

The Importance of an Emergency Fund

Presented by Dick Bell to the National MS Society "Relationships Matter"
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Good afternoon or evening to our audience, depending on where you may be in the country. And welcome to a discussion of our topic: "The Importance of An Emergency Fund". Here's our format for the presentation. I will speak for about 35 minutes and then we will open up the phones for your questions.

Ideally, I would like to handle questions as we go along and the questions are fresh in your mind, but that's just not possible using an audio conference. So please have a pen and paper handy to take down some notes and to jot down any questions. After I cover the topic, I'll ask our operator to give you instructions on how to phone in with a question or comment.

So here goes. Imagine a young couple starting out their married life together. They have modest incomes now and lots of things they'd like to buy as they establish their home ... and their lifestyle. And they have great income potential for the future. But at this point, their income is fairly well committed and, if they are like most young couples, they have very little in savings.

Then it happens. One of them has a car accident and there is substantial damage to the car. Oh, it can be repaired but they first have to pay a \$500 deductible. There's no question the car needs to be repaired. Driving around with a large dent in the car is not an option. Now, one of two things happens to them. Ideally, they have \$500 in the bank to pay the deductible. Because if they don't, then they will have to borrow the money.

40 years ago you'd have to go to your parents or an older brother or sister for what you hoped was a temporary loan. And they hoped it was temporary, also. Or you could go to Household Finance Company and borrow the \$500, possibly at 30% interest. But here's what you could not do in 1967 ... you couldn't put the \$500 on a credit card. You see, Master Card didn't come out until 1968. The young couple had to make some real efforts to get the \$500 and they had to discuss "how are we going to pay this back?" Ideally, they were responsible enough to adjust their lifestyles to spend less and focus on paying back the loan.

But fast forward to today. Our young couple, like its predecessors, does not have the \$500 in the bank. And they really don't want their parents to help ...after all, they're responsible adults, right? Ah, but they do have credit cards. Ideally, they have used them only for convenience and been able to pay the balance each month. But this is different. They don't have \$500 in the bank and they have no prospect of having \$500 in additional disposable income the next

month when the credit card bill comes due. As so they begin what we call the “debt spiral”. They start to pay interest.

Unfortunately, our society has conditioned them to think ... not in terms of what something costs ... but in terms of monthly payments. Think of the last time you bought a car. The main question the salesperson wanted you to answer was how much you could afford each month. Then the objective was to work that payment into the most expensive car possible, without regard for length of time you pay, interest rates, etc.

Anyhow, our young couple now gets a credit card bill for \$500. They determine to pay the minimum monthly amount ... 2% of the balance or \$10. After all, they don't have to reduce their lifestyle by much to handle the \$10 extra a month. And the credit card company will dutifully bill them monthly with the minimum payment of \$10 in BIG PRINT. Heaven forbid they should pay more. Now, if they owe \$500 at 18% interest (not an unusual interest charge today) and they only pay the \$10 monthly minimum, do you know how long it will take them to pay off your card ... 90 months. That's 7 years and 6 months. If they pay \$10 a month for 90 months they will pay \$900 on a \$500 charge ... \$400 worth of interest.

You know what's worse? This won't be the only time in their lives that they will get a \$500 surprise. When I first got married my wife and I agreed that we didn't have many problems in life that wouldn't be solved by having \$500 in the bank. You know, that number should probably be \$5,000 today ... and that's what prompts this topic.

Of all the areas of financial planning that I deal with ... and that ranges from employee benefits to estate planning to retirement counseling ... I find that there is one common denominator problem that everybody faces ... how to make limited resources stretch to cover unlimited wants. Everybody wants more than they can reasonably afford. And many people spend to the maximum of their ability ... and then some.

So why would you want to have what I am calling an emergency fund ... a chunk of cash in the bank where you can get your hands on it quickly? There are a lot of reasons people give me:

1. Having cash helps reduce anxiety and stress ... and that's pretty important for somebody with an illness like multiple sclerosis ... you want to avoid stress.
2. Having cash keeps me from being taken advantage of by bank fees, late charges, bounced check charges, overdraft costs and high credit card interest charges.

