

FIVE TIPS FOR YOUR EMERGENCY FUND

Whether you are just starting out with your career or you are transitioning into or already in retirement, it is important to have an Emergency Fund reserve. Financial emergencies can come in the form of a job loss, significant medical expenses, home or auto repairs or something you've never even considered. The last thing you want to do is be forced to rely on credit cards or a personal loan which could simply compound the problem.

A choppy economy and uncertain job market have underscored the importance of building a cash cushion to cover your costs in case of unanticipated expenses. At the same time, available yields on emergency-fund-appropriate investments have shriveled to next to nothing.

What to do? Here are some considerations:

1. Customize, based on your own situation.

Three to six months' worth of living expenses is a reasonable starting point when setting your emergency fund amount. But think of it as just that: a starting point. From there, you'll want to customize your emergency-fund amount based on your own situation. The basic question is this: How much time would you want to replace your job if you lost yours? The key factors that may affect your decision are how flexible you are in terms of your career choices and lifestyle.

Consider holding a larger emergency fund (six months' to a year's worth of living expenses - or more) if you:

- Have a high-paying job
- Hold a position in a highly specialized field
- Are self-employed or have significant variability in your income
- Work on a freelance/contract basis
- Have dependents
- Have a nonworking spouse
- Have high fixed expenses, such as a mortgage, auto loans, and tuition bills
- Have a pre-existing medical condition that could result in hefty health-care bills if you were forced to purchase private health insurance

On the flip side, you may be able to get by with a smaller emergency fund if you:

- Have a good degree of career flexibility because you are in a lower-paying position and/or haven't yet developed a specialized career path
- Have other sources of income that could help defray a large share of household expenses, such as a working spouse
- Have a great degree of lifestyle flexibility (for example, you would be willing to relocate or get a roommate)

2. Focus on the essentials

Setting aside even three months' worth of living expenses might sound like a daunting sum, particularly if you look back on your real-life spending habits. But once you strip out discretionary expenses that you could easily live without if you needed to, your emergency-fund amount is going to look a lot more manageable. To help find the right emergency-fund target, look back on your fixed expenses during the past several months: mortgage or rent, taxes, utilities, insurance, car payments, and food bills.

Bear in mind, however, that one key expense category could spike up if you lost your job: health-care costs. Your company's human resources administrator should be able to provide you with a quote on what obtaining COBRA continuation health coverage would cost, and you can also go to ehealthinsurance.com to obtain a range of insurance quotes for a person/family in your age range.

3. Build a two-part emergency fund.

If you've decided to be conservative and build a large emergency fund - and that's a good strategy if you currently have a higher-paying job and high fixed costs - you might consider splitting it into two portions. For example, you might allocate three months' worth of living expenses in a traditional emergency-fund savings place (or a combination of them) such as: your checking and savings account, a CD, money market account, or money market mutual fund.

To help address the fact that those truly safe investments are yielding next to nothing, you could then allocate another six to nine months' worth of expenses (or more) in a vehicle that would deliver a slightly higher yield in exchange for modest fluctuations in principal value, such as a short-term bond fund or a short-term municipal fund if you are in a high tax bracket.

However, it's critically important to keep in mind that the purpose of the allocation is for emergency purposes, should one arise, and avoid getting caught up in chasing a higher return at the potential risk of loss of principle.

4. Multitask through a Roth.

What if you're trying to build an emergency fund while saving for retirement at the same time? If that's you, you may consider building at least part of your emergency in a Roth IRA, if applicable. This can be a viable option because the Roth, unlike a traditional IRA or 401(k), enables you to withdraw your **contributions** at any time and for any reason prior to age 59 1/2. Under a best-case scenario, the assets in your Roth would increase until you began withdrawing them in retirement. But if you lost your job, you could withdraw your Roth contributions if you needed the money to cover living expenses.

The key drawback to this approach is that ideally, you'd hold any assets you have earmarked for your emergency fund in something safe, such as a money market fund or CD. But those safe investments have very low long-term return potential, making them inappropriate if your goal is long-term growth for retirement.

5. Set up additional safety nets.

Finally, while emergency funding is on your mind, investigate additional safety nets that you could turn to if you've exhausted your emergency assets. For example, obtaining a home equity line of credit may also make sense for homeowners who have built up substantial equity in their properties. The key to making this strategy work is to use the HELOC only in case of a true financial emergency and after you've exhausted other types of funding, rather than to cover discretionary expenditures such as cars and vacations.