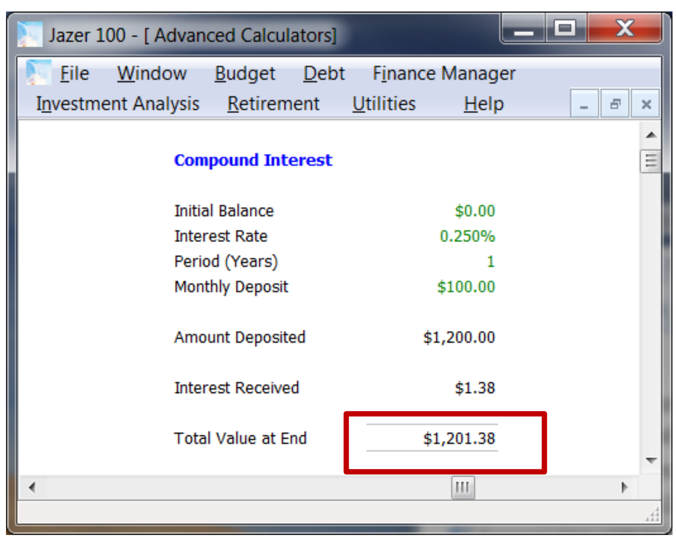
The Emergency Fund and Saving in General

We briefly touched on the topic of saving in “Addressing Debt and Saving at the Same Time”, but it requires a lot more attention. We know that we need a savings account and should be saving for major purchases like cars and homes, emergencies, and life changing events like marriage, a college expense or retirement. We know how hard it is, and how we forget to make the deposit if it isn’t automatic, and how hard it is to just leave the savings alone. It just sits there earning a meager interest rate, and we’ve got bills to pay. Never the less, we have to save.

Saving is one of those things that we have to make into a habit, and psychologists say that it takes about three months of continued action to establish a habit. After that, it becomes pretty regular and unless something upsets the cycle, it will just continue. This is really good news, but getting started seems to be the most difficult part. Then, how much to save and where to save are the questions I hear most. Let’s start with how much.

There are two “how much?” questions. The first has to do with the weekly or monthly amount to save, and the second has to do with how much savings is recommended…or “how much should be in our emergency fund?” The answer to the first is pretty simple…save as much per week as we can without stretching things too thin. Even $25.00 or $50.00 a week can become significant over time.

For example, if we were to save $100.00 per month using a regular savings account at our local bank, after one year the balance would be $1,201.38 (shown to the right). We can make the deposit automatic from our checking account if that’s convenient or direct deposit from our employer in some cases. Having $1,201.38 in a savings account would be a great start, and after two years, the balance would be $2,405.76.

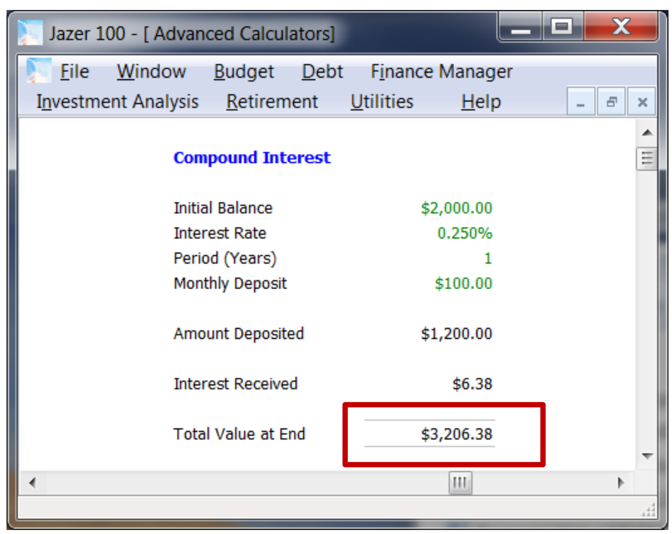


Some people might say that scraping $100.00 out of a monthly budget is a significant sacrifice when it only accumulates $1,201.38, but what if we started ten years ago? If we started ten years ago we’d have **$12,149.98**. The point is to get started. The years will go by either way, but if we’re saving, then we're in a much better financial situation. Overcoming inertia and just forming the habit of savings seem to be the enemy in a lot of situations.

If we increase the saving deposit to $150.00 per month, after one year we'd have $1,802.06, after two years $3,608.64, and after ten years $18,224.96. At a saving rate of $250.00 per month, the first year balance would be $3,003.44, after two years $6,014.40, and after ten years our balance would be $30,374.94. These are all great numbers, but again the idea is to get started with a savings amount that we can handle, and to make it regular.

I intentionally used a very low interest rate in the examples above because we were talking about a local bank savings account. As we begin to accumulate savings, we can look at splitting our savings into different accounts to take advantage of higher interest amounts. We don't start out this way, because we need access to some amount of cash that will act as a cushion for surprise expenses. Let's continue, and now we'll adjust the interest rate.

