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November 13, 2005

Getting Going

Six Months of Emergency Cash? Get Real.

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It's conventional wisdom: In case you get hit with a financial emergency, you should keep six months of living expenses tucked away in conservative investments held in your taxable account.

This is a joke, right?

Sure, if you are rolling in dough and you aren't having any problem meeting your financial goals, by all means stuff heaps of cash into a savings account or a money-market fund.

But for the rest of us, this advice borders on the ridiculous. Folks are struggling to make the mortgage payment, save for retirement and pay for their kids' college education.

Instead, however, we are being told to build up this enormous emergency reserve and then leave the money idling in low-returning investments. Let's face it: This just doesn't make any sense.

Taking Precautions

"In a perfect world, people would have a huge stash of emergency cash, they'd have 150% of the retirement savings they need and they'd have enough to send their kids to Harvard," says Sal Miceli, a certified financial planner in Littleton, Colo. "But the reality is, people

don't have the money."

So what should you do? Maybe it's time to ditch the whole notion of a separate emergency fund. Instead, start with these four steps.

First, think of your emergency money and retirement nest egg as one big pot of money. Second, build up the savings in your taxable account, using this money to buy tax-efficient stock funds such as market-tracking index funds and tax-managed funds.

Third, allocate at least part of your 401(k) plan or individual retirement account to bonds. Fourth, set up a home-equity line of credit.

Putting Out Fires

What is the point of all this? Suppose you suddenly need \$15,000 to pay a hefty hospital bill. If stocks are flying high, that's no problem. You can sell part of your taxable account's stock-fund holdings and pay the hospital that way.

What if we were in the middle of a brutal bear market? You would still sell \$15,000 of your taxable account's stock-fund shares. But this, of course, seems foolish. After all, selling shares at fire-sale prices isn't exactly smart investing.

With that in mind, you would immediately want to repurchase the stocks in your retirement account, by shifting \$15,000 from bonds to stocks. Result: You have maintained your stock exposure, you have lightened up on bonds and you have the \$15,000 to cover the hospital bill.

Meanwhile, view your home-equity line of credit as an additional source of emergency cash. With any luck, you won't ever use it.

But suppose you get hit with a truly costly financial emergency or, for some reason, you don't want to tap your investment portfolio. The credit line gives you an alternative source of cash.

"Even if you don't agree that you should use the line of credit as part of your emergency reserve, having it is always a good idea," Mr. Miceli reckons. "It's an extra layer of protection."

Helping Yourself

The above strategy should bolster your portfolio's overall performance, because you no longer have a huge wad of money languishing in low-returning investments. "Having \$30,000 sitting in your bank account earning 1% for 40 years is absurd, particularly if you're struggling to save for retirement," Mr. Miceli contends.

The strategy, however, won't just boost your returns. As an added bonus, you will also

enjoy a fistful of tax advantages.

For instance, the tax-efficient stock funds in your taxable account shouldn't kick off large taxable distributions -- and those distributions you do receive will probably get nicked at the long-term capital gains or dividend-tax rate.

These days, that means paying a maximum of just 15% to Uncle Sam. You will likely also pay that rate if you have an emergency and have to liquidate part of your taxable account's stock-fund holdings.

By contrast, you wouldn't want to pay for a financial emergency by dipping into your retirement accounts. That would be likely to trigger both income taxes and tax penalties, which together might snag 40% of any withdrawal.

That said, retirement accounts can be a great investment vehicle, in part because they offer tax-deferred growth. Thanks to that tax deferral, these accounts are the best place to hold your bonds, including the bonds needed for your emergency-money strategy.

As you probably know, the interest from taxable bonds gets dunned at ordinary-income-tax rates -- and that will be true whether you hold your bonds in a regular taxable account or a retirement account. Nonetheless, if you stash your bonds in a retirement account, you should amass greater wealth.

The reason: You get to defer the tax bill. Until you pay that tax bill, you can use the money earmarked for Uncle Sam to earn additional investment gains.

Even the home-equity line of credit has tax advantages. If you tap the credit line, you should be able to deduct the mortgage interest on your tax return. I am no fan of second mortgages. But if you have to borrow, it's probably your best bet.

Danger Ahead

Sound appealing? There are a few drawbacks with the strategy. For starters, folks may use it as an excuse not to save.

They like the idea of skipping the six-month emergency reserve. But I worry they may never get around to buying the tax-efficient stock funds in their taxable accounts.

Similarly, while a home-equity line of credit is a useful financial backstop, I fear families will start viewing their home as a piggybank. Remember, the credit line is there to pay for emergencies, not next summer's vacation.

Indeed, you shouldn't use the above strategy as an excuse to ignore upcoming costs. Let's say you plan to buy a new car within the next three years.

This isn't an emergency expense. Rather, the new car is a known cost -- and you should

save for it by socking away money in a short-term bond fund or a money-market fund.

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