How Big An Emergency Fund Do You Need?

Date: August 15, 2016 **Publication:** Bottom Line Personal **Source:** Jim Holtzman, CFP, Legend Financial Advisors, Inc.

It May Be More…or Less…Than You Think

Most financial advisers agree that consumers should keep some readily available cash in a very safe account in case they face an unforeseen expense ranging from car or home repairs to big health-care costs to the loss of a job.

But how much cash is enough?

Too little could force you to draw on credit card or home-equity loans or liquidate long-term investments, and yet 28% of US adults have no cash savings at all, according to a recent Bankrate survey. And 46% do not have the equivalent of three months of expenses.

Of course, there also are drawbacks to having money stashed in safe savings-type accounts—including the fact that it doesn't appreciate very much.

I have helped hundreds of clients—those still in the workforce and those who have retired—to create the right-size emergency funds for their situations. Here's a five-step plan to determine how large your emergency fund should be…

Working or Retired

Step 1: Make sure you have suitable health, auto and property insurance coverage. This is crucial because without such coverage, even a minor incident that involves going to the emergency

room, fixing your car or repairing your roof could put a big dent in your finances. Talk with your insurance agent about the right coverage for you, taking into account annual premiums and deductibles. If you stop working before age 65, you will need to arrange for health insurance until you qualify for basic Medicare. Even then, you need to consider additional Medicare coverage and/or supplemental private insurance for potentially costly items such as prescription drugs and dental work.

Step 2: Decide what is likely to be your most severe financial emergency that is not covered by insurance. For individuals still in the workforce, that's likely to be a job loss, since you might have no income for many months until you find a new job. Also, your health insurance premiums could be much higher if you need to extend your workplace coverage through the COBRA program. Retirees don't have to worry about a disruption in wages, but despite that, many of them need a*larger* cash reserve than working people do, depending on how much income they draw down regularly from their retirement portfolios. That's because a retiree's costliest potential emergency might be a bear market that forces the sale of investments at the worst possible time, when investment values have plunged.

You Are Still Working

Step 3: Figure out what your monthly budget would be if your employment income stopped.

If you depend on wages and lose that source of income, you'll want to temporarily reduce your spending to basic living expenses. How much will that be? To find out, first create a list of all your normal expenses. Then cross off nonessential spending. This includes items such as vacations, gifts and restaurant meals…funding your retirement savings…and credit card and other debt payments above their minimum required levels.

Cutting out these expenses typically reduces average monthly expenses by 30% or more. What's left are bills that can't be skipped without negative consequences, including mortgage and utility payments, insurance premiums and discretionary expenses that you consider very important, such as helping support an aging parent.

Step 4: Decide on the size of your emergency fund. Think in terms of how many months of current income you might need to cover basic living expenses. Use the following guidelines as a starting point to determine the number of months of income you are likely to need.

Three months: This is the smallest emergency fund most people should have. It's only for individuals with secure jobs and excellent insurance coverage, including short-term disability insurance that kicks in within 90 days of disability.

Six to nine months: This is the amount of emergency reserves many of my clients feel comfortable with. That's because most people who lose a job usually are able to find a new one within this period.

12 months: This longer time frame is for my clients who are self-employed or in high-risk industries where layoffs are common. I also recommend this larger emergency fund during recessions when layoffs are more common and the average length of unemployment is longer.

More than 12 months: Keeping more than one year's worth of basic living expenses in cash generally is not a good idea, because most people are likely to find a job within a year—even if you don't, you have that whole year to find ways to fund additional jobless months, such as obtaining a home-equity line of credit or downsizing your home.

Step 5: Fine-tune the time frame up or down depending upon your personal circumstances. Questions to ask yourself…

How secure is my job, and how easy would it be to find a new one? According to the US Bureau of Labor Statistics, about half of the management-level professionals who lose their jobs find new jobs in about four months—but that varies by industry and position. The less certainty you feel, the greater the amount of emergency savings you'll want.

Do I have any supplemental income? Dependable income outside of your wages would allow you to cut down on the size of your emergency fund. For a limited time, so would any guaranteed severance or buyout package you have in place at your job and any unemployment benefits you can expect.

How many people depend on my paycheck for support? Two-income families often need less in emergency savings. I typically use the percentage that the higher-earning spouse contributes to monthly expenses to determine how much cash is needed. *Example:* I had a client whose spouse had a steady job providing 30% of the family's basic monthly expenses versus 70% covered by my - client's income. The monthly expenses came to about $8,000 a month, and the husband figured it would take him about four months to find work if he lost his job. Since 70% of $8,000 multiplied by four months comes to $22,400, that's the size his emergency fund should be. That amount also would be enough if the other, lower-earning spouse were to become unemployed.

You Are Retired

Most retirees depend on at least some income from their investment portfolios to meet their monthly expenses, and that income often comes from periodically selling assets. If this describes you, you should have an emergency fund big enough that you aren't forced to sell investments during the course of a severe market downturn. What to do…

Follow Step 3 (on page three) to figure out your emergency monthly budget. Then make sure you have enough in cash to cover 18 months of basic living expenses—that is the average length of a bear market.

Example: I had a retired client who needed a minimum of $4,000 a month for expenses. A pension from a former job provided her with $2,500 a month, but she had to draw down the additional $1,500 from her investment portfolio. She needed an emergency fund of $27,000 ($1,500 x 18 months). *Note:* If you receive additional money each month from part-time work or from your family or children, it will reduce the amount of cash you need to put aside.

Even if retirees can meet their monthly emergency budget entirely through guaranteed income such as pensions, annuities and Social Security, I typically recommend that they keep the equivalent of six to 12 months' worth of expenses in cash. For those retirees, the biggest financial emergency is likely to be out-of-pocket medical costs. *Example:* Typically, Medicare fully covers basic services for the first 20 days of a skilled-nursing facility after a major hospitalization. But what if you take longer to recover? If you don't have supplemental insurance, you typically pay $161 per day in coinsurance from day 21 to day 100 (totaling up to $13,000) and the full cost beyond day 100. Take such costs into account.