How Much Should You Have in an Emergency Fund?

Description

Investing isn't just about making money. In fact, you may have several accounts for different purposes. While some of those purposes might be for retirement or a house one day, another might simply be for an emergency.

But how much do you actually need in an emergency fund? And if you don't have that much available to you right now, what steps can you take to get there? If this last year has proven anything, it's that catastrophes can happen. So, make sure you're prepared.

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The magic number

In an emergency, what you're going to need is payment for necessary expenses. No one knows how long that emergency will last, but a good rule is to have three months of savings for necessary expenses set aside for an emergency.

Let's take today's COVID-19 pandemic as an example. If you or a loved one is on a ventilator, the hospital stay could last months, and you may be out of work even longer. While it's good to claim government benefits, you will likely still need more money coming in. Three months' worth of savings will let you and your loved ones breathe easy, knowing you have a stash of cash to take care of bills that won't just disappear.

What are some of those necessary expenses? That would include rent or mortgage payments, groceries, utilities, property taxes, and even minimum debt payments. However, it does not include subscriptions, streaming services, or eating out. While these items should be included in a budget, in an emergency you probably won't be worried about binging your favourite show.

So, let's say all of your necessary expenses add up to about $4,000 per month. That means you'll need $12,000 in your emergency fund. If this sounds like a lot, there is a simple method to put that aside and grow it for a time when you may desperately need it.

Automatic payments

If you have $12,000 to simply pop in an emergency fund, great! But if you don't, I don't blame you. But there is a really easy way to get started, and that's through automated payments. Each month, dedicate some of your paycheque to go towards your emergency fund. In this case, that would mean setting aside $1,000 each month. If you have a partner, then it could be even just $500 per month! If you make $40,000 per year, that's only 15% of your paycheque going towards this fund.

Then when your paycheque comes in, set up automatic transfers so that money isn't accidentally spent. This cash will then pile up, and before the year is out, you (and potentially your partner) will have saved up an emergency fund. But it gets better.

TFSA + dividends = prepared

If you put that emergency fund in a Tax-Free Savings Account (TFSA) you can then invest and grow your emergency fund even bigger. I would highly recommend dividend stocks, as that means you'll get practically guaranteed income each quarter or month. These stocks also tend to be stable, meaning you don't have to be concerned your emergency fund will suddenly drop to zero. But just in case, definitely invest in a few options.

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I would highly recommend starting with stable companies like the Big Six banks. These banks have been around for 100 years or more, not missing any pay outs on the way. Each also support dividend payments, and while the banks may fall during a market crash once a decade, they also have a history of rebounding within a year.

So, let's say you went with a bank like **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD). The stock has grown at a compound annual growth rate (CAGR) of 11.23% over the last decade. It sports a 3.81% dividend with a CAGR of 9.81% over the last decade as well. So, today, if you put that $12,000 towards TD Bank stock, you would receive $451.66 in dividend payments per year. That's almost a month's payment for you or your partner!

Bottom line

It doesn't have to be a financial burden or difficult to put aside a necessary emergency fund. Who knows what will happen in the future? But hopefully this never happens to you. That means 20 years from now, you could have a $191,393 emergency fund by simply reinvesting dividends.

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