Don’t Have An Emergency Fund? Here’s Why You Absolutely Need One

Description

There are two kinds of mediocre investors – the one that holds all of their cash in the bank “waiting for the next big crash”, and the one that invests every last cent of their income, with nothing left at the end of the month. Both of these individuals are exposing themselves to unnecessary risks.

When it comes to investing, it is important to remember that your life and all the ups and downs that accompany it can make a significant impact on your portfolio and retirement plans. Adverse life events can significantly impact your financial well-being, especially if you don’t have enough saved up to weather the storm.

Therefore, prudent and smart investors should always ensure they have an emergency fund stocked away to cover up to 6 months of reasonable living expenses. Let’s go through the reasons why.

When life gives you lemons

Nobody likes to imagine the worst, but the reality is that as we age, we are exposed to more and more risks. The two risks that could impact your finances the most are medical emergencies or the loss of a job. Fortunately for Canadians, we have a robust public healthcare system that covers most expenses. Nonetheless, a protracted bout of illness or even disability will severely reduce your income and earning potential.

If you are uninsured or underinsured in terms of extended health benefits, getting sick or disabled could cost you significantly in terms of income. This risk is exacerbated if you have ongoing liabilities to pay, such as car loans, mortgages, or credit card debt. Losing the strong cash flow you had before can set you back badly in terms of your retirement plans and savings goals. Having an emergency fund allows you to offset this loss for several months, giving you time to get back on your feet.

Avoiding bad debt

If you don’t have a well-stocked emergency fund, you could be forced to seek income for your living expenses elsewhere. If you're lucky, you might have assets such as a home to serve as collateral for a low-interest loan, such as a home equity line of credit (HELOC). If not, you might have to take on unsecured personal loans or lines of credit at higher interest rates, or even worse, credit card debt.

Incurring these debts can leave you in a terrible position financially. Once back on your feet, you're essentially back at square one for your savings and investment goals again, having to make interest and principal payments on the debt before putting a cent towards retirement. As the proverb goes "A bird in the hand is worth two in the bush" – the emergency fund is the bird you can catch today for a rainy day later.

Don't drain your nest egg

In some cases, taking on debt might not be attainable, whether due to a poor credit score or a low risk tolerance. Individuals in these cases might consider cashing out the investments in their Tax-Free Savings Account (TFSA) to provide income during their emergency. This is less than optimal for many reasons. Firstly, you run the risk of setting your retirement back. Time in the market allows your investments to compound and grow significantly. By withdrawing, you could lose out on many potential years of high returns.

Secondly, your timing might be less than ideal. Imagine having no emergency fund at the start of 2008 during the Great Financial Crisis, coupled with suffering a medical emergency and losing your job. Unless you took on debt, you would have to sell and cash out some investments to provide income while you recovered. Unfortunately, doing so when markets are at an all-time low would cause your investments to lose significant value. You're essentially buying high and selling low, which all but tanks your retirement prospects.

The Foolish takeaway

Prudent investors keep an emergency fund large enough to cover 6 months of reasonable living expenses for 3 reasons: to cover medical emergencies/job losses, to avoid taking on debt, and to avoid dipping into retirement investments.

Investors should consider keeping their emergency fund in money market instruments such as a redeemable Guaranteed Investment Certificate (GIC) or a High-Interest Savings Account (HISA) with their bank. Doing so ensures the emergency fund stays protected, accessible, and earns some interest until you (hopefully never) need it.

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