3. I like this one the best and it perhaps summarizes all other reasons. Having cash gives me choices in life. And so it does.

Let me give you a true story. Perhaps you are familiar with payday lending firms. If you're not, drive through one of the poorer sections of your town and you'll see firms offering check cashing and payday loans. Here's how they work. You need \$200. A payday lending firm will loan you \$200 for example. And you give them a postdated check for \$230, dated as of your next paycheck. Now, your next paycheck may be only five days away. Makes no difference. \$230 then will get you \$200 today. Never mind that the interest rate can approach 600%.

Now I had no exposure to payday lending until a firm moved to my town, Calabasas, California, using the exact same business name that I use. Well, they changed their name but neglected to tell their old customers. So people who were trying to find them dialed information and they were given the phone number to my office. We were getting about 20 calls a week. And we were pretty good about referring these folks to the right phone number. But my associate, Annette, seeing how much these folks were paying in interest, said to me: "Why don't these people just save the \$200 by reducing their lifestyles temporarily and they would never pay these huge interest amounts again?" It was hard to believe.

Finally, I went to the office of the payday loan company, showed the owner my business card and suggested that he might want to quit using my business name. He replied that he was no longer using it but that some people called information using the old business name. I told him that we would refer the calls to his new company name for another month and then we would tell people we had no idea where to find him. As we were parting, he said to me: "You know, we're in kind of the same business!" I was outraged. I said that what he was doing was financially abusing the poor and downtrodden in our society and his business didn't help them at all while my financial counseling really did. And then he said: "You look at the \$30 interest charge as being high. But if you are about to bounce 5 checks you wrote for a bounced check charge of \$29 each, my fees look downright reasonable. And I guess he had a point.

But I hearken back to Annette's words: "Why don't these people just save the \$200?"

Well, if you've been listening to these audio conferences over the past several months you'll see that there is one recurring theme ... to get ahead in life you have to live on less than your income. That's it! That's the habit you have to develop. And without that habit, you are doomed financially. Why are so many lottery winners broke quickly after they receive their payments? Don't you think they'd be smart enough to at least put some of the money into savings rather than go hog-wild with their new-found spending ability?

OK, OK, you say, I know I need to save some money! But how much should I save and where do I put it? What goals should I set for my emergency fund?

I'll give you three goals in order from the easiest to the hardest. And each goal will build on the previous goal.

Goal #1 – Build up \$1,000 in savings. Don't do it by taking a cash advance on your credit card. Don't do it by refinancing your home to pay off your credit cards and then setting some cash aside. Do it by reducing your spending pattern. We all have places where we can cut back and squirrel a few dollars away on a regular basis. And I'll give you some specific tips that will help you in a few minutes.

People ask me: "Is it more important to build up a \$1,000 emergency fund or to pay that money on my credit cards?" I can argue both sides of that question, but methodically building up the savings will give you tangible evidence that living beneath your means really works. Having \$1,000 in the bank may help you from running up more credit card bills.

Goal #2 – Build up three months worth of living expenses in your savings account. Accumulating three months of income would be even better but three months of expenses buys you a lot of freedom. I'm in southern California, as I mentioned. The writers guild went out on strike a month ago. Now these folks write all the scripts for your favorite TV shows. And many of them make some pretty good money and can afford to be out of work a while. However, without the writing, there are no new shows being produced ... except those where the scripts had already been written. Jay Leno just had to lay off a lot of people. So we have all sorts of cameramen, lighting technicians, sound engineers, etc. out of work. And you can bet that not many of them were financially prepared to be missing this many paychecks. For too many people in this country, long range planning is this Friday night. Three months worth of living expenses buys you a lot of time.

Goal #3 – Build up six months worth of living expenses in your savings account. More is better. To get to this amount will take you some time and some serious savings. In other words, you will have reduced your spending pattern enough that savings has become a habit. And every time you increase your savings you have that good feeling that you are really better off. My younger sister and her husband methodically built up six months of expenses in what they called their "Go to Hell" fund. It was the money they would live on if one of them got so frustrated with their job that they just wanted to quit. And, you know what, that day came and they were thrilled to have the financial wherewithal to quit and find something better.

