

BUILD A STRONG FINANCIAL SHELTER TO WEATHER ANY STORM.

by: Tim Sullivan, CFP®, EA

To conclude that the first five months of 2020 were stressful for many Americans is an understatement. A pandemic unlike any seen in readers' lifetimes roiled financial markets, upended "normal" routines, and led to tens-of-millions of Americans being out of work. In addition, civil strife, much of it peaceful, has added a layer of anxiety as opportunistic criminals turn well-intentioned protests into chaos. When a storm rises, it is important to have a financial plan in place to ride it out until calmer skies return. Consider the following a guide to preparedness for any financial storm.

The first step is having an appropriate amount of cash on hand. If the goal is to survive a storm, shelter is essential - the stronger the better. In a financial storm, liquidity (cash) provides families shelter. Consider 5% of annual income a minimum requirement for a basic emergency fund. This at least provides a tent as shelter from a storm. It is better than nothing, but not ideal.

This column has previously advocated a two-part strategy as an ideal version of adequate liquidity. Part one consists of Ready Cash (because it is money that is available immediately or nearly so) and should be equal to 10% of annual household income (20% if self-employed or 30% if retired). Once established, protection from the storm is now equivalent to an outdoor shelter with a strong roof and solid foundation. It will protect from the rain and hail, but those open sides still leave some vulnerability.

Part two of this liquidity strategy involves funding an Emergency Cash account for financial disasters. This money is available for true emergencies only. So what constitutes an emergency? Any unintentional drop in tax brackets caused by a decrease in income is considered an emergency. This often is precipitated by a job loss or medical illness in the family or a combination of multiple illness in the family or a combination of multiple smaller crises.

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The Emergency Cash amount should be twice the Ready Cash total or two years of mortgage payments, whichever is larger. An important caveat here is for this money to be held in a retirement account like a 401(k) or an IRA.

Building the Emergency Cash fund in a pre-tax account offers two important advantages. First, the money is more difficult to access and thus less likely to be spent haphazardly. Second, money allocated to a pre-tax retirement account can save significant tax dollars today which makes the saving target more attainable. This money should be allocated to an ultra-safe option in the retirement account not subject to market volatility. Once an Emergency Cash account is established, your storm shelter is now fully enclosed and impervious to any rain, hail, or strong winds thrown at it.

As a second step to storm preparedness, strive to pay off any consumer debt. Besides saving on interest charges, paying off credit card and car debt allows liquidity to last substantially longer in an emergency. Paying off any consumer debt is like adding hurricane straps to an already strong financial shelter. It is not indestructible, but it is getting close.

Lastly, it is crucially important to live well-below one's means. During good times, this allows for increased savings toward retirement. In bad times, it can mean the difference between financial destruction or simply a period of uncomfortable bumps in the road. If the pressure to "keep up with the Joneses" is stifling financial success, consider finding some new "Joneses" in a different neighborhood. When combined with the other recommendations, a concrete financial shelter has now been constructed.

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On a personal note, I have never been tempted to invest our own emergency fund money as I was over the last two months when the market was at rock bottom. However, we can never predict when a “triple-whammy” might hit. One of my two boys could get sick, my wife could lose her job, I could be injured in an accident, or the pandemic could drag the economy into a deeper recession. Life is unpredictable. The only thing predictable is that more storms will come. Take this time to make sure your financial shelter is built to survive even the worst of them.

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Tim Sullivan is the owner of Clarity Financial, LLC a fee-only advisory firm in Columbia, MO, a CFP practitioner and member of the National Association of Personal Financial Advisors and has earned the Enrolled Agent designation from the IRS.