Money and You: Expect the unexpected and prepare for it

by Carrie_Schwab_Pomerantz

I talk to investors all the time, and I'm almost always impressed by their ability to focus on the future. People are tapping the opportunities of the financial markets to build wealth for long-term goals. Most investors are pretty diligent about reviewing their portfolios and making adjustments as situations change. But many of us fall short when it comes to taking care of the more mundane aspects of our financial lives, particularly when it comes to preparing for the unexpected.

A layoff, a serious illness or an injury could disrupt your normal income stream. An aging parent or an adult child might need your financial help in a hurry. A natural disaster might put a heavy short-term burden on your liquid assets. You can't foresee the unexpected, of course; however, you can prepare for it by building and maintaining a viable emergency fund, and by making sure you've got the insurance coverage that makes sense for you.

A STASH OF CASH

Your first line of defense should be an emergency fund. How much is up to you, but I agree with most personal finance experts that a good goal is to have from three to six months of living expenses stashed away in a very safe and liquid investment vehicle.

I realize that in today's world plenty of people can get cash when they need it; however, many of their liquidity options are bad ones. Cash advance on a credit card? High fees and the high cost of interest payments. Sell an existing financial asset like a stock or a mutual fund? You might have to sell during a downturn or you could be triggering tax liabilities. It's much better to keep some money on hand so you don't have to resort to these potentially expensive alternatives.

A home equity line of credit (HELOC) can be a great source of liquidity, assuming you own your home and you've established the HELOC before you need it. Most HELOCs can be tapped simply by writing a check - and there is a tax deduction - but make sure you understand the procedures and the potential costs before you need to access the credit. I'd still prefer to use existing cash over adding to my debt burden.

PUTTING YOUR EMERGENCY CASH TO WORK

When I say "cash" I don't mean hundred dollar bills stuffed into your mattress. Though if you live in an area with the potential for natural disasters, like floods, earthquakes or wildfires, it's wise to keep a few hundred dollars in cash at home. Your primary emergency fund should be safe and accessible, but that doesn't mean it can't be earning something.

You have quite a few choices. You could keep your emergency cash in an interest-bearing checking or savings account at your bank, both of which offer convenience and the benefit of FDIC insurance (up to $100,000 per depositor per bank). But the interest rates tend to be quite low. Another choice is a money market bank account, also FDIC insured. It will likely offer a higher yield than a traditional passbook savings account, but often with a higher minimum balance requirement and limited transactions. Another alternative is to invest your money in a money market mutual fund, although that is not FDIC insured. For all of these options, shop around to get the best rate and the right level of accessibility. Make sure you understand the withdrawal procedures and fees.

I'd certainly advise you to keep at least three months of living expenses in something completely liquid and accessible. If you want to have another several months of emergency cash or cash for short-term goals (like paying for an upcoming vacation or a child's wedding), you could buy a three-, six-, or nine-month CD and increase your yield a little bit more. But remember if you have to access the CD before its maturity, you'll forfeit quite a bit of interest.

PROTECT YOUR ASSETS WITH INSURANCE

There is no question that an emergency fund will help you weather a short-term financial storm; however, when you're preparing for the unexpected, insurance also plays a crucial role. In general I take a pretty cautious view when it comes to buying insurance - I often see people who have purchased unnecessary or inappropriate coverage.

Everyone needs to understand the serious financial problems that can arise from serious illness or injury. Health insurance is a must for everyone, regardless of their age. If your work doesn't provide it, shop around and get your own policy. Some 50 percent of bankruptcies in this country are caused by health care expenses, and even a substantial emergency fund can't begin to cover the out-of-pocket expense of a serious uninsured health problem.

In addition, I view disability insurance as a must for anyone who relies on their employment income. According to the National Association of Insurance Commissioners, if you're between the ages of 35 and 65, you have a 30 percent likelihood of facing a period of 90 days or longer during which you won't be able to work. Disability insurance is one of the best ways to make sure that your disability, no matter how severe, doesn't turn into a full-fledged financial disaster.

Of course, if you have dependents, you have to have life insurance (if you don't, don't waste your money on this). Term coverage is quite inexpensive if you're young and in good health. And homeowners should purchase home insurance, including extra coverage for those in earthquake or flood-prone areas. If you rent a home but have a lot of personal property, you should consider renter's insurance.

I still believe that the biggest challenges for most people are the long-term ones, like a financially secure retirement and paying for college for their children. Don't neglect the challenges of the near-term. Start putting something away for the proverbial rainy day. Make sure you've got the insurance coverage you need. You can't anticipate the unexpected, but you can certainly prepare for it.

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