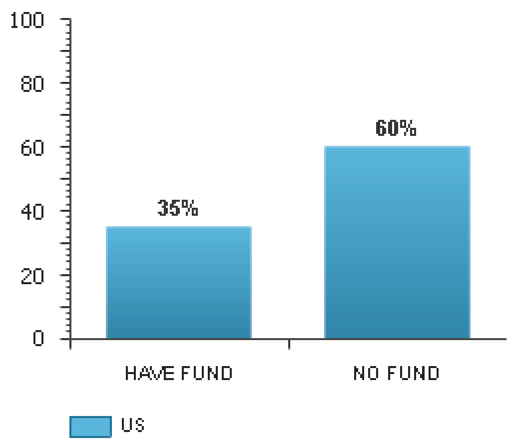
The Emergency Fund

What's next on your financial to-do list? Save for college, pay off your car, get a new job, save for retirement? Not so fast. Almost every article or book offering financial advice will agree: the very first thing you should do, after budgeting and meeting basic financial needs, is to start building an emergency fund.

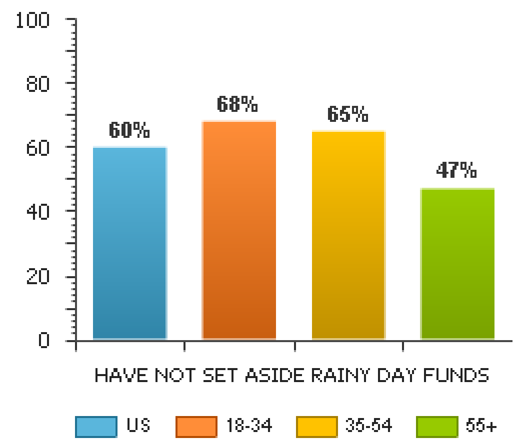
What Is an Emergency Fund?

An emergency fund is a stash of easily accessible money that has been set aside only for emergencies. Also known as a "rainy day fund," money stashed away to deal with unexpected emergencies can give someone a sense of security knowing that an unexpected event won't destroy or derail their financial plans. According to a 2009 Financial Capability Study, 60 percent of Americans don't have money set aside. Following is data from the national study:

"Rainy Day" Funds



"By Age Group"



The news changes a bit as you look at data by state. Here is a sample of data taken from the Financial Capability Study based on a few states:

Have an emergency fund?			No fund by age group		
State	**Yes**	**No**	**18-34 years**	**35-54 years**	**55 +**
Florida	34 percent	61 percent	69 percent	67 percent	50 percent
California	37 percent	58 percent	67 percent	58 percent	48 percent
New York	45 percent	49 percent	55 percent	53 percent	37 percent
Illinois	33 percent	62 percent	68 percent	63 percent	53 percent

How does your state match with the national averages?

(The Financial Capability Study can be accessed here: http://www.usfinancialcapability.org)

It's important to understand the true meaning of an emergency. For example, new clothes, a new video game or even a new car are not emergencies. Real emergencies would be getting injured, losing your job, or a broken air conditioner unit in the middle of summer. A good rule of thumb: if you're not sure if it's an emergency, it probably isn't.

If something unexpected happens, will you have the money to pay your bills? Insurance is one way to protect yourself against certain situations, but even the best insurance doesn't protect against every financial problem.

The unexpected is inevitable and always unpredictable. People that have an emergency fund to protect them from unexpected things are going to come out in far better shape than people who do not. Those without an emergency fund are more likely to turn to credit and new debt to help when the unexpected arises. Even though it feels like you can't afford to have an emergency fund, you really can't afford <u>not</u> to have one.

How Much Should an Emergency Fund Have?

It's hard to say exactly how much an emergency fund should have because it's personal and different for everyone. The security you feel having your fund may not necessarily provide the same amount of comfort to someone else. You may require a larger or smaller fund than another person to achieve the same feeling of security.

However, just because there isn't a foolproof formula to answer this question, doesn't mean there isn't expert financial advice to follow. Some experts believe $1,000.00 is sufficient, while others advise that three to six months' worth of expenses is enough. More conservative experts suggest eight to 12 months of expenses is an absolute minimum. Most experts agree that setting up your emergency fund is a critical step to financial health, and once you've saved enough for the cushion, then you can move to other financial goals. You will find out how much is enough by examining your own situation and doing what works for you.

Getting Started

It's as easy as depositing a small amount, such as $25.00, $50.00 or $100.00, into an interest bearing account. Before you decide how much to start with, be sure your basic living expenses are met. Next, the money in your fund should be easily accessible, but not too easily. If you can get to your cash too easily, you might be tempted to dip into it for non-emergencies.

"The Automatic Millionaire" by David Bach recommends these three simple steps:

1. <u>Decide how big of a cushion you need:</u> The author recommends a minimum of three months' worth of expenses, but stresses that more is better.
2. <u>Don't touch it:</u> According to David Bach, the reason most people don't have emergency money in the bank is because they think they have an emergency every month. A real emergency is something that threatens your survival, not just your desire to be comfortable.
3. <u>Put it in the right place:</u> "Not earning interest on your emergency money is almost as bad as burying it in your backyard," writes David Bach.