People ask me: "Where should I invest the money?" I don't care. When you're starting out, put it in a mug at home or a shoe box. The interest earnings aren't

important ... yet ... when you are starting out. Several years ago a CPA referred a couple to me for financial planning. Their major concern was that they never seemed to be able to save any money. Before we met I asked them to go back through their credit cards and check books for the past three months so they could tell me where their money had been going.

When I reviewed the sheet that they put together, I saw that they each had \$1,500 a month in ATM withdrawals. I asked them where the money was going. And they couldn't answer. They honestly could not tell each other where they were spending \$3,000 a month. That's a lot of money to spend at Starbucks so it wasn't all going there. They were as surprised as I was. So they agreed that whenever either of them used an ATM they would take some of the dollars that they would normally have spent and they would put it into a shoebox. They got a shoebox, duct-taped the top on it, and cut a small slit, big enough to insert some bills. I told them not to tell each other how much they were putting into the shoebox. And they were not to open it for a year. I guess they really got into this and took particular pleasure in stuffing some bucks into the shoebox from time to time.

Anyhow, they opened the shoebox one year later ... to the day ... and this couple, who had not been able to save any money before they met me ... found that the shoebox contained \$8,000. I'm pretty sure the shoebox wasn't paying them any interest so that must have come from their lifestyle. It proves that good things happen when you focus your efforts.

So how do you build up six months of living expenses in a savings account? As somebody once said: "It's a cinch by the inch but it's hard by the yard!" You simply start saving small amounts any way you can. Here are some examples:

1. Have money taken out of your paychecks before you even see it. Transfer \$25 or more each paycheck into an account at your credit union. Or write a check to your savings account at your bank. Small amounts add up when you do it consistently. In fact, that's why 401(k) plans work so well in this country ... money is set aside for your retirement before you ever see it ... and small amounts start to grow. When you get a raise, increase the amount you have taken from your paycheck.

2. Overwithhold on your income taxes. If you are claiming three dependents, decrease that to one. You'll find that you won't miss the dollar amount but you will have more money withheld than necessary when you file your taxes. That way you'll get a bigger refund which you put right into your emergency fund. Now I know some people will say: "You're giving the government free use of your money and you aren't getting any interest on it!" Yeah, yeah ... I know that. But just how much interest were you expecting to earn on that additional \$25 that was being overwithheld from your paycheck. What you have here is a forced savings account.

3. Set aside 10% of everything you take from an ATM machine. And don't increase your withdrawal to cover it. Learn to spend only 90%.
4. Deliberately go without something you enjoy and set that money aside into the savings account. Starbucks comes to mind. Instead of going every day limit yourself to two days a week and save the money on the other days. Put it into a mug at home.
5. Pay cash for small purchases. Don't charge anything less than a certain dollar amount, such as \$10. In a recent study it was shown that people who use credit cards for the bulk of their purchases spend 11% more on their lifestyle than those who pay cash. When you only have \$20 in your pocket you think twice about spending \$8 of it and you often choose to go without. When you pay cash, you'll get change. Put your change in a mug at home. My wife and I did that and we recently wrapped over \$200 worth of coins. Granted, that took us some time to get that much but it was a very small effort that added up over time.
6. Sell things that you do not need on Ebay and put that money into your emergency fund. It's amazing how much "stuff" we hang onto that we don't use. Turn it into cash.
7. Final idea! If you get paid every other week, you really get 26 paychecks a year instead of 24. Build your budget around 2 paychecks a month and bank the two extra ones into your emergency fund.

I hope you see the importance of building up an emergency fund. The habits you use to do so are the same ones that build up a car fund, a college education fund, etc. Our overall objective is for you to go from paying interest to earning interest.

With that, I'll close and invite any questions from our listeners. Operator, will you please tell folks how they can call in?