"> • Set up a study fund for your children • Begin a new career to supplement your livelihood • Open a South African foreign bank account for each child
Medium-term objectives
<ul style="list-style-type: none"> • Invest money for each child as a deposit for his or her own home • Establish an investment portfolio for each child • Buy a second property with money from your next career • Establish a trust for each child • Go for your knee operation during your next career
Long-term objectives
<ul style="list-style-type: none"> • Supplement your retirement package • Retire at 60 (or 55) • Travel for two months of the year • Buy a holiday home

Now determine your own short-, medium- and long-term objectives.

STEP 4

Next you have to make specific investments to attain these objectives. Consult various institutions as well as your broker and implement your own unique plan of action.

First debts, loans and accounts should be paid off with the money from your package. Invest the rest of the package, for example in a structured fund. From the income from your next job you could make other investments, for example:

- Invest money for each child in a South African foreign bank account.
- Invest in unit trusts to make provision for deposits on your children's homes.

There may not be another career or job for everyone, so the package should be used – and invested – to meet all your basic objectives. Very few people who receive packages will be in a position to help their children to achieve their goals. Whether you reach your long-term objectives (particularly those that concern your financial independence after retirement) will depend on the size of the package and the effectiveness of your investment(s).