

Emergency Fund Essentials

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Only about one-third of American households have sufficient emergency funds to tide them through three months of unemployment or other large unexpected expense. The recommendation that consumers should set aside three months of expenses for emergencies can be daunting to households with substantial consumer debt and little savings. Many households rely on credit to deal with emergencies. With money market funds and savings accounts paying negative real rates of return, educators need to emphasize building emergency reserves in savings options that are safe and reliable but pay higher returns.

Purpose

The purpose of this article is to emphasize the relevance of emergency savings and to provide educators with recommendations for teaching why and how to structure an effective emergency fund. A review of the research literature provides justification for teaching the importance of emergency funds. Recommendations on how to structure an effective emergency fund are provided.

Review of Literature on Maintenance of Emergency Funds

Johnson and Widdows (1985) conceptualized emergency funds as three graduated stages of liquidity: quick, intermediate, and comprehensive. Quick funds are very liquid and include checking, savings and money market funds; intermediate funds include quick funds plus certificates of deposit; comprehensive funds add stocks, bonds, and mutual funds to the quick and intermediate measures. Using the 1977 and 1983 Surveys of Consumer Finances (SCF), Johnson and Widdows concluded that only one-third of households had sufficient reserves.

Regardless of the state of the economy, studies have reported uniform findings on the percent of households meeting emergency fund guidelines. Consistently from 1977 to 2003 about one third of households met the three month income criterion. DeVaney (1995) compared the 1977 and 1989 SCF, using the comprehensive measure and three months of income criterion. Results were almost identical to those of Johnson and Widdows, with 34% having adequate funds in 1977 and 35% in 1989. Using 1983 and 1986 SCF data, Chang (1995) found that in both years 37% met the guideline of three months income in comprehensive funds. Hanna and Wang (1995) used the 1990-91 Consumer Expenditure Survey to determine that 31% of households had three months of expenses in comprehensive assets. Chang and Huston (1995) used the 1983 and 1986 SCF and the intermediate emergency fund definition. In each year 32% of respondents met the three month guideline. However, only 21% of households met the guideline in both years, while 10% had no emergency reserves. The median level of household intermediate emergency fund reserves was 8.8% of income (one month) in 1983 and 10.8% in 1986. Using the 1992 SCF, Huston and Chang (1997) concluded that only 22% of the households met the three month quick emergency fund guideline, 28% met the intermediate definition, and 33% met the comprehensive definition. A comparison of the 1998 and 2003 SCF confirmed the consistent finding from previous studies that only one-third of households meet the guidelines (Bhargava & Lown, 2003).

Household characteristics positively related to meeting emergency fund guidelines were age, education, and homeownership. Non-white and large households were least likely to meet the guidelines. Huston and Chang (1997) were the only researchers to examine household type and found that single parent households were the least likely to meet the guidelines.

Hatcher (2000) and Chang, Hanna and Fan (1997) suggest that households may be rational to maintain emergency funds at less than the traditionally prescribed level. Households with high

job security, access to credit and extensive investments may not need an emergency fund. Hatcher's analysis was published at the end of the decade-long bull market in stocks.

Teaching about Emergency Funds

Consumers need to be informed about the need for emergency funds and a continuum of savings options that provide a balance of liquidity and returns that keep pace with inflation and taxes. In the current low interest rate environment, does it make sense to maintain three months of expenses in emergency reserves? For households with consumer debt, much of it on high interest credit cards, an aggressive program to pay down credit card debt should precede building emergency savings. What about households with little or no consumer debt and the capacity to borrow against credit cards and home equity? Building a reserve in intermediate funds is the most appropriate emergency fund strategy.

Target Audiences for Emergency Fund Education

Single parent households are least likely to have sufficient emergency funds (Huston & Chang, 1997) and thus should be a top priority in education and outreach efforts. Non-white households with lower education levels are less likely to have reserves. Young adults are another key audience in need of advice on how much and where to hold emergency reserves.

How much does one need in an emergency fund?

Since research consistently shows that two-thirds of households fail to meet the guidelines, Huston and Chang (1997) questioned whether there might be a problem with the guideline. While they raise a valid concern, recent economic events suggest otherwise. Lengthy periods of unemployment, re-employment at lower wages with low or no benefits, higher consumer and

mortgage debt levels, and the growing bankruptcy rate argue against recommending an emergency fund of less than three month's expenses, especially when the comprehensive measure is used.

Although there may be some debate among financial educators and planners regarding the appropriate amount for an emergency fund, researchers seem to agree that three months worth of living expenses is a realistic target. According to DeVaney (1994), the three month guideline was based on the average length of unemployment. The current duration of unemployment is four months; however, unemployment statistics overlook the discouraged workers who have dropped out of the workforce and are not counted among the unemployed (Davey & Leonhardt, 2003).

