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Paying for the Unexpected

An emergency fund can help you cover unplanned expenses that otherwise might jeopardize your finances.

KEY POINTS

- Set aside enough money to cover three to six months of expenses, depending on your needs.
- Start contributing to the account right away, and then build it up over time.
- Hold your emergency funds in a bank savings or money market account.

The primary purpose of an emergency fund is to help keep your finances and savings goals intact should you experience a financial shock. "With an emergency fund in place, you won't have to run up a balance on your credit card or tap in to your retirement savings to get through a period of uncertainty," says Judith Ward, CFP®, a senior financial planner with T. Rowe Price.

Financial surprises

There are a number of unexpected situations that can jeopardize your financial plans.

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1 **Job loss.** Lack of income due to a job loss or disability can be emotionally challenging. Knowing you have a cash reserve available to see you through this difficult time may help reduce some of the anxiety. (See "How Long Does Unemployment Last?")

2 **Large, unanticipated expenses.** You can budget for routine household repairs, maintenance, and regular health care costs. However, you also may face unplanned, big-ticket expenses at the most inopportune times.

3 **Need for flexibility.** Beyond paying unanticipated expenses, an emergency fund could offer some flexibility if you also want the freedom to leave your job to try something new. While this may not rise to the level of an emergency, having a cash reserve may give you the peace of mind to make important changes in your life without additional financial stress.

3 to 6

The number of months of expenses that you should aim to save in your emergency fund.

Setting your goal

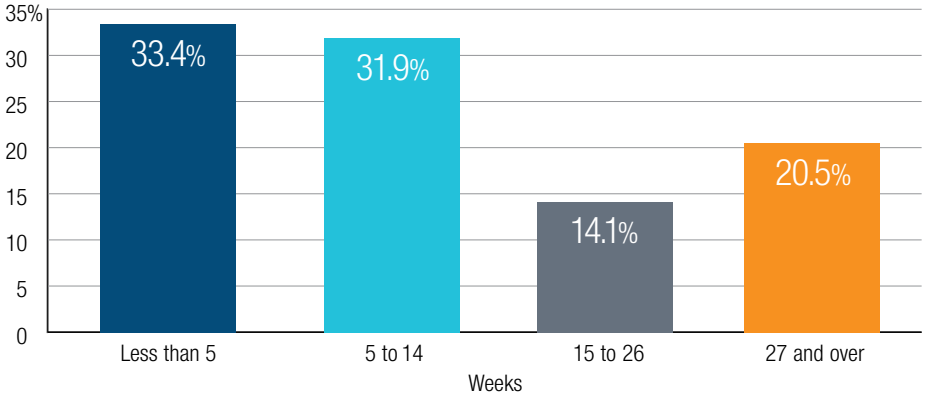
The appropriate amount for an emergency fund varies from household to household. A good rule of thumb is to target enough savings to cover three to six months' worth of expenses.

For two-earner households, three months' worth may suffice given that having two incomes provides its own level of protection against the unexpected loss of one job. Single-earner households, by comparison, should aim for closer to the six-month end of the savings target, or more.

Other factors to consider include the source of income and your plans for the future. If your income is less predictable, as is the case for some self-employed individuals, you may want to set aside a little more in reserve. You also may want to save more than six months' worth if you anticipate a career change or another disruption to your income stream.

How Long Does Unemployment Last?

The majority of those unemployed remain jobless for about six months or less.



Source: U.S. Bureau of Labor Statistics. Economic News Release, Table A-12. Unemployed persons by duration of employment, seasonally adjusted, December 2018.

Building your emergency fund

You may need to modify other savings programs and cut spending for a short period of time while building up your cash reserves. Start by saving $1,000 to $5,000 right away. (See "A Good Starting Point.") Then continue building up your reserve over time with a goal of completing the process within one to two years.

"If you have to reduce your retirement contributions in order to fully fund your reserves, remember to reinstate these contributions to their original level as soon as you reach your emergency fund target," says Ward. If possible, contribute enough to get any company match, if available, while simultaneously funding your emergency reserve. Hold your emergency fund in an accessible account, such as a money market or bank savings account, that will maintain its value regardless of market performance. And when you use your emergency fund, be sure to replenish it as soon as you can afterward.

Protecting your retirement savings

One of the key benefits of having an emergency fund in place is that you'll have money available and won't need to withdraw assets from your retirement accounts to cover the cost of a financial emergency. In most cases, tapping in to your retirement accounts, like an IRA or 401(k), means paying a 10% early distribution penalty if you are under age 59½, in addition to taxes on the amount withdrawn. Worse yet, the money you withdraw won't benefit from additional years of tax-deferred growth potential.

"An emergency fund is an essential tool for helping protect your long-term financial stability," Ward says. "The sooner you start saving, the more quickly you'll have a safety net in place."

A Good Starting Point

Begin by saving $1,000 to $5,000 to help cover expenses like:

- Medical emergencies
- Unplanned travel due to family illness or death
- Pet illness or emergency visits
- Home repairs
- Replacing a broken appliance
- Auto repairs

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201905-835614