Retirement Daily

Your Money

Protect Your Finances from Natural Disasters

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By Clayton Alexander

From one side of the country to the other, including severe storms that slammed the east coast last week to wildfires fueled by ferocious winds in California, natural disasters highlight the need to be prepared for the devastation that can impact our communities.

In the calm before any storm, though, there's no better time than now to protect your finances and financial situation. Regardless of where we live, complacency and procrastination aren't luxuries many Americans can afford when it comes to catastrophes.

Apart from the damages that perils like earthquakes, hurricanes and wildfires can inflict, there is also inland flooding, winter storms and the increasing losses from severe

thunderstorms and tornadoes. It seems that few if any places in the U.S. are immune to natural disasters.

You don't just need to insure your home, you need to insure your finances. That's only achievable through a holistic approach that includes insurance protection as well as emergency savings and portfolio diversification.

We'll start with homeowners insurance. When was the last time you reviewed your coverage? If you were to suffer a significant loss, would your insurer pay full value? The answers may surprise you.

Why You Should Review Your Homeowners Coverage

Underinsurance is a persistent problem, but many U.S. homeowners are unaware they don't have enough coverage. They only find out after a disaster. What an insurer will pay isn't tied to the market value of your home, and if you live in areas prone to catastrophes there are other things you need to keep in mind. This includes the costs of building materials and labor, which typically peak following a catastrophe, and whether wind or water caused the damage.

Analysis earlier this year by Core Logic, the global property information, analytics and data provider, found that reconstruction costs rose anywhere from 5.6% to 7.6% from 2016 to 2018 in disaster-prone areas, including California, Florida, Oklahoma, and in Houston.

Core Logic's analysis is a wake-up call to update your coverage to current replacement and reconstruction costs. For example, if just 1% of homes prone to California wildfire risk are destroyed, the undervaluation would equate to about $25 million if coverage isn't current. If 5% of Florida homes with very high to extreme storm-surge risk were destroyed, the undervaluation would be about $205 million if coverage isn't current.

Estimates were higher for severe thunderstorm and tornado risk in Oklahoma and for flooding in Houston. (An estimated 70% of flood-related damage wasn't covered from flooding caused by Hurricane Harvey in 2017).

Insurers cover wind damage, but flood insurance is typically purchased from the U.S. government's National Flood Insurance Program. If you live near a flood zone but weren't required to purchase flood insurance when you purchased your home, you may have decided to forgo it. Perhaps a real estate agent said you didn't need it, or you were looking to save some money. Regardless, you should reconsider that decision.

Also keep in mind that, if you live in a coastal state prone to hurricanes, your insurance coverage most likely includes a "percentage" deductible specifically for damages caused by a hurricane or tropical storm. For example, if your home is worth $300,000 and the deductible is 5%, the first $15,000 of a claim could come out of your pocket. Insurers

began moving to these hurricane deductibles following Hurricanes Katrina, Rita and Wilma in 2005.

In California, homeowners devastated by wildfires often discover they are underinsured, too. Nearly two-thirds (66%) of victims from the 2017 North Bay Fires reported being underinsured, according to consumer-advocacy group United Policyholders. Data from the 2018 Camp Fire, the deadliest and most destructive in California history, is still being collected.

Because of changes to policy language following 1994's Northridge earthquake in California, many insurers (a trend that now stretches across the country) provide replacement cost or extended replacement cost coverage instead of guaranteed replacement cost coverage. Rather than pay the costs to rebuild your home as it was before the disaster, regardless of the policy's limit, insurers might only pay the policy's coverage limit, or 20% to 25% above that limit.

That means you may be underinsured if your home has increased in value in recent years. The bottom line is to review your coverage each year when you renew your policy. If you're budgeting, look to save money elsewhere, but not on your homeowners insurance. This is your first line of defense.

Other Ways to Plan

Another line of defense that is practical and part of a sound financial plan is having an emergency savings fund and some cash on hand. Keep the cash as well as copies of important financial documents and insurance policies in a fireproof and waterproof box. Having three to six months of savings, or even more, can help pay the mortgage bills if you're unable to work following a disaster.

It can also cover expenses if you and your family need to evacuate, or pay for other unexpected financial emergencies. Knowing that you have money in the bank can partly alleviate some of the stress levels that might follow a disaster and provide the liquidity you need while insurers are investigating and processing your claim.

We already talked about the importance of protecting your home through homeowners insurance. It's probably your biggest financial asset, but what about if you're still paying off your mortgage and something unforeseen were to happen to you? Would your family be protected? Could they handle the additional financial responsibility?

You can purchase life insurance up to the value of your mortgage or higher. If you're still young and in good health you'll likely qualify for lower rates. Unlike mortgage-protection insurance, which pays the remainder of your loan balance directly to the lender, life insurance is paid out to your beneficiaries. They have control over whether

to use a death benefit to pay off the mortgage or to use it for other purposes. The proceeds also are generally tax-free.

Diversifying Your Portfolio

Natural disasters also affect economies and financial markets, so it makes sense to have a diversified portfolio. Whether that means broad exposure geographically or across market sectors, diversification of risk is always an important factor in preparing your finances.

The professionals in the catastrophe-insurance business invest a great amount of time in scenario-planning and attempting to quantify their risks. Banks do the same thing when it comes to stress testing the impact of economic and market shocks on their fixed assets and portfolios. You can have your financial adviser perform a similar exercise for your investment portfolio.

Why consider stress testing? In general, there is always an inherent uncertainty to investing in the financial markets. Yet getting a grasp on how correlated your portfolio's investments are to each other and to particular scenarios, such as a deep recession, spike in interest rates, or significant stock market drawdown, enables you to take actions to reduce and manage risk.

And it may be time for a checkup. Take the bond market. In recent years, accommodative monetary policy from global central banks has helped keep interest rates at historical lows. But interest-rate risk might be higher than you would expect.

The popular Barclays U.S. Aggregate Bond Index, a benchmark for many bond mutual funds and ETFs, has experienced an increase in duration of nearly 50% in the past decade to an average of close to 6.0 years. Duration measures interest rate risk. So, a simple rule of thumb is that, for a one percentage point increase in interest rates, a fund with a duration of 6.0 would experience a 6% decline. That is not something most long-term investors want from bonds if they're seeking income and growth, nor if they're drawing down from that investment to pay for monthly expenses.

Then there is credit risk. Low interest rates have allowed more companies to "kick the can down the road" on their debt repayments, but overall credit quality has deteriorated. Looking again at the Barclays Aggregate Index over the past decade, the index's weighting of triple-B-rated bonds has roughly doubled. That rating is just shy of below investment-grade, or high-yield, bond ratings.

Investors' search for yield in this environment has also compressed the risk premium for high-yield bonds. Double-B-rated high-yield corporate bonds currently are priced over safe U.S. government bonds roughly where they were between June and July 2007.

As we near the late innings of the current business cycle, how likely will these companies be able to keep up with their interest and principal payments if the economy weakens? Will they be able to refinance their debt at as favorable terms as they were earlier in the cycle? Does what is occurring in the initial public offering market offer a cautionary tale of current market sentiment?

These are all questions to discuss with your financial adviser since there may be more risk than you think lurking within your portfolio. As we said with protecting your home, take actions to disaster-proof your portfolio (to the extent that you can), so you have another line of defense for your finances.

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