Is There a Need for Emergency Funds?

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ABSTRACT

A common advice given by nearly all financial planners is that everyone should first build a minimum balance in an emergency funds account. The funds in the account are to be used for a personal financial emergency, which supposedly lurks in everybody's future. The amount needed is often stated as a casual rule of thumb, such as four or six months living expenses, or two or three months' salary. The funds are to be kept in extremely liquid and low risk investments, such as money market mutual funds or checking or savings accounts. These investments yield low returns. There are very few formal models analyzing the benefits and costs of this low return savings vehicle, which is to be maintained for one's lifetime. The intended benefit is the avoidance of possibly high cost loans or suboptimal liquidation of investments intended for other needs, such as retirement or education.

Interestingly, much of the research on the topic assumes the need for such an account as a given, and looks at the empirical evidence as to the actual existence of the accounts among households and their relative levels compared to prescribed norms. Some evidence seems to suggest that wealthier households and those headed by educated individuals are more likely to meet the norms. This is often interpreted as sound financial planning. Extant research does not seem to address the cost side of investing significant sums of money in low return investments. Hatcher (2000) is one exception where he develops a formal model equating the benefits and costs of maintaining a low-yield emergency fund account. Holding emergency funds enables one to avoid high cost borrowing in the event of need. The trade-off is the loss of higher returns one could have earned from riskier, long-term investments. Hatcher derives a simple relationship between the liquidity premium forgone with the "safe" emergency fund investments, cost of borrowing emergency funds, and the probability of an emergency occurring. Deterministic simulation runs of the model using broad assumptions suggest that one needs to have a rather high probability of emergencies to justify the commonly prescribed levels of emergency funds.

We extend Hatcher's model, and using the same broad framework, run simulations with combinations of stocks and bonds and random investment returns. The primary objective is to see if Hatcher's results hold in a random return and more uncertain world. Initial results suggest that the benefits from holding emergency funds may be overstated for most individuals.

Selected Bibliography

Hatcher, C. B. (2000). Should households establish emergency funds? *Journal of Financial Counseling and Planning, 11*(2), 77.