Greninger, Hampton, Kitt, and Achacoso (1996) conducted a study of financial planners and educators and found strong consensus that liquid assets (intermediate) should equal a minimum of two and a half to three months of living expenses. Hanna and Wang (1995) argue that the three month guideline is more sensible than six months because of the low likelihood of experiencing a drop in income of 50% or more.

How much a household needs depends on many factors such as the number of earners, whether a non-earner could easily move into the workforce in the event of job loss of the major breadwinner, amount of job security, access to health insurance, and debt levels. No matter how often or strongly educators tell low-income, single parents that they need to have financial reserves, the money likely will not materialize. What alternatives are there? Households can be encouraged to play a "what if" scenario: what if I lose my job and can't pay the rent? Can I move in with relatives? What if I incur large uninsured medical expenses? How will I cope? The answers to some of these questions might motivate savings or at least a financial back-up plan.

Where should one invest emergency funds?

A web search for "emergency funds" revealed few citations. Web resources limited their discussion to quick or intermediate definitions of emergency funds. Rarely were stocks, bonds and mutual funds included in discussions of emergency funds (Answers to your money, 2003). Because only about one-third of American households have emergency reserves to cover three months of expenses, it is important for educators and advisors to expand the definition to the comprehensive definition. Many web sources (Bankrate.com, American Century Investors) advocate having at least six months of expenses set aside in highly liquid form. Internet sources almost universally recommended keeping emergency reserves in money-losing accounts such as savings and money market funds. Consumers seeking advice from Internet sources face confusing and unrealistic recommendations.

Too many mass media resources on emergency funds limit their recommendations to the "quick" category of savings accounts and money funds. With interest rates hovering around 1-2%, all quick accounts are losing purchasing power to inflation and taxes. While it is prudent to have some readily available cash, it is not wise for consumers to maintain three month's worth of expenses in an account that pays a negative real return over an extended time. Although most emergency fund recommendations focus on quick accounts, this strategy is insufficient in the long run. In the short run, consumers can use their credit cards to pay for immediate emergencies; thus only a small amount (perhaps two to four weeks expenses) should be kept in quick accounts.

The next step is the intermediate level which adds certificates of deposit (CDs) to the mix. EE savings bonds and I bonds (<http://www.savingsbonds.gov/>) pay higher rates of return than CDs of less than 5 years' maturity and are free from state income taxes. A laddering technique should be used with CDs of staggered maturities and by buying EE or I bonds at regular intervals. While CDs can be redeemed early by paying an interest rate penalty, EE and I bonds must be held at least 12 months.

Unlike most money market funds that require \$1,000 or more, government bonds can be purchased for as little as \$25. Setting up an automatic purchase plan for EE or I bonds is a painless way to build emergency reserves. The intermediate rather than the quick level is where households should “store” the bulk of their emergency savings. It is possible to earn a positive real rate of return and the funds are harder to access than a savings account or money fund, providing less temptation to dip into reserves.

The comprehensive category adds stocks, bonds, and mutual funds to the mix. These are truly investments and thus can serve double duty by working towards financial goals while providing a cushion for a low frequency but serious emergency like unemployment. It isn't necessary to have a fund set aside solely for emergencies, to never be used for other goals.

Since interest rates on quick emergency reserves have been below the inflation rate for many years it would be unproductive to suggest that households maintain large reserves in assets with negative real rates of return. It is more productive to hold emergency funds in intermediate funds. Some advisors recommend holding most emergency reserves in stock mutual funds, under the assumption that true emergencies occur rarely and it is important to keep ahead of inflation and taxes in the long run (Clements, 2001). Another factor to consider in structuring a realistic and effective emergency reserve plan is that all the funds are rarely needed at once. For example, in the event of job loss, unemployment compensation can provide some income and emergency funds can be used gradually as needed, starting with the most liquid accounts.

Conclusions and Recommendations

The bottom line for many households is that they should aggressively pay down their consumer debt as the first step toward building financial security. Paying off a credit card balance is far more productive than earning 1-2% on savings. Once this goal is

accomplished, consumers should set up an automatic savings plan to build emergency reserves in intermediate accounts.

Educators should explain how to structure emergency funds on a sliding scale, trading off liquidity for higher returns. A money market fund or savings account provides a foundation for emergencies. From there, one can add short-term (3-6 months) certificates of deposit, and then add less liquid but higher return/lower tax government EE and I bonds.

With increasing levels of financial uncertainty due to job insecurity, volatile investment markets, rising debt burdens, and decreasing health insurance coverage, an adequate emergency fund is even more essential in the 21st century than in the past. After paying down credit card debt, the next step to financial security is building a three month emergency fund invested in intermediate level assets.

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