



Saving for a Rainy Day

Into each life, some rain must fall goes the old song (any Ink Spots fans out there?) Given that certainty, one of the first recommendations we make when looking at a client's financial situation is a recommendation on their emergency fund.

The general rule of thumb is that we should all have from three to six months' worth of our expenses in an emergency fund, standing ready to cover unexpected costs (the furnace needs to be replaced, the car needs a major repair, etc.), or, more critically, standing ready to pay the bills if somebody loses their job.

Whether you should target a six month (or more) fund or can get by with a smaller cushion is dependent on how many wages earners there are in your household (how dramatically would your cash flow be affected if someone lost their job?) and how secure those jobs are (how likely is it that somebody could be facing a job loss?).

Because an emergency fund's purpose is to provide cash in case of an emergency, the fund's balance has to be invested in a liquid security -- which means the security has to be easily convertible to cash without running the risk losing principal. Bank accounts and money market funds are liquid; stocks, bonds, and mutual fund shares (unless shares of a money market mutual fund) are not. CDs are liquid at a price: you will normally have to pay a fee to cash in a CD prior to maturity. However, if your emergency fund is in a CD and you don't need to tap it, you may have gotten a better yield for the time period than you would have received in a completely liquid money market fund.

One always pays a price for liquidity, of course; of all the major asset classes, cash-like investments have posted the lowest historic long term average rates of return. You're not trying to maximize your return on your emergency fund dollars -- you're trying to maximize your liquidity.

That can make it hard for some clients to follow our recommendations for an emergency fund. We have more than once heard from new clients: "it's okay, I don't need an emergency fund - I have a HELOC (home equity line of credit) that I can draw on if I need cash".

We've never liked that approach, as adding to your debt levels while you're unemployed can start a descent into real financial distress. Now, recent developments provide another reason to avoid this approach: some financial institutions are freezing clients' HELOC accounts, making them unavailable as a source for borrowing.

As reported in this month's *Money Magazine*, and 04/13/2008's *New York Times*, lenders have sent "several hundred thousand" letters to homeowners in many parts of the country, informing them that they cannot draw on their HELOCs at this time. The lenders are trying to protect themselves from losses, of course, as home prices fall.

They are within their contractual rights; according to the Times' article, the terms of HELOC agreements allow banks to rescind the credit at any time.

This event points to the risk of relying on a HELOC for your cash reserves; if it's not available, it's obviously an unreliable stand-in for an emergency fund. So our advice remains: calculate your monthly spending (not including taxes and savings) and set aside at least three to six months' of that spending in an account that will provide you immediate cash should you need it.

-- Therese Govern. Posted 05/20/08.