Ask the Advisor – Dealing with and getting through financial emergencies

Posted on May 6, 2020 by Mark

To quote Mr. Mike Tyson once again on my site:

"Everybody has a plan until they get punched in the mouth."

-Mike Tyson, former heavyweight boxing champion.

How true.

I've been doing a lot of reflecting and thinking during this financial crisis – given we all got punched in the mouth to some degree. In working towards our personal goals we'll have deal with and get through some financial emergencies from time to time.

Recently, I've written about the following as I ponder what insane market and economic calamity has occurred over the last couple of months:

How might I prepare for an upcoming global recession?

How should I invest to get through any major stock market crash and eventually benefit from it?

Although I save, invest and try to do other things well in my life – I'm far from perfect. I continue to remind myself there is no perfect personal finance plan.

With my inbox overflowing in recent weeks with questions, emails and more financial perspectives from readers, I thought it would be interesting for today's post to bounce a few questions, a few theories off an advice-only, Certified Financial Planner® with Money Coaches Canada.

Enter in, Mr. Steve Bridge!

Steve, let's dive right in…

I recently got a question in my inbox about saving versus investing. I see savings as money to be spent or needed short-term (say, within a year or so). That should be in cash. I see investing as money to be grown long-term (not needed for another 5+ years). With many people dealing with a variety of financial changes and challenges right now do the same way and why or why not?

I agree with your definition, Mark. And one is not necessarily more important than the other. We hear about investing all the time, probably because it is more exciting, but saving is just as important to financial success. In fact, you could argue that saving is **more** important, because if you can't save, you won't have money to invest. Saving has to come first! Not having savings could be a sign that you are spending more than you are making (living above your means) which, as we'll touch on below, is a serious problem. This leads us around to cash flow, the most important piece of financial security and success (which we'll also discuss below).

This COVID-19 crisis has many people rethinking the value of any emergency fund. I've received a number of emails on this subject. Although I can't speak for what others need or want, I know we keep our emergency fund rather constant at this minimum level. What are your suggestions to help people establish a fund after they deal with this crisis?

First of all, I love that you have an emergency fund, and the reasons you state in your article are spot on. When an unforeseen event happens, the emergency itself is stressful enough; adding financial worry on top of it makes it even worse. The emergency fund takes one stressor (the financial implication of the event) away.

In my opinion, a reasonable target for an emergency fund should be a minimum of three months' necessary expenses. Some people say six and I have even heard of having an entire year (this seems excessive to me), but to me three seems like a reasonable number to aim for. Retirees or near retirees may already have significant amounts of cash on hand for lifestyle spending or guaranteed retirement income from a pension, so this guideline doesn't necessarily apply to them.

With regard to how to establish an emergency fund, the first step is to determine how much your fixed monthly expenses are. These are things like mortgage/rent, hydro, cell phone, car/life/property/disability insurance, internet, condo/strata fees, prescriptions, etc. Anything that is paid every month on the same day for the same amount needs to be accounted for.

The next step is to figure out how much you would need for variable monthly expenses like groceries, personal care, gas, pet food, etc. These are things you buy every month, but for which the amount varies. Go through your bank and credit card statements (or check your app if you use one for tracking) and do your best to come up with an average for the past two or three months. Consider that during an 'emergency' situation, you will likely spend less than normal.

A third category are items that are paid annually, like property taxes, professional or accounting fees, car insurance (if not paid monthly), etc. and that will be coming due no matter whether you are working or not. For example, if property taxes were $5,000 for the year, I would add $417 ($5,000 divided by 12) into this category.

So, an emergency fund calculation might lead you to the following value:

- Step 1 = fixed necessary monthly expenses (mortgage, insurance, cell phones, hydro, condo fees, internet) = $4,000
- Step 2 = variable monthly expenses (groceries, personal care, gas, pet food) = $1,800
- Step 3 = fixed annual expenses (property taxes, car insurance, accounting fees) = $650 (calculated by adding up the annual cost of these things and dividing by 12)

Total = $5,800 x 3 months = <u>$17,400 in cash.</u>

This amount may take a while to build up, so don't feel you need to have that money all at once. Keep it liquid in a high-interest savings account and not locked in, so that you can access it quickly should the need ever arise. I like the idea of keeping it at a separate financial institution, like an online bank because it's apart from your 'regular' money (it's not visible so less temptation to use it for non-emergency purposes) and you will likely get a higher interest rate.

