Emergency Cash Reserve

Setting aside money to meet unexpected expenses provides a financial safety net and allows you to take advantage of financial opportunities as they arise. Most experts recommend an emergency fund equal to 3 to 6 months living expenses; however, you do not need to set aside this total amount in a low-yielding passbook, certificate of deposit, or money market account. The amount of your emergency fund depends upon your age, health, job outlook, and personal financial situation (e.g., amount and kind of insurance coverage). An emergency fund might be adequate with enough to cover 3 to 6 months of expenses using a combination of cash and credit if you have a source of low-cost borrowing (e.g., home equity credit-line loan, cash-value life insurance, or retirement plan). If your household has multiple sources of income or dual earners, you can count on those other sources of income in an emergency.

You might want a larger emergency fund if you are in business for yourself, your work is seasonal, your job is uncertain, or you rely heavily on commissions. If your health is questionable (e.g., you foresee long-term disability or extensive medical expenses), you anticipate a large expenditure for the care of a relative in the near future, or your child is about to enter college, you may also need a larger cash reserve.

Your emergency cash reserve can be subdivided to minimize penalties for early withdrawal of large amounts of funds at one time and to maximize interest earned on accounts should an emergency occur. Money that would be needed within 3 months of a financial emergency is best placed in an interest-bearing checking account, passbook savings, money-market deposit account, or money market mutual fund. Funds needed 4 to 6 months after an emergency could be placed in short-term certificates of deposit (CDs) as well as 3- and 6-month Treasury bills. Money that would not be needed for 7 months to 2 years could be placed in a money market mutual fund and longer term CDs (12-, 18-, and 24-month). Money you can avoid withdrawing for 2 to 5 years during a financial emergency could be placed in Treasury notes, short-term bond funds, or 3- to 5-year CDs.

Action Steps Emergency Cash Reserve