Motley Fool's *Rule Your Retirement* Newsletter

Everyone Should Be Prepared for an Emergency

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When I was in high school, I thought I'd grow up to be a priest or a helicopter pilot for the Coast Guard. So I applied to both the Immaculate Heart of Mary Seminary and the U.S. Coast Guard Academy, getting accepted to both. I decided to attend the former. While I obviously chose to become a Fool instead of a priest, I have often wondered what my life would have been like in the Coast Guard. I figure it would have been a steady job with predictable pay, good benefits, and a pension in retirement.

That is, until the recent partial federal government shutdown.

Current and former employees of the U.S. Coast Guard are among the millions of Americans whose financial lives have been disrupted. NBC News reports that the 42,000 active members of the Coast Guard have stopped receiving paychecks, and 50,000 Coast Guard retirees are at risk of not getting their pension checks. Admiral Karl Shultz, the commandant of the Coast Guard, released a statement to active-duty members, writing, "To the best of my knowledge, this marks the first time in our Nation's history that service members in a U.S. Armed Force have not been paid during a lapse in government appropriations." Unlike the other armed forces, which operate under the Department of Defense and are still being funded by Uncle Sam, the Coast Guard falls under the Department of Homeland Security, which is currently not fully funded. To make ends meet, some members of the Coast Guard have turned to local food pantries.

Apart from the absolute ridiculousness of these people not getting paid for the important work that they do, the shutdown offers an important lesson for all of us: An unpleasant and unexpected financial emergency can happen to just about anyone.

Unfortunately, many Americans aren't prepared to weather an income disruption or an unexpected big-ticket expense.

CNBC's Emmie Martin recently published an article with a sobering headline: "The Government Shutdown Spotlights a Bigger Issue: 78% of U.S. Workers Live Paycheck to Paycheck." Martin gets that stat from a CareerBuilder survey, which also found that more than 50% of respondents save less $100 a month. She also cites a GoBankRates survey which found that 61% of people don't have an emergency fund. And then there's the Federal Reserve survey which found that 40% of people don't have enough cash to cover a $400 emergency.

The First Line of Defense

Everyone should be prepared for an unexpected and unpleasant financial surprise. It could be a loss of income -- a government shutdown, a layoff, an employer that goes under, or an illness or accident that leaves you unable to earn a paycheck for medical reasons. Or the surprise could come in the form of a big expense: a home repair, a car accident, a hospital bill.

And emergencies don't just happen to workers. Retirees experience them, too, whether in the form of unexpected expenses, or a disruption in income because of a bear market or an underfunded pension.

What's the first line of defense when such a calamity occurs? The often-recommended and sometimes-denigrated emergency fund! Why denigrated, you ask? Because building up a bunch of cash can be boring. Some experts also argue that having too much money in low-returning cash is needlessly conservative, and costs too much in terms of missing out on the higher returns that can (usually) be earned in the stock market. Even I have sometimes wondered how necessary a big emergency fund really is.

But then something like this shutdown or a recession or an Enron or a Lehman Brothers happens, and I am once again reminded how an emergency fund can save people from selling assets prematurely and/or going into debt.

How Big Is Enough?

The most common rule of thumb is that each household should have three to six months' worth of must-pay expenses in safe, liquid, accessible cash. (You can find high-yielding savings accounts at The Ascent.) Some experts think that's too small. Personal-finance guru Suze Orman thinks an emergency fund should be big enough to cover eight to 12 months' worth of expenses. David Bach of *Automatic Millionaire* fame thinks it should be sufficient to cover at least a year of expenses; his personal emergency fund is twice that size.

Is there anything empirical upon which we can base the right size for an emergency fund? Fortunately, yes. Bankrate recently published a study in which 30% of respondents said they or someone in their immediate family had experienced an unexpected big-ticket expense in the past year. The median cost of the expense was $3,750, with 36% reporting a cost of $5,000 or more.

What about job loss? According to the Department of Labor, the current median duration of unemployment is nine weeks. This is roughly in line with what we've seen during normal times over the past few decades. But during the Great Recession of a decade ago, that figure spiked to 25 weeks -- in other words, almost half a year.

Ideally, if you get laid off, you'll get some sort of severance package. A common formula is one to two weeks of pay for every year of service; you should definitely inquire about your company's policy.

Once that runs out, you may be eligible for unemployment benefits, though don't expect a windfall. Each state has its own maximum weekly benefit, which ranges from $240 in Arizona to $683 in Minnesota, with the average being about $400. Not a lot of money, but better than nothing.

