Emergency Cash Is A Necessity, Not A Luxury

When it comes to planning for those unexpected but inevitable financial speed bumps in life, Americans seem to think denial is a reasonable strategy.

A dismaying 31 percent of respondents to a Lawyers.com survey reported that their liquid savings wouldn't cover their living costs for one month. Just one month! And 45 percent said their cash stash wouldn't cover the regular bills for three months.

I don't care how healthy or young you are, or how financially stressed: You need an emergency cash fund, and you need it now.

It's wise to eventually build up a six- to eight-month fund, because there's a good chance you won't earn a paycheck for at least that long if you're laid off or become too sick to work. Even if you have disability insurance, it often doesn't kick in for the first six months of your disability.

Nevertheless, more than 80 percent of the respondents to the Lawyers.com survey don't have a cash fund that would cover their living costs for at least six months.

Compounding the Problem

Let's face it, even relatively "small" emergencies can send your finances into a tizzy. An unplanned medical test or two can quickly add up to a four-figure doctor's bill even if you have health insurance. Remember, insurers are working hard to shift medical care costs onto consumers as much as possible, and that means higher co-pays and reduced coverage for certain procedures.

Or say your house needs some serious unplanned repairs. Tapping into your homeowners insurance can backfire. First, you're going to have the deductible to deal with, so you'll need some cash regardless. And when you actually use the insurance, you're probably looking at a premium hike at your next policy renewal.

Consumers are also quick to pull out their credit cards to pay for unforeseen expenses. That's fine if you qualify for a no- or low-interest-rate card, but with the average rate at an obscene 15 percent, plastic isn't a smart solution for everyone.

Don't Bet the House

Using home equity to bail yourself out of unforeseen economic shortfalls can also be a very expensive solution. Thanks to the constant rise in the Federal funds rate, home-equity line of credit interest rates are now more than 8 percent for borrowers with excellent credit, and over 9 percent for those with merely good credit.

And those rates aren't fixed -- they change every time there's a change in the Fed funds rate. Even if Ben Bernanke and company at the Federal Reserve choose to stop raising the rates, no one is forecasting a rate reduction. Paying more than 8 percent to bail yourself out of an emergency, big or small, is too costly a strategy.

The same goes for borrowing from your 401(k) plan. I've covered this territory before, so here's a short-recap: The money in your 401(k) is pre-tax, meaning Uncle Sam has yet to take his cut. When you take that money out as a loan, you'll eventually have to pay it back, and that's going to come from money you've already paid taxes on.

Then, when you retire and start making 401(k) withdrawals, the same money you used to repay your loan is going to be taxed again; all withdrawals are subject to income tax. Paying taxes twice on your money isn't a reasonable strategy.

Besides, if your emergency is that you were laid off, you won't be able to take out the loan anyway. And withdrawing money outright from a 401(k) means you lose twice: If you're under 59 and a half, you'll have to pay an extra 10 percent IRS penalty for an early withdrawal, and you've just gutted your retirement savings.

Plan, Don't Procrastinate

OK, now let's get smart and actually plan for the "what ifs" in life.

I appreciate that it will take some time to build up a sizeable cash fund, but an emergency could strike tomorrow. As a stopgap, if you have a FICO credit score of 720 or higher, you could shop around for a credit card that will charge you no interest or a very low rate. But don't use the card -- it's only for a true emergency.

A Roth IRA can also bail you out. Because the money you invest in a Roth has already been taxed, you're free to withdraw your contributions -- but not your earnings -- with absolutely no tax or penalty, regardless of your age. Of course, this is a last-resort move; as I said, raiding your retirement savings to cover a shortfall today is not an ideal solution.

Make It Easy

The best way to build up an emergency fund is to open a savings account into which money from your primary bank account is transferred every two weeks or so.

Online banks often offer the best rates. Check out EmigrantDirect, where you can earn over 4.5 percent interest on your savings. It's easy to set up regular electronic transfers, and you can start with just $25 or $50 a month.

Invest $50 a month at 4.5 percent interest and you'll have more than $625 saved up in a year. Double your automatic transfer to $100 a month and you'll have more than $1,250 in 12 months and over $2,500 in two years. If you can afford $100 every two weeks, in just two years you'll have saved nearly $5,450.

Don't tell me you can't afford it. My experience is that once people commit to an electronic savings plan, their spending habits adjust to compensate. If you feel a pinch, it's time to take a serious look at where you can tighten your belt.

Thinking Ahead

Here are some other savings possibilities:

- Boost your car and homeowners insurance deductibles to at least $1,000. The chances that you'll ever need to make a claim on them are fairly low, and by opting for the higher deductible you can reduce your overall premium costs by 10 percent or more.
- Use the same company for your car and homeowners insurance; that can get you a further premium reduction of around 10 percent.
- Ditch your land line if you can get by with just your cell phone. Depending on your plan, you might be able to free up $30 to $50 a month.
- Adjust your federal tax withholding. The average tax refund is more than $2,000, which is a waste. Why wait more than a year to get back taxes you paid but didn't owe? Adjusting your withholding means less cash deducted from your paychecks. That's money you can put to work today in a cash stash.

There's no way to predict when an emergency will strike, or to know how expensive it will be. But you can plan. An emergency cash fund is your best line of defense.

Credit – Suze Orman