You Need an Emergency Fund

What if that rainy day you've been saving for turns out to be today?

Whether you make $30,000 a year or $300,000, you should have an emergency fund — a stash of cash earmarked for major, unexpected expenses like a new roof, or an income shortfall due to illness or job loss. Without one, you could be forced to take extreme financial steps to make ends meet. Fortunately, you can avoid doing so with a little forethought.

Do the math
To be safe, an emergency fund should cover three to six months' worth of expenses, *without income*. If you and your spouse both work and you have no dependents, aim for three. Aim for six if your family is dependent on your income alone, you have dependents, and/or you have tuition, mortgage payments, or other large fixed monthly costs.

Make a list
Add up your monthly expenses. The obvious ones are food, rent or mortgage payments, utilities, telephone, and car payments. But don't forget the not-so-obvious ones — *all* your credit card bills, gas for the car, cable TV, and other costs that may not necessarily leap to mind. Multiply that sum by the number of months you think you'll likely go without income.

Make it happen
Your emergency fund should be held in a conservative, fluid investment, such as a savings account at your local bank or a cash-equivalent account. The interest you'll earn in either account won't be much, but you're looking for stability and accessibility, not high returns. Keep in mind that a certificate of deposit (CD) is *not* an ideal emergency-fund vehicle. Tap it before it matures—which you'd likely have to do in a cash crunch — and you'll pay a significant penalty.

To build your emergency fund, make regular payments into the account you choose, just as you do with your retirement savings plan account. No amount is too small. Be sure that you don't *substitute* emergency fund payments for retirement savings plan investments. It would be in your best interest to do both. And remember, you're never too old to start saving for a personal calamity. They aren't age-specific.

Don't touch your retirement savings
In a pinch, borrowing money from your retirement savings plan may seem logical (it *is* your money), but doing so may do more harm than good. For starters, you will lose the benefit of compounding — the potential for your principal and interest to grow exponentially. When you pay the loan back, you replace pretax money with after-tax income — a losing proposition. Generally, you have to repay the loan within a number of years. If you don't, you'll incur a 10% early-withdrawal penalty. And then when you retire and start withdrawing the money, you'll be taxed *again*.

Setting up an emergency fund is among the simplest and most important ways you can financially protect yourself and your family. Should the day come when the pipes burst and your basement is flooded — or you get sick or laid off — an emergency fund could be your saving grace. So plan wisely. In a time of need, you'll be glad you did.

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