As a follow-up Steve, I believe this COVID-19 crisis has many people questioning the use of their Home Equity Line of Credit (HELOC). What is your advice to folks using any HELOC?

Generally, I am debt-averse, but these are really tough times for many people and a HELOC might be the best option when it comes to getting through the current circumstances. Interest rates on a HELOC are lower than other types of loans, and while you need to pay back at least the interest owing each month, you have flexibility with regard to the timeline and how much you pay on top of the interest.

I would say the two most important things when it comes to using your HELOC as an emergency fund during these times is to a) borrow the minimum possible and b) have a plan to pay it back once things return to normal. A cash flow plan/budget will help with both of these because you can see exactly what you need to take out from the HELOC now (i.e. borrow the minimum, thus reducing the amount of interest you have to pay) and also with being able to know how much you can afford to pay back each month once life returns to normal.

One problem I see with consumer debt repayment is that often people will try to pay back too much too soon. They just want to get rid of it, which is understandable, but this can get them into trouble. For example, let's say you really want to pay off your credit card bill, so you pay $2,000 of it off. You can't really afford it, but you just want it gone. The following month a car repair or other unexpected expense comes along and because all the money was spent on the credit card payment last month, there's no money saved for the car repair. The credit card gets used again, and the cycle repeats. We call this the 'Never Ever' plan because the debt never ever gets paid off.

I shared my thoughts about how I intend to get through any stock market crash above – and benefit from it long-term. As an advisor who helps people every day with their financial plans, what are you telling clients right now to get through this time?

Mark, I love your advice on getting through a stock market crash. It's in line with one of my favourite financial sayings:

"You make most of your money in a bear market, you just don't realize it at the time."

-Shelby Cullom Davis

The hard part about investing is that humans are hardwired to be very bad at it. It's not our fault, its biology. Everyone knows they should buy low and sell high, but our feeling brains (the one that is actually in control) get us to do exactly the opposite of what would be best for us (the field of behavioural finance has done fascinating work on this).

What I told my clients in an email in early January was that when the inevitable correction comes your two choices will be: 1. Do nothing and 2. Buy more.

I have one client who happens to have a large amount of cash (from before we started working together) that she had been sitting on for over a year, unsure of what to do with it. I made a financial plan for her and her husband, and we are now moving money slowly into the market over the coming months (using a robo-advisor and globally diversified index funds).

I like that quote Steve!

Like eating well, "living below your means" sounds so easy to do yet it's very difficult for most people to put into constant practice. Why? Is this an income problem, a savings problem, or both for most? What are you seeing with clients?

Mark, you hit the nail on the head with this observation! Living below your means does sound easy but is possibly the #1 challenge for people when it comes to setting themselves up for financial success.

In my opinion, living below your means is not an income problem (once you are making enough to pay for basic living expenses). What happens with most people is that as they make more money, they start to 'need' newer or more expensive houses, cars, vacations, phones, toys, gadgets, etc. This is called lifestyle inflation or lifestyle creep and has nothing to do with how much we make. I had clients who made $500,000 annually but were spending $600,000. They saw no way they could cut back on expenses and that the only way to get ahead was to make more money. They saw it as an income problem, but it was very much a spending problem.

Flipping the script a little bit, I would say living below your means can be seen as a spending problem instead of a saving problem (this may be just semantics, but I hope your readers see what I'm getting at).

As far as why it is so difficult, that is a good question. What I see is that people are pretty good at tracking their spending using apps or spreadsheets, but most of these are only good for looking backwards. Knowing how much you spent on groceries, clothes and car repairs last month is great, but it doesn't necessarily help you prepare for next month. This is where I come in by developing **a money management system that looks forwards.** Once we get it in place, it's pretty much automated and ensures there will be money for groceries, rent/mortgage, next year's property