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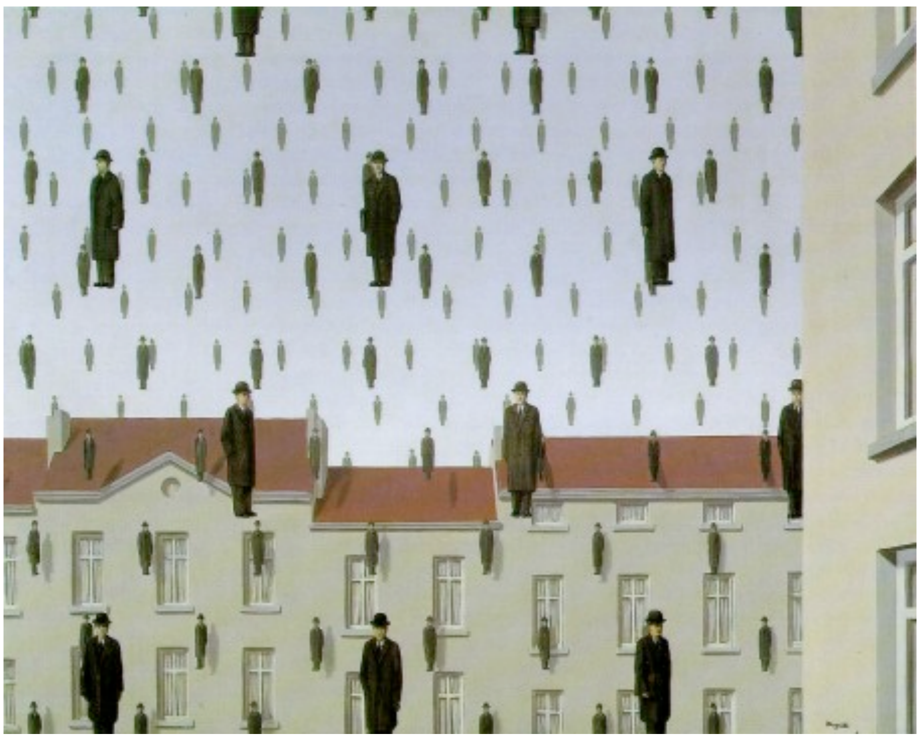
Job Risk Dictates Rainy Day Fund Size



"Golconde," By Renee Magritte.

Financial planners have scrapped the old rules for emergency funds as the time it takes to find work has skyrocketed.

The U.S. economy picked up a little bit of steam, growing at a 2.5 percent annual rate in the third quarter. But economists expect the unemployment rate to remain stuck around 9 percent for many months.

To protect against a potential job loss, financial planners until recently advised clients to set enough cash aside to cover their expenses for three to six months. Today, six months is their starting point. And the amount of financial cushion should be based on each individual's job security – the more risk, the bigger the emergency fund. It's similar to the argument that an entrepreneur, for example,

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should balance his or her job risk by investing conservatively.

“I ask a lot about their job,” said Rand Spero, president of Street Smart Financial near Boston. “I say you need to be in a savings mode and it needs to increase substantially.”

To calculate an emergency fund, every household needs to know two things: how much fat they can cut out of their budget and how much they can expect to receive in unemployment benefits. Benefits typically cover up to half of the state’s average weekly wage. It now takes 10 months, on average, to find a new job.

Using six months as the baseline, several planners outlined the risks for various life circumstances:

- High levels of credit card debt are a form of risk, because they can become an extreme burden during unemployment. Young adults deep in debt should prepare well for a potential layoff, said planner Samantha Vient, a partner at Craig & Associates in Orange, Calif.
- Low-income or low-skilled workers are already struggling to make ends meet and find it difficult to save. But if they do become unemployed, federal benefits will replace a higher percentage of their earnings, somewhat reducing the savings they’ll need. For clients who “feel under siege” financially, Spero suggests they work toward saving a couple of months’ earnings.
- Older workers are taking much longer to find a job and need more savings for a potential layoff, said Lee Munson, a money manager in Albuquerque, New Mexico. “Six months is the very bare minimum. You need to be looking more toward a 12-month time frame and it’s scary,” he said.
- If the older worker earns a high income and is the sole breadwinner, it’s difficult to reduce fixed expenses, such as a mortgage or private school, in a layoff. “I generally am getting more conservative and saying, ‘I want you to have a higher level emergency fund,’ ” said Laura Scharr-Bykowsky, owner of Ascend Financial Planning in Columbia, South Carolina.
- Couples with two incomes have more flexibility than single-earner households and single people. For example, if the husband loses a job the working wife can temporarily cut her 401(k) contributions. A rule of thumb for couples is to base the fund’s size on how much of total expenses would be covered if one of them lost their job.
- However, if the husband and wife work at the same company, they’re at a higher risk if their employer downsizes, requiring more emergency savings.
- If unexpected expenditures are looming, such as a parent needing care, the fund should be increased.

When people become unemployed, it can be extremely difficult to reduce spending, which may mean require drastic steps such as saying no to children or even selling a house.

Determining the size of an emergency fund “is an analytical process,” said David Diesslin, a planner and money manager in Fort Worth, Texas. “Keeping it intact is an emotional issue.”