Crisis Management 101: Emergency Savings

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Everyone runs into times of bad luck. I recently had my own series of “Unfortunate Events,” which made me decide on the subject for this article. Things happen: the refrigerator goes, the roof leaks or you trip going down the stairs. Certainly, these events can ruin your morning or your food (if the frig goes on the fritz). Many of life’s emergencies also come with unexpected expenses. No one knows when an accident or problem will occur but they are inevitable. As financial advisors, we are often asked about debt, retirement or college planning. However, one of the primary ways to improve your financial situation is to plan for the unexpected.

An emergency savings account is at the core of solid financial planning. One of the main questions about savings is how much to put aside for emergencies. Typically, three to six months of living expenses is the benchmark. In actuality, it depends on your specific situation. For example, someone who is at a firm that faces uncertainty might desire more emergency funds in case of job loss. Someone who has a secure career might only want a minimal three months in expenses set aside. If your car or your roof is old and nearing replacement, upping your savings for these items is an intelligent way to avoid unnecessary debt. However, with interest rates at record lows, taking a loan for a new car makes sense but a down payment is important. Therefore, saving enough for a down payment makes sense but taking a loan for the remainder at 0% makes even more sense many times.

When considering whether to take the loan or pay cash, look at the interest rates involved, your credit rating and overall debt burden. You don’t want too much of your income going toward debt payments or have too much debt overall. A good financial advisor can help with these decisions. It also depends on your risk tolerance. It is more conservative to have less debt and pay cash for items. Most of us don’t have that luxury.

Another important aspect of emergency savings is where to put the money until it is needed. Right now it’s frustrating to have money in savings accounts, money markets, and even certificate of deposits (CDs). They aren’t earning much to make them worthwhile unless you go to a long maturity, which isn’t a good idea. Emergency savings should be kept in easily accessible accounts. Because the money is for those surprises that bring you up short almost immediately, locking the money away in a CD with a penalty for early withdrawal or a variable security (the principal fluctuates) is not a good investment for this purpose. This is why a savings account or money market is the only place to hold these funds. Safety and liquidity are the goals for this money, not growth. You should also keep emergency money accessible, but not too easily used. The money set aside for emergencies is not for new shoes, a spring wardrobe or the latest toy. People need to set a barrier against emergency funds being squandered on other purposes.

What if you have credit card debt built up? The first step is to look back and see how this came about. Were the funds used for an emergency when no cash was built up? If so, paying down the debt and building up an emergency savings to avoid it happening again are key. Putting money away doesn’t have to all be in one place. Optimizing your money is one way to increase your net worth. An advisor can work through the best ways to use your funds.

An open line of credit, a Home Equity Line of Credit (HELOC) for example, can come through during a short-term cash crunch, especially in a low interest rate environment. My recent run of bad luck included totaling my car. From the time my car was totaled to when I got the insurance check, I needed a vehicle. My option was to continue to rent or buy a new vehicle, for which I needed a down payment. My rental cost would be $30/day plus tax, etc. I could also pull money from my emergency savings, which was at another bank. My solution was to pull money from my HELOC that matched the money I would eventually get from the car insurance company. With the interest low and tax deductible, the total interest for the week I had the loan outstanding was only $23, less than one day's rental. I paid it all off with the settlement from the insurance company and had my new car sooner.

You never know what life will hand you so being prepared for the unexpected with various financial resources, such as a Line of Credit and emergency savings, can pay dividends and permit you to keep away from credit card debt and pulling from retirement or other accounts with penalties.

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