Attitudes Toward Insurance

Insurance coverage can be tricky to shop for, because it requires making specific financial decisions about some hazy and unpredictable concepts. Depending on the type of insurance you're looking into, you might find yourself pondering some downright uncomfortable questions:

- What would happen if I get sick the day I'm supposed to leave for the three-week European vacation I've been planning forever?
- What would happen if a major earthquake damaged my home? If my basement flooded? If there was a fire in my apartment building?
- What would happen if I became so ill I couldn't work any more?
- What would happen if I had a break-in?
- What would happen to my family if I died tomorrow?

And just in case following this worst-case-scenario thought spiral isn't depressing enough, figuring out the right amount of coverage also requires some awkward speculation: how much, in dollars, would it cost to "replace" you in the event of a tragic accident? What's the total value of every single thing you own? If you were disabled to the point of not being able to work, how much money would you need in order to get by for the rest of your life? These questions are hard to think about and even harder to answer. Mixing the matter-of-fact nature of finances with the randomness and unpredictability of life is a complicated process.

Although individual insurance policies and coverage details can seem endlessly complex, the fundamentals of insurance coverage—and your attitude towards it—can be simple. Understanding the expectations you have of your insurance policy can make much of the confusion and second-guessing disappear, so that you can focus in on what you truly need from your insurance provider.

Insurance is not an investment
Many people automatically categorize insurance coverage as a complete waste of money, especially if you never end up needing it. Let's take a moment to think about how backwards that is. Using that logic, in order to get your money's worth from your insurance provider, you would need to make a huge claim. But here's the thing: in order to make a huge claim, you would first need to suffer a major loss, and major losses typically result from unfortunate events. If you expect your insurance payments to act as an investment, you're basically *hoping* for a natural disaster, property damage or serious illness—or worse.

Adding to the confusion are plans like whole life insurance policies (or return of premium policies), where if you outlive the term of the policy, the money you've paid in premiums is returned to you. This may or may not make sense for you personally for many different reasons, but return on investment should not be one of them. Insurance is not an investment; insurance is protection, and therefore needs to be prioritized differently from investment products in your personal financial plan.

Insurance is a transfer of financial risk

So if insurance coverage isn't an investment, what exactly is it? When you take out an insurance policy, what you're actually doing is paying your insurance provider to take on your financial risk regarding a specific situation outlined in your contract. Consider this: your insurance provider fulfills this responsibility *whether or not that specific situation ends up taking place.*

As an example, let's say you have a car insurance policy that, among other things, includes coverage of any damage resulting from a tree falling on your car. Let's also say (for the purpose of this example) that, statistically, there's a 1% chance that a tree will fall on your car this year. By paying your annual premium, you are transferring any financial consequences associated with that 1% risk over to your insurance provider. If a tree falls on your car (a rare scenario), the insurance provider reimburses you for the damage. If a tree falls on your car 12 times throughout the year (a very rare scenario!), the insurance provider would reimburse you each time. If zero trees fall on your car this year (the most likely scenario), there is no tree-related damage for the insurance provider to reimburse. In all three of these outcomes, the insurance provider is still assuming that 1% risk. You pay your insurance provider to hold up its end of the deal, and the provider is doing that, whether or not a tree ends up falling on your car.

Insurance protects against losses

When shopping around for insurance coverage, it's best to think of your policy as simply a way to cover a significant financial loss—and significant is the key word.

Purchasing insurance for something that you could easily replace yourself in the case of a loss (like a $20 set of earbuds) doesn't make a ton of sense, because it often costs you more to have it insured than to just assume the small financial loss yourself, should you need to replace it.

The same goes for expenses that fall under the emergency fund category. Though emergency funds share some of the same roles that insurance policies do (financial protection from unexpected circumstances), they are not interchangeable, and a solid personal financial plan requires both. Emergency funds are designed for situations that realistically will happen eventually (a stretch of unemployment or a car breakdown), even if the "when" and "where" are unpredictable. These emergency situations can usually be smoothed over with a few thousand dollars' worth of emergency fund savings—it's a lot of money, but it's not an *impossible* amount of money.

A significant financial loss, by contrast, is a seemingly impossible amount of money to recover—tens and even hundreds of thousands of dollars. A significant financial loss is the kind that would literally change the course of your life and the lives of your dependents. It's for those losses that insurance coverage offers the best protection.

The more realistic you are about how much a particular loss would cost you, the better you'll be able to articulate your insurance needs when shopping for a policy. Instead of blind guessing, put a little bit of thought and research behind your estimates. If you're considering fire insurance, for example, you might start by doing an inventory of the contents of your home—but you should also consider researching the cost of construction in rebuilding a home after fire damage.

Insurance policies are complex, but your attitude towards them can be straightforward. Insurance policies are not designed to grow your money—they're designed to protect you and your family from significant loss by transferring your financial risk associated with a specific set of unpredictable circumstances. It's up to you to determine which unpredictable circumstances warrant protection (and how much protection to have in place), but by simply identifying the role of insurance in your financial plan, you'll be better prepared to make smart decisions about what to insure.