Let's say that once we have $5,000.00 in our local banks savings account, we feel that's a reasonable small cushion and we take $3,000.00 out of that and open a money market account that pays 1% interest. Now we have two accounts working for us. The first (at our local bank) has the remaining $2,000.00, we're still depositing $100.00 per month, and it's still getting 0.25% interest. After another year goes by, the balance is **$3,206.38** (shown to the right). The second account (our money market account) is merely accumulating interest on the $3,000.00 initial deposit. We're not making any deposits into this account, and after one year the balance is $3,030.14.



Now, our total savings from both accounts is $6,236.52

Admittedly, it takes time. In our example, it took a little over four years to reach $5,000.00 in the bank savings by depositing $100.00 each month; we took out $3,000.00 and opened the money market account, and another year has elapsed gone by, so it's taken five years.

These examples are in line with the reality of what a lot of people are able to save on a regular basis. To increase (or even set) the saving amount requires a hard look at our budget (what we spend) and may require a change somewhere to find an amount that can be carved out for saving. A budget for our purposes is not a list of limits for spending or buckets of money that we set aside for expenses, but what we actually spend and where. If we don't know where our money goes, there is no chance we can manage and plan effectively. If we don't have a budget, then we don't know what's available, where we might trim, or where we need to make an adjustment; and saving is a start-and-stop exercise that usually ends in a withdrawal to make ends meet. A budget must come before a savings plan, and a savings plan must come before an investment plan.

Living Expenses	Weekly	Monthly	Yearly
Weekly Essentials	$100.00	$433.33	$5,200.00
Food	$200.00	$866.67	$10,400.00
Phone	$20.77	$90.00	$1,080.00
Cable TV	$20.77	$90.00	$1,080.00
Other #1	$0.00	$0.00	$0.00
Other #2	$0.00	$0.00	$0.00
Other #3	$0.00	$0.00	$0.00
Housing Expenses			
Mortgage/Rent	$600.00	$2,600.00	$31,200.00
Elec/Gas	$69.23	$300.00	$3,600.00
Repairs/Maint.	$46.15	$200.00	$2,400.00
Water/Sewer	$4.62	$20.00	$240.00
Other #1	$0.00	$0.00	$0.00
Other #2	$0.00	$0.00	$0.00
Other #3	$0.00	$0.00	$0.00
Auto Expenses			
Fuel	$40.00	$173.33	$2,079.96
Loan Payment	$80.77	$350.00	$4,200.00
Auto Insurance	$23.08	$100.00	$1,200.00
Maintenance	$11.54	$50.00	$600.00
Other #1	$0.00	$0.00	$0.00
Other #2	$0.00	$0.00	$0.00
Other #3	$0.00	$0.00	$0.00
Debt Reduction			
Credit Card #1	$80.77	$350.00	$4,200.00
Credit Card #2	$57.69	$250.00	$3,000.00
Credit Card #3	$27.69	$120.00	$1,440.00
Credit Card #4	$0.00	$0.00	$0.00
Loan #1	$0.00	$0.00	$0.00
Personal Loan	$0.00	$0.00	$0.00
Other Loan	$0.00	$0.00	$0.00
Total Expenses	$1,383.08	$5,993.33	$71,919.96

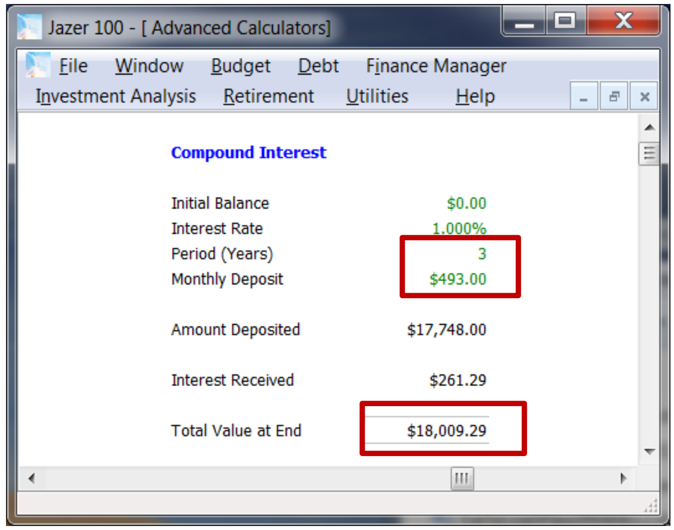
We haven't touched on IRAs, 401(K)s, Treasuries, Bonds, or Mutual Funds, and have kept this in the realm of passbook type savings and money market accounts intentionally. Venturing into investment vehicles without establishing a "cushion" and emergency fund wouldn't be prudent for most. This brings us to the second how much question…the question about the size of our emergency fund.

