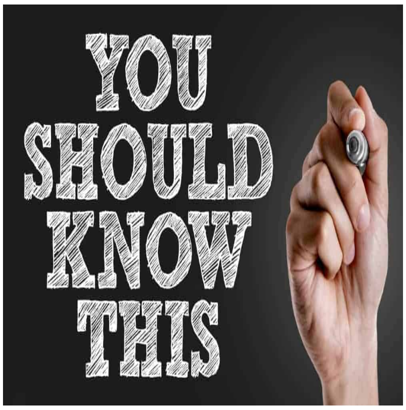

Stocks in Your Emergency Fund? Bad Idea!

Description

Everyone needs to have an emergency fund. You never know when a situation will come up out of nowhere and require you to spend a large sum of money. For this reason, many financial advisors recommend that you put aside a full year's income for emergencies. It makes a lot of sense. When you put aside money for a rainy day, you're safer than you would be if you hadn't.

There's just one problem: money in a savings account loses purchasing power over time.

This year, inflation in Canada is approaching 5%. Yet savings accounts still only pay out tiny 0.01% interest rates. With that kind of spread between inflation and interest, you lose real wealth rapidly. The only way to keep up with inflation in such a scenario is to constantly top up your account, which takes a bite out of your spending power.

It's at this point in the discussion that many people start thinking about investing their emergency funds in stocks. Stocks often deliver returns in excess of 10% a year. Last year, it was closer to 20%. With returns like that, your emergency fund can really grow. Unfortunately, it's not as good an idea as it sounds.

Why it's a bad idea

Investing your emergency fund is a bad idea because stocks are volatile. They go up and down all the time. In 2020, the TSX at one point went down more than 30%. Today, the NASDAQ is going through a major crash.

Over time, stocks tend to go up. But you can't be assured that they'll be up when you need to withdraw money for an emergency. So, stocks aren't suitable for an emergency fund.

GICs and money market funds

Having established that stocks aren't appropriate for emergency funds, now we can consider what is a good investment for your emergency fund.

One good option is cashable GICs. Banks like **Toronto-Dominion Bank** offer a variety of GICs that you can buy. Most of them require that you hold for a particular term. The maturity date is a specific date you cash out at. But others, called cashable GICs, let you cash out early. So, if you run into an emergency, you can simply cash out of the GIC and spend the money you need to spend. If you don't run into an emergency, you can hold the GIC to maturity and enjoy a small return (probably something like 0.2% per year).

Another good option is money market funds. These are funds based on treasuries such as Canada bonds. These funds have the potential to deliver somewhat better returns than GICs do. So, they are definitely worth looking into. You can buy money market funds through a bank like TD, just like you can GICs. Of course, you could also run out and buy TD Bank stock. It's a good play, with high dividend income and the potential to profit in a high-rate environment. But it's not for your emergency fund. There, you'll want to use TD's products — not its stock.

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