Adding the evidence from the Bankrate survey to the median duration of unemployment, we can see how the "three to six months" rule of thumb is a reasonable starting point. What's the right amount for you? The following factors would point to bigger being better:

- The need to cover large, non-negotiable expenses such as a mortgage, a car loan, a student loan, alimony, or child support
- Having dependents
- Being a one-income family
- Having a job with fluctuating income
- Have a job that is sensitive to the economic cycle

- The prevalence of ongoing health issues with you or members of your family
- Being retired, at which point the emergency fund could be part of your three- to five-year income cushion of cash and bonds

After the Fund Is Gone

Once you've depleted your emergency fund, you must begin relying on your other resources (or rely on them immediately if you didn't have an emergency fund to begin with). Here are six of the most common options, along with their pros and cons.

1. Sell investments in regular, taxable accounts

Pros:

- The money is easily accessible; most trades settle in a few days at most.
- If you do this at a time, like now, when many stocks are down, you can engage in some tax-loss harvesting by realizing capital losses that will reduce your tax bill.

Cons:

- You'll miss out on the future potential growth of those investments.
- If you sell investments at a gain, you'll owe taxes, so make sure to set that money aside.

2. Credit cards

Pros:

- Accepted just about everywhere at any time.

Cons:

- Interest rates on credit cards just keep going up -- the current average rate is 17.47%, according to CreditCards.com.

- Once you've accumulated a significant amount of credit card debt, it's difficult to eliminate it, given the high rates.

3. Home equity line of credit (HELOC)

Pros:

- Allows you to tap up to 85% of your home equity as needed.
- According to Bankrate.com, the current average rate on a HELOC is 6.73% -- much lower than the rates on credit cards.

Cons:

- Requires a credit check and loan approval.
- May involve setup fees similar to the cost of getting a first mortgage, as well as annual fees.
- Rates are often variable, which is good if they drop but not so much if they rise.
- Payments may initially be interest-only, which means you won't be paying down principal at first.
- You're using your house as collateral, which is risky if you can't pay off the loan.

4. Borrow from employer-sponsored retirement accounts such as a 401(k), 403(b), or the Thrift Savings Plan (TSP)

Pros:

- Allows you to tap half your vested balance or $50,000, whichever is less.
- No credit approval required, because it's your money.
- The rate is usually 1% above the Prime Rate (which is currently 5.5%) -- again, lower than credit card rates.
- You pay the interest to your own account, and not to a bank.

Cons:

- Not every plan allows this; ask your employer.
- The money you borrow will be taken from your investments, which means you miss out on future growth.
- The loan must be repaid within five years or soon after you leave your job, whichever comes first; loans not repaid will be considered a distribution, and may be subject to taxes and penalties.

5. Withdraw money from an IRA

Pros:

- The money is easily accessible; most trades settle in a few days at most.
- If you put the money back within 60 days, it's considered a tax- and penalty-free rollover.

Cons:

- Money not returned within 60 days is considered a distribution and may be taxed and penalized.
- Rollovers are limited to one every 12 months -- if you've already done a rollover and then withdraw money, it's automatically considered a distribution.
- You'll miss out on the future potential growth of the money, shortchanging your retirement.

6. Borrow from family and friends

Pros:

- No credit check, origination costs, or annual fees.
- Potentially low to no interest rate.

Cons:

- Mixing money and family (and friendships) can get tricky.
- Asking friends and family for money can be uncomfortable.
- Giving others money or charging below-market interest rates is considered a gift for tax purposes, and may necessitate filing Form 709 if the gift exceeds $15,000 ($30,000 per married couple) in one year.

The Foolish Bottom Line

The government shutdown isn't just affecting the 800,000 federal workers who aren't currently getting paychecks. There are the approximately 4 million government contractors who are potentially affected, and then all the businesses that are built around some aspect of the government, such as suppliers, service providers, restaurants, dry cleaners, tour companies, cab drivers, and so on. Fool HQ is in Alexandria, Va., which is just across the Potomac River from Washington, D.C. And most of us know people who have been affected by the shutdown – including spouses of Fools.

So, yes, the recommendation to build an emergency fund is the most standard and boring financial-planning advice *ever*. But right now, there are millions of Americans who are either very glad they have one or strongly wish they did. Do yourself and your family a favor by building your financial plan on a foundation of sweet, safe cash.