There are a few rules of thumb regarding the amount that should be in our emergency fund. Some say three months worth of expenses, others say six months, and still others say that we should have enough to cover a year of expenses stashed away in our emergency fund. Frankly if I have none, then my first goal would be to save three months worth of expenses. Then I'd work on six, and so on. If my budget is the one shown above, then my first goal is to save $18,000.00, which is about three times monthly expenses.

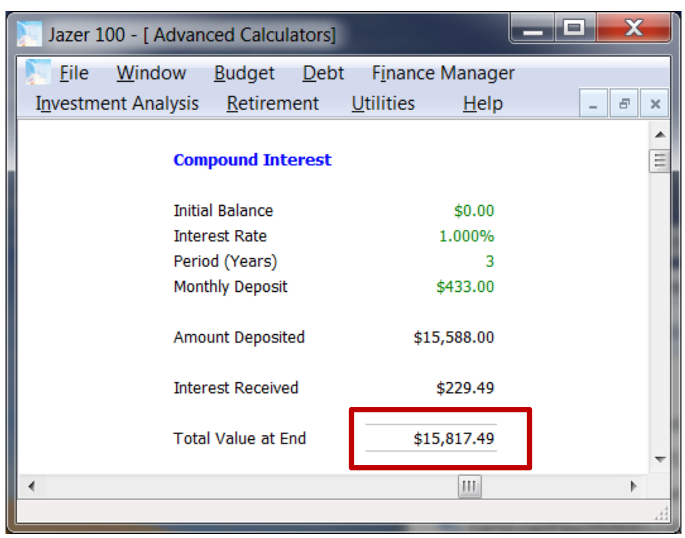
3 months x $5,993.33 = $17,997.99

Now we see the dilemma. In our saving example above, we were able to save $6,236.52 after five years, but my goal is $18,000.00 just to cover three months of expenses. This seems unachievable.

Let's back into the numbers and see what it would take to save the $18,000.00 in a year. If we divide $18,000 by 12 months then we need to save $1,500.00 each month. This is impossible. To save the amount in 2 years would require $750.00 each month in savings, and to accomplish the goal in 3 years would require saving around $493.00 per month. We have to start somewhere, so let's start here.



I set a goal to have 3 months worth of expenses in a money market account within 3 years. This actually requires about $493.00 in savings each month or about $113.77 each week. I go back to my budget, and decide to stretch my weekly essentials and cut back to $75.00 per week, cut back on eating out and reduce my food budget to $150.00 each week and eat at home more (eating out is very expensive), and that's all I can do for now without creating a problem. This gives me $75.00 per week to apply to savings in addition to the $25.00 I had been saving. I include it in the budget as the last entry in the Living Expenses category so that it's accounted for in the budget.



At $100.00 per week (or $433.00 per month), it will take a little longer to achieve the goal of $18,000.00, but at the end of the 3rd year I will have saved **$15,817.49**. Any additional amount that I can deposit along the way will shorten the time period to achieve my goal.

Choosing a 3 month, 6 month, or 1 year goal depends on our current situation. How much savings do we currently have, is our job fairly stable, when will a replacement car be needed, and the timeline to a major purchase all have to be considered. The bottom line is that saving must be a part of our regular financial routine, and planning and setting saving goals plays a major role.

In the examples we used local bank savings account and money market account interest rates. For an emergency account, we need to be able to access the money easily and quickly in an emergency without paying a penalty. These types of accounts provide these benefits. We also used a calendar timeline in our examples. The individual timeline for each of us would be different. To account for this, many timelines are established in dollars. As an example, we would set goals in dollar amounts and when a goal is achieved we would move to the next one. As an illustration, we might set up a plan where we saved into a local bank savings account until we had a balance of $5,000.00. Then we might deposit into a money market account until that balance was $5,000.00 as well. Next we could consider a Mutual Fund or Bonds for money that doesn't need to be as readily available. These other investment accounts provide better returns on our investment. A good Financial Advisor can point out the benefits and risks for each and assist in financial planning for the future based on our individual needs and goals. The first goal is to get started, establish a saving routine, and let it develop into a habit. Based on our expenses (budget), the emergency fund amount that we feel is adequate should be the goal.

Emergency Fund Saving Examples:

	Emergency Fund			**Monthly Savings Required to Save 3 months of Expenses in 3 Years**
Monthly Budget/Expenses	3 Month	6 Month	1 Year	
$1,800	$5,400	$10,800	$21,600	$150.00
$2,600	$7,800	$15,600	$31,200	$216.00
$3,200	$9,600	$19,200	$38,400	$266.00
$3,800	$11,400	$22,800	$45,600	$316.00
$4,400	$13,200	$26,400	$52,800	$366.00
$5,200	$15,600	$31,200	$62,400	$432.00

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