How much should I put in an Emergency Fund?

Abstract

How much cash should I have on hand?
How should I invest my emergency fund?

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"By failing to prepare, you are preparing to fail."

Benjamin Franklin

"It wasn't raining when Noah built the Ark."

Howard Ruff

"Money speaks only one language: If you save me today, I will save you tomorrow."

Anonymous

What is an Emergency Fund and do I really need it?

We've all been in situations where something suddenly happens to us that we didn't plan for. In the stock market, it's called a Black Swan event, in psychology it's known as the boomerang effect, science calls it an adverse reaction and those with a sense of humor might call it Murphy's Law. However you look at it, an emergency is an unexpected event that impacts our lives in many different ways. The purpose of an Emergency Fund is to provide you money, which has been previously set aside, for the purpose of taking care of the financial impact caused by an unexpected event. In this article we will discuss what it is, whether or not it is needed and if so, how to get started.

As stated earlier, an Emergency Fund is money that had been set aside at an earlier time for the sole purpose of handling the financial consequences of an unexpected event. Having an emergency fund gives you peace of mind knowing that when something adverse actually happens, you can focus more on dealing with the emergency itself and not having to worry whether you are going to survive financially. So now that we have defined what it is, let's talk about what it is not: it is not used for making large purchases such as a house, auto, college tuition, etc., it is not used for general wants, such as elective surgery, a new bike or that brand new big screen, it does not have to start off as a large unattainable amount and it does not need to be a specific amount in terms of dollars or percentages.

But do I really need it you might ask? Here are some reasons why it might benefit you:

1. Money at the Ready – sudden expenses are bound to arise. No need to disturb the budget or more importantly, rack up the credit card debt. If you have money set aside, you're bound to avoid both of these pitfalls.
2. Income Disruption – as we have all recently seen with the Covid-19 pandemic, unemployment can happen to anyone, even if you thought you were immune and in a solid place job-wise. An emergency fund can bridge that gap while waiting for unemployment income, PPE payments or government help to arrive in your account.
3. Avoid Liquidation Costs – avoid having to liquidate holdings at a loss or at an inconvenient time. Better to plan on taking long or short-term gains which can possibly be offset with

losses or taking your gains over a longer period of time rather than being forced to take them immediately and end up paying higher taxes.

How to get started

While the size of your emergency fund will depend on many factors such as your income and expenses, lifestyle, number of dependents, etc., the important thing to remember is not how much you start with but that you actually start! There is a general rule of thumb among experts that you should save between three and six months' worth of expenses, again depending on your particular circumstances. Are you the sole breadwinner in the family? Do you have a difficult time finding a job or have a set of very specific job skills? Are you just starting out or are you close to retirement age with a large retirement fund? Answering yes to those types of questions would most likely put you in the camp of saving closer to six months or more, rather than less. According to the latest available data, The Bureau of Labor Statistics reported that the average American spent $61,224 for the year. Based on that amount, the average emergency fund should be between $15,300 and $30,600.

So how should you start an emergency fund? The first step is to set up your savings goal; remember, it doesn't have to be funded all at once. Next, create a monthly income statement (subtract all of your expenses from your income) to determine how much free cash flow you have to work with. Finally, develop a plan whereby you can set aside a specific amount every month in a separate account until you meet your savings goal. There are several options you can choose regarding where to place your savings:

1. High Yield Savings Account - easy access, available whenever you need it, interest-bearing
2. Money Market Account – easy access, available whenever you need it, interest-bearing
3. Certificate of Deposit – interest-bearing
4. Brokerage Account – easy access, several low risk investment choices
5. Multi-faceted approach – put a little bit in several different choices

Remember here that the goal of your emergency savings account isn't to be risky; the goal is to create a little nest egg with the purpose of stability and access rather than excessive risk and volatile returns. Do not invest your emergency fund in anything that is not easily converted to instant cash – in other words, keep it highly liquid (for example, not an annuity, and not an unbreakable 5-year CD). The last and maybe most important step to consider…stick to the plan! Hang in there and continue to contribute until you've reached your goal.

The Downside of Emergency Funds

For most people, an emergency fund is a wise and prudent way of preparing for a bad situation, but there are some instances where the opportunity cost of parking money might not be in their best interest. First of all, stashing away an overly large amount of money in a low rate investment could actually cost you over time due to the effects of inflation. For you, having a small amount saved might be the best way to go and consider any additional monies available to be put in a higher paying account or in an IRA or 401k. That type of investment brings up another good point: if you are of retirement age or close to it, investing in a Roth IRA account might be a better option because of a potential higher return and tax free growth. At your age, you can always access your money right away if needed, no reason to keep a separate account. If you are the type of person that doesn't mind asking for a helping hand, maybe you have friends or family that would be willing to lend or give you money in time of need. If that's the case, an emergency fund would probably not be a wise choice for you. Also, if you are wealthy enough and have a large enough asset base, or maybe you are a dual income family that can afford the loss of one income temporarily, a stash of emergency savings may be unnecessary. Lastly, if you are carrying some high credit card debt, it might make more sense for you to try and pay that down rather than save; or at the very least put a small portion in an emergency fund every month but the lion's share into paying off that debt .

Summary

Most people should have an emergency savings plan as a fundamental part of their overall financial plan. The size and scope of the emergency savings plan are subjective, but in my view, the benefits outweigh the costs. However, it might not be the best choice for everyone…it's up to you and your advisor to determine the best way to handle the circumstances that life throws your way.

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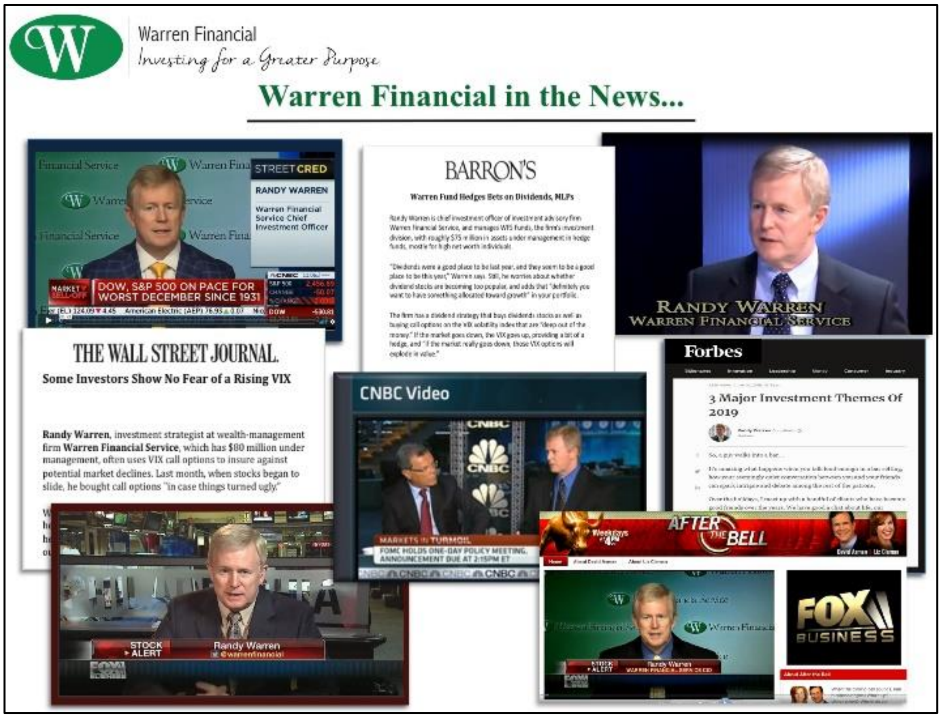

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