An investor education initiative

Edelweiss MUTUAL FUND

4 things an Emergency Fund is NOT

The pandemic, and the events that unfolded as a consequence, shone the spotlight on the importance of having liquid reserves by way of an Emergency Fund.

If you dislike the negative connotation, give it a PR makeover. Call it a savings buffer or a cash cushion, a bailout plan or a family reserve, a cache or a stash, a contingency fund or an exigency fund. Just ensure that it is a critical aspect of your financial plan.

Having said that, there is a lot of misconception that surrounds an Emergency Fund. Let's tackle them.

It is NOT a waste of time.

Crises have financial repercussions. The pandemic is not only a health crisis, but also a burgeoning financial crisis for many. The death or sudden sickness of a loved one in another city or country may require travel of the entire family. A pet falling sick and needing surgery will require substantial funds. Tragedy has a financial angle.

Disruptive events can cause a tremendous amount of stress. The idea of an Emergency Fund is so that you will not have to deal with monetary stress, in addition to the emotional upheaval. Think of it as a financial shock absorber.

One reason that individuals do not give this much thought is because they can source funds from various avenues. But there is always a cost to it. A personal loan from the bank or the use of your credit card is convenient, but carries a stiff interest rate. Taking a loan against your house is not cheap. Alternatively, borrowing from family or friends comes at zero interest, but has its own share of humiliation and obligation. Eventually, all these loans will have to be squared off. Getting into debt because of an emergency is very stressful. Tapping your own assets is invariably a better way to scrape up cash than borrowing.

You can dip into your provident fund or sell investments. But what if the stock market is abysmally low? You could be selling at a significant loss. Moreover, you would be drawing these funds from your retirement savings plan or child's education plan. What will happen to those financial goals if you are going to deplete the money earmarked for them? The trick is to tide over the emergency without incurring debt, while simultaneously keeping your financial house stable.

It is NOT a wealth creation avenue.

The one rule of your Emergency Fund cash is that it should be money you can easily access in a pinch. Anything that has a lock-in period does not qualify; money in your Public Provident Fund (PPF), Employee Provident Fund (EPF) or Equity Linked Saving Scheme (ELSS) cannot be part of your Emergency Fund.

Avoid equity. Because markets go up and down, and it would be a shame if you had to needed to sell when the market was in the doldrums. When it comes to an Emergency Fund, cash is king. You can whine about how much more your money could be earning, but selling in a down market or not being able to access it when you need it is a bummer.

Safety and Liquidity are the only two parameters that should be taken into account. You could consider a liquid fund, an overnight fund, an ultra short term bond fund or a bank fixed deposit. It need not be either, but a combination of such investments.

The Emergency Fund is a personal insurance policy and not a wealth builder. The money must be easily accessible to you and your immediately family, or it may defeat the purpose if you are elsewhere or hospitalised and cannot access it.

It is NOT a fixed amount.

Some would have a fund of at least six months of basic expenses, while others would prefer 12 months. You need to figure out how much you need for your peace of mind.

Also, the amount could vary over different phases of your life. If you were newly married with both spouses earning, the Emergency Fund could even be just three months of expenses. But over the years, if a parent moves in and you have a child, the Emergency Fund must balloon accordingly to take care of additional dependents.

Also take into account how long it may take you to find a new job should you lose yours. If you are very senior or work in a highly specialised field, it may be more difficult to find a new placement.

Finally, you need to figure out if you want to include lifestyle expenses into your Emergency Fund or just basic living expenses (regular bills and insurance premiums). You can even decide if you want to budget for your SIPs amounts, so even if you lose your job, your investments are uninterrupted.

To err on the side of caution, if you can stash a year's worth of bare essential expenses in an Emergency Fund, that would be wise. If it is large and unattainable at one go, build it over months.

It is NOT for planned expenses.

Creating a safety net in case of job loss is the key reason to set up an Emergency Fund.

The second is to pay for unexpected bills. A dental emergency. A devastating flood or cyclone could damage your house severely. You may need to buy a new refrigerator or air conditioner if either one breaks down in the peak of summer. A tax bill that you failed to anticipate. A pet could need surgery. Sudden travel for a family emergency. Life is full of surprises; not all of them good. You need a financial safety net. And once you draw from it, ensure that you have a plan to replenish the amount utilised.

An Emergency Fund is not to replace the carpet on your floor or book a vacation. Before you dip into your Emergency Fund, ask yourself 4 questions: Is it unexpected? Is it urgent? Will it put me at tremendous inconvenience or loss if I do not attend to it? Will I regret not going ahead?

The biggest benefit of an Emergency Fund is the peace of mind and financial stability it can provide. If you're already short on cash, even a single unexpected expense could adversely affect your overall financial health. The true value of it will only become clear when you need it.

Stay safe.

An investor education initiative by Edelweiss Mutual Fund

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