The most important step to having a fully funded emergency fund is to get started <u>now</u>. A step-by-step approach works best. Begin with a first deposit and keep reminding yourself of the fund's importance. A beginner emergency fund is a good place to start; set a $500.00 goal and save until that goal is met. Then grow the fund to $1,000.00 and stop until all of your debts, aside from your mortgage, are eliminated. Then begin adding to the emergency fund again until you have a full three to six months' worth of expenses. Your monthly budget should contain money to reduce and eventually eliminate your debt, but don't confuse debt reduction with your emergency fund. Remember, debt reduction gets you out of debt, and your emergency fund helps you stay out of it.

There are three simple steps to finding the money for building your initial emergency fund:

- **Earn more money:** Work extra hours if you can or find a part-time job. Direct all extra earnings into your emergency fund.
- **Spend less money:** Look at your current expenses and find things you can do without. Be sure to direct the money you save into your fund.
- **Sell old or unused items:** There are always extra things we no longer use or need.

These steps will get you started on a path to growing your emergency fund.

Small steps are inevitably going to be your first steps, and they definitely count. Once you have put aside $25.00 one week and discovered that you can live without that $25.00 in your spending account, then you have the confidence to know that you can do it again. You may even have the confidence to think, "Well, hey, if I put aside $25.00 and I didn't miss it, I'm going to try to put $50.00 aside and not miss it." Jean Chatzky, Bankrate.com interview, July 2007

Choosing the Best Place for Your Money

Deciding where to house your emergency fund is important. If your emergency money is too easy to access, you might be tempted to use it. But, it needs to be easily accessible too, because you'll need quick access during an emergency. Here are some tips for making your fund slightly difficult to access:

- Use a bank closer to work instead of home
- Use an account not linked to a debit card
- Use an online brokerage account
- Use an online savings account

The account should:

- Pay a decent interest rate
- Have little or no fees
- Not be easily accessible
- Not be difficult to access

Some people choose a Certificate of Deposit (CD) for their emergency fund, or a series of CDs of approximately equal value, with one maturing every six months or every year. This approach is called laddering, because you can rollover the CDs as they mature, to keep your ladder intact. The loss of interest you face for taking money out early may motivate you to keep your fund intact. But in a real emergency, the interest you may lose is a small price to pay for having the money you need. And, if you have to spend any of the money, you should plan to replace it.

You might also consider buying United States Treasury Bills with some of your emergency fund. They can be timed to mature on a regular schedule, and like CDs, they tend to pay more interest than a simple savings account. While they aren't bank products, they are backed by the federal government, which means there is no risk of losing principal if you hold them to maturity. Since they have very short terms — four, 13, or 26 weeks — they usually don't expose you to inflation or interest rate risk.

Other options for an emergency fund include money market mutual funds, which are funds that must, by law, invest in low-risk securities, such as government securities and CDs. Compared with other types of mutual funds, money market funds are highly liquid, low-risk securities. Unlike money market deposit accounts, money market funds are not federally insured. While they are intended to pay dividends that are comparable to prevailing short-term interest rates, they can lose value.

Will the Fund Grow?
Savings accounts, CD laddering, mutual funds, and Treasury Bills are all interest-bearing accounts that will help grow your funds. Once fully funded, an emergency fund will sit, ready to help if needed, but will also grow until then. How much exactly will it grow?

There is a financial calculation that computes a final amount of a deposit taking compounding into consideration. Each time interest is paid into an account, interest is being paid on that interest. The formula is called the compound interest formula and it works like this:

$$A = P\left(1 + \frac{r}{n}\right)^{nt}$$

A = Final balance
P = Principal amount (initial investment)
R = Annual interest rate (as a decimal)
N = Number of times the interest is compounded each year
T = Number of years

Example:
An emergency fund of $1,500.00 is accumulated in an account paying an annual interest rate of 4.3 percent, compounded quarterly. Find the balance after six years.

Using the formula above:

P = 1500
R = 4.3/100 = 0.043
N = 4
T = 6

$$A = 1500\left(1 + \frac{0.043}{4}\right)^{4\times 6} = 1938.84$$

The balance after six years is $1,938.84.

Now you try:
An emergency fund of $1,850.00 is accumulated in a group of accounts. Together, they pay an annual interest rate of 2.75 percent, compounding monthly. Find the balance of the fund after three years.

Creative Ways to Build Your Fund
Here are a few tips that might help when you are thinking about ways to find extra money to devote toward building your emergency fund.

- **Start small:** The important thing is to get started; your fund will grow over time.
- **Automatic savings deduction:** If you are able to devote a set amount toward your savings plan, have it taken from your account automatically. You are less likely to miss it if it is already taken out of your account.
- **Treat your saving as if it were a bill:** Add your emergency fund contribution to your list of bills and pay it as if it were a bill.

