INVESTING SPECIALISTS

Set and Invest Your Emergency Fund

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The following is part of our 21 Days to Improve Your Financial Life special report.

Emergency funds need a PR makeover.

First, there's the name itself--who wants to contemplate broken-down cars, sick dogs, or job loss? Perhaps a name like "cushion fund" would hasten interest.

Then there are the ideal emergency-fund (oops, cushion fund) amounts that are usually bandied about--three to six months' worth of living expenses in very safe investments. That's a decent starting point, but it sounds hopelessly off-putting to people just getting their financial footing. In reality, the only living expenses you need to cover with your emergency fund are the very basic ones--housing costs, insurance expenses, utilities, and food; from that standpoint, amassing a cash cushion looks a lot more manageable.

In addition, people often assume that building a cash cushion means they'll have to hold off on investing for the long term. But that's not necessarily true: While it's always valuable to have some money on hand in accounts that could be liquidated on a moment's notice, a Roth IRA can serve as a good multitasker. Because Roth IRA contributions can be withdrawn at any time and for any reason without penalty, the accounts can be useful for people who would like to simultaneously build a cash cushion while also growing their retirement nest eggs.

Emergency funds need better messaging because they're an absolutely crucial aspect of any financial plan, regardless of life stage or situation. For people who already have high-interest-rate debt, having an emergency fund can help guard against resorting to additional high-cost financing in a pinch. Having a cash cushion on hand also helps you defray unexpected expenses, whether a new roof or out-of-pocket healthcare costs, without needing to raid your retirement accounts. Finally, the big reason to have an emergency fund--and this is where the three to six

months' worth of living expenses guideline comes from--is to cover your basic costs in case of job loss. The greater your fixed expenses and the harder your job would be to replace (because it's specialized and/or higher-paying), the larger your emergency fund needs to be.

Here are the key steps to take when setting up your emergency fund.

Step 1: Determine your monthly living expenses.
Tally up your essential monthly outlays: housing costs, utilities, food expenses, servicing debt, insurance, and taxes, to name the biggies. As noted above, you don't to include nonessential items that you could live without in a pinch, such as discretionary clothing purchases, high-cost cable packages, and the like. Multiply your essential living expenses by three months. This is your absolute minimum savings target for your emergency fund.

From there, you can customize your own emergency-fund amount upward based on your own situation; this calculator can help you factor in the crucial variables. One of the biggest determinants of emergency-fund size is your career path. As discussed here, contractors or other workers with lumpy income streams should obviously have bigger cash buffers than noncontractors. Also factor in the nature of your position: The more remunerative and specialized your job, the harder it will likely be to replace. Age, unfortunately, is a related issue: In part because they tend to earn more and occupy more specialized positions, it took older workers longer to replace lost jobs in the last recession than it did younger workers. (Age discrimination is no doubt in the mix, too.)

Finally, factor in how much flexibility you have to adjust your expenses downward in a pinch. New grads who could readily relocate, get roommates, or move back in with mom and dad can get away with a smaller emergency fund. But if you're carrying a mortgage, have two car payments, as well as children and related expenses, your emergency-fund should obviously be much larger.

Step 2: See how much you have right now.
Add up the aggregate investments that you hold in your checking and savings accounts, money market accounts and funds, and CDs. Exclude any assets that you have earmarked for other purposes, such as money that you're saving for a car down payment or college tuition; also exclude any cash holdings in your stock or bond mutual funds. This is your current emergency fund.

Step 3: Set your emergency-fund savings target.
Subtract the figure from Step 2 (your current emergency fund) from the figure in Step 1 (your target emergency fund). This is how much you need to save at a bare minimum--it should be double this level or more. Setting money aside to hit this savings target should be your main savings priority in the months ahead. (If you're also paying off high-interest credit card debt, you should try to build up your emergency fund at the same time.)

Step 4: Identify appropriate investments.
Cash yields are unenticing today--1% if you're lucky. But your emergency fund is not the spot to stretch for extra income, especially given how small the differential is between FDIC-insured cash instruments and riskier alternatives like bond funds right now. My advice is to use plain-vanilla cash investments: checking and savings accounts, CDs, and money market accounts. Today, online savings accounts are one of the highest-yielding cash options; credit unions also frequently offer decent yields.

As you shop for cash options to populate your emergency fund, remember that not every product type is FDIC-insured; money market mutual funds, for example, do not qualify for FDIC protection though in practice they've been quite safe. (Money market accounts on offer at banks are FDIC-insured.) Bankrate.com enables you to compare yields on FDIC-insured products. Remember that CDs carry penalties if you need to get your money out prematurely.

Step 5: Find the right receptacle.
Finally, being able to access emergency-fund assets in a pinch is crucial--you don't want to have to deal with taxes or penalties. For that reason, it's ideal to maintain your emergency fund outside the confines of your retirement accounts; that way you won't have to pay any taxes or penalties if you need to spend from your emergency fund prior to retirement.

However, as noted above, your Roth IRA can help back up your emergency fund if need be. While it's not ideal to use your retirement savings as a piggy bank, you can tap Roth IRA contributions at any time and for any reason. Because of that flexibility, setting one up is a great first step when you get started in investing.

If you're a homeowner, it can make sense to augment (but not replace) your emergency fund by setting up a home equity line of credit to use in case of emergency. That way, should you find yourself in a real bind and have to exhaust your emergency fund, you'll have another safety net in place. Interest rates on home equity lines of credit are usually quite low relative to other forms of

financing, and the interest is tax-deductible in most situations. Set one up while you're employed, because it's much harder to secure this type of financing if you're not.