Buckingham

Wealth Planning Conversation: Emergency Savings Planning

Category: Net Worth Development
Best Practice Frequency: 3 years
Essential: Yes

Buckingham Perspective: A critical step in the saving and investing process is to establish an emergency fund. An emergency fund, or rainy day fund, is a stash of money set aside to cover the financial surprises that are an inevitable part of life. Unexpected events can be stressful and costly, and having adequate funds set aside in anticipation of those possible events is an important step in saving that can help mitigate the risk of unforeseen expenses.

The most appropriate size for an emergency reserve fund will vary by household, depending on its financial obligations, number of earners, debt, income sources, insurance coverage (e.g., short-term and long-term disability insurance) and other factors. There is no one-size-fits-all solution. Establishing an appropriate emergency reserve – or ensuring that such an adequate reserve has already been established – is an essential part of every wealth management relationship. Advisors should review their clients' emergency reserves with them every three years or whenever there is a material change in income (amount or sources), expenses, liabilities and other relevant factors.

For assets to be considered as part of a client's emergency reserve, the assets must meet two criteria:
1. The principal value should be largely insulated from market fluctuations.
2. The assets must be able to be converted to cash quickly and with little to no cost.

Appropriate assets for emergency reserve accounts include checking accounts, savings accounts, money market funds, Treasury bills, liquid certificates of deposit (CDs), and ultra-short-term bonds. In some cases, modestly less liquid assets may also be appropriate, such as CDs without liquidity features and I bonds.

Appropriate account registrations for emergency reserve funds include individual accounts, joint accounts, revocable trust accounts and, potentially, Roth IRAs.

Advisor Role: Advisors should educate clients on the importance of having an emergency fund that comprises ultra-low-risk investments, even though such amounts may generate little to no earnings.

If such an emergency fund is not already adequately funded, helping a client to rectify this planning gap should be among an advisor's highest priorities. Cash flow should be reviewed, and to the extent

a surplus exists (income exceeding expenses), advisors should help clients prioritize how to use those funds (which should often be used to build the emergency savings fund up to adequate levels).

To that point, advisors should also help clients determine what an "adequate" or "sufficient" emergency reserve looks like. Historically, financial planners have recommended having three to six months' worth of expenses on hand, but clients with multiple higher risk factors (e.g., unstable income, no or minimal disability coverage, single household earner, etc.) may benefit from larger emergency reserve funds.

Best Practices:

- Educate clients about the importance of having an emergency fund and how it differs from other investment assets.
- Use only ultra-low-risk investments for emergency reserve funds.
- Use only registrations that allow the client to control distributions and that offer penalty-free access of funds.
- If a client qualifies for a Roth IRA contribution and cannot afford to save more than that amount, the Roth IRA (registration) is often the best place to house the emergency reserve fund.
- Review at least annually the client's net worth assets and compare that to the last-reviewed set of statements to identify trends or changes.
- Review emergency fund assets to determine if those funds exist, if additional funding is needed and whether the location of these funds is easily accessible.
- Review the adequacy of emergency reserves whenever there are material changes to the client's financial situation.

Resources:

Hierarchy of Savings Vehicles for Households
Emergency Saving Factors and Features

Preparation

1) Review notes from any prior emergency savings wealth planning conversations (WPCs) and make note of the previously agreed-upon target amount, related factors and location of the emergency funds.

2) Review the client's latest account balances (ideally linked within the client portal), specifically noting the liquid assets and emergency fund savings.

3) Review a recent tax return or financial plan to get a clear estimate of the client's current income and expenses. Reach out to the client, if needed, to validate the current income and expenses.

Analysis

1) A general rule of thumb for the *minimum* size of emergency fund:

- Single individuals/one-income households with low-income reliability = at least six months after-tax expenses.

- Married couples/dual-income households with high income reliability = at least three months after-tax expenses.
- Be mindful that each household is different. These are general guidelines. Each client has a different risk tolerance and comfort level when it comes to cash on hand. Review the Emergency Savings Factors to help understand under what circumstances to increase or decrease a target amount.

2) Cross-reference the appropriate size of the emergency fund to the client's net worth statement. Identify any gaps or insufficiencies, if applicable.

3) Review the asset location of the emergency funds. Are they in an appropriate registration type that provides convenient access without a major tax implication?

4) Review the allocation of the emergency funds. Are they in an appropriate investment, such as money market account, savings account or liquid CDs? Or are they invested in something more volatile and/or more illiquid?

Client Conversation

1) Be mindful that every client will have a different risk tolerance and comfort level when it comes to cash on hand. Use the Emergency Savings Factors one-pager to explain the circumstances that influence the target amount of emergency savings and come to an agreement on an emergency savings target amount for the client.

2) Educate the client on the types of accounts that work best for emergency savings planning and the importance of the money being quickly converted to cash (if not already in cash-based accounts).

3) Review the net worth statement together with the client and validate that all information is current.

4) If the emergency fund is appropriately funded, there is no further action.

5) If the emergency fund needs more funding, discuss the best way to segment assets into this fund. The recommendation might be a systematic transfer from a paycheck or simply moving money from another investment account.

6) If the emergency fund is overfunded, discuss reallocating the excess funding to more productive assets to help the client improve the possibility of achieving other goals.

Follow Up

1) **Create any client-owned action items in CRM.**

2) **Create any advisor-owned tasks in CRM.**

3) **Save any documentation** related to this analysis to the client's files:

4) Additional tasks to consider:

- Internal Analysis Summary - An internal summary of this analysis for your or your team's future reference.
- Client-Facing Summary – A brief summary of this analysis for your client's future reference.

Closing Guidance

Contact your Relationship Manager should you have any questions for our Advanced Planning team or would like more information about First Element Insurance Planners.

Disclosures

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