- **Reduce one expense and save the difference**: Find something you already spend money on and cut back. Maybe you buy a cup of coffee each morning? Skip that purchase one or two days a week and put the cash into your fund.
- **Redirect eliminated debt payments**: Once you've paid off a recurring debt, put that payment into your emergency fund.
- **Budget big on groceries and save the difference:** If you usually spend $100.00 each week on groceries, budget $125.00 and save the difference.
- **Save your change:** Pay for items with only dollars. At the end of each day, empty your pockets of change and put it into a jar. Once a month, go to the bank and deposit the change. It adds up!
- **Brown bag approach:** If you buy lunch out most of the time, try bringing your lunch one or two days a week, and put the money you would have spent on lunch into your fund.
- **Try one month of no extra spending:** Buy only bare necessities for one month. This means no extra activities such as dining out, clothes shopping or movies. Put all of the money you saved into your emergency fund, you'll be amazed at the quick savings boost.

Advanced Savings

Now that you've started saving, found creative ways to put away extra money, and reached the $1,000.00 savings level, it's time to get serious and increase your emergency fund to three to six months' worth of expenses. But just how much is that? This is where your monthly budget will come in handy. You've become really good at living within your means, finding ways to cut back, and found ways to include your emergency fund as a necessary expense. Put your three to six months' worth of expenses down on paper and calculate how much you'll need to fully fund your permanent emergency fund.

Create and Stick to a Strict Budget

A good budget will help achieve your goals and will be flexible enough to adapt to changing circumstances. Here is a step-by-step formula for building a flexible, effective, and efficient budget.

1) **List your regular monthly expenses:** Necessary items include rent, mortgage, car expenses, and payments to reduce debts. However, don't forget to leave room for monthly entertainment or shopping.
2) **Calculate your earnings:** Income from your paycheck, as well as interest, investments, or side jobs.
3) **Subtract expenses from earnings:** The difference between these two numbers will determine your budget. For some, this number will be negative. If you have left over money, that's great. If not, there is work to be done.
4) **Rework the budget:** If your budget turned out negative, go back over your expenses and look for items you can reduce or cut. It will be important for these numbers to balance, and you may have to make sacrifices to do so. This is also a good time to find ways to make regular contributions to your emergency fund.
5) **Don't forget about debt reduction:** It will be very important for your budget to include payments against your debts so you can eliminate them more quickly. Look closely at your budget and try to get as much debt reduction out of it as you can.
6) **Work your budget and stick to it:** Once your budget is ready, test it out, and try to live within the numbers you have created. Make necessary adjustments, but try to stick to it as closely as you can. You'll know right away if you are able to live within the budget.
7) **Monitor and adjust:** Review your budget each month to see if anything has changed? Do you need to dedicate more resources to some things and less to others? Have any of your debts been eliminated?
8) **Keep assessing:** A good budget is never finished. It constantly evolves and changes as your situation changes. Keep crunching numbers, catch any overspending, and correct it.

Example:

Tyler is an 18-year-old, recent high school graduate currently examining his financial stability. He has no emergency fund, is exposed to unexpected events making it difficult or impossible for him to pay his bills, and spends every cent he earns except for a college savings fund he is building. He would like an emergency fund consisting of three months' worth of essential expenses, but has no idea how to find extra cash.

He looks at his checkbook, debit receipts, and credit card statements, and writes a list of every expense he has encountered in the past month. Below is a table showing those expenses. Take a look at Tyler's spending and in the column provided, indicate if you think each expense is necessary.

Expense	**Amount**	**Yes**	**No**
Rent	$850.00		
Car payment	$263.00		
Movie night	$42.00		
Car insurance	$212.50		
Bought lunch (16 times)	$185.00		
Cell phone bill	$84.95		
Date night (three dates)	$160.00		
Gasoline (three fills)	$135.00		
Shoe shopping	$97.00		
Morning coffee (20 stops)	$78.00		
College fund payment	$175.00		
Total	$2,282.45		

1. For Tyler to build a fully funded, three-month emergency fund, how much must he save?

2. Make your recommendations for how Tyler should adjust his spending and indicate how much you will save him each month.

Expense	**Amount**	**Recommendation**
Rent	$850.00	
Car payment	$263.00	
Movie night	$42.00	
Car insurance	$212.50	
Bought lunch (16 times)	$185.00	
Cell phone bill	$84.95	
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Total	$2,282.45	

3. How much did you trim from Tyler's spending?

4. How long must Tyler follow your recommendations to save three to six months' worth of money in his new emergency fund?

5. If Tyler's emergency fund is in an account paying 2.5 percent interest each year, compounding monthly, what is the balance after one year?

Being in control of your finances is empowering, and an effective budget will help you get there. The emergency fund is an important component of your financial stability, while helping to keep your budget realistic. Unexpected expenses happen to everyone at some point, and if you are prepared for them, those expenses won't break your budget or force you into taking on more debt. The combination of a fully funded emergency fund and a frugal, yet realistic budget will empower you to take control of your finances and enjoy financial stability.