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The Importance of an Emergency Fund

What is an emergency fund?

Ideally, every individual should have access to extra cash to meet large and unpredicted expenses. This monetary source is referred to as an emergency fund. While the concept is quite simple, establishing an appropriate and adequate emergency fund is often overlooked.

What are the risks of not building an emergency fund?

Unexpected situations will occur throughout life that will negatively impact your cash flow. You could lose your job, become injured or disabled, face a costly home repair, or experience a personal crisis. Regardless of the cause, the effect is the same: **you will need money**. When these tough times arise, it is critical to have options that will not ultimately cause you harm. For example, it is important to avoid:

- 1) Selling assets in a down market and losing principal.
- 2) Tapping into your retirement savings, and possibly incurring early withdrawal penalties from qualified accounts.
- 3) Borrowing money at high interest rates.
- 4) Not having options, and losing your home, health insurance coverage, or other essential assets or services.

How much of an emergency fund should I have?

The general rule of thumb is to have enough cash handy to cover three to six months of non-discretionary expenses.

- First, itemize your necessary *fixed expenses*. These include your mortgage, property taxes, automobile payments, and insurance premiums.
- Next, quantify your essential *variable expenses* that will fluctuate from month to month. These will include groceries, utilities, gasoline, clothing, and entertainment.
- Add together your necessary fixed expenses to your minimal variable expenses, and target an emergency fund that represents three to six months of these combined cash outflows.
- Households with two wage-earners and several income sources can lean towards a three-month emergency fund.
- On the other hand, a family relying on one earner with one income source should establish an emergency fund to cover six months of expenses.

Simplifying Life by Creating Wealth Solutions through Understanding.

DEFINITIONS:

Emergency Fund

A reserve that can be quickly converted to cash to fund emergencies without loss of principal

Liquidity

The ability to convert an asset to cash quickly, with minimal or no loss of principal

Short-term

Certificates of Deposits

A fixed-income investment available through financial institutions with a fixed interest rate and a set maturity date within one year.

Money Market Account

A special savings account that offers an above average interest rate in exchange for larger than normal deposits.

What type of assets are appropriate for an emergency fund?

Where you hold your emergency fund is as important as establishing an adequate balance. Your emergency fund assets should provide for the security of principal and be highly liquid. During these moments of financial need, you will not have the luxury of time. You will not be able to wait for the market to rebound, or for the day you turn 59½. You will need immediate access to your cash with as few negative consequences as possible. Therefore, some investments or accounts that are the most suitable for your emergency fund include:

- Savings Accounts
- Money Market Accounts
- Laddered Short-term Certificate of Deposit
- Checking Accounts

These investment vehicles will have marginal earnings; however, not establishing an emergency fund could prove financially devastating.

Strategies of establishing your emergency fund:

If you feel that your emergency fund is insufficient, consider the following strategies:

- 1) *Pay yourself first* – put a set amount or percentage of your monthly income away for emergencies.
- 2) *Review monthly expenses* – identify spending areas that can be reduced or eliminated.
- 3) *Save unexpected cash inflows* – save bonuses, salary increases, and any other income that you are not currently relying on for support.
- 4) *Work overtime or get a part-time job* – consider taking on additional hours or picking up part-time employment until your cash reserve goals are met.
- 5) *Monitor interest rates* – take advantage of the best rates offered by banks.

In addition to utilizing some or all of the above mentioned strategies, you are encouraged to speak with your Tri-Star Trust Bank advisor to discuss your emergency fund, and to identify solutions for meeting your short-term and long-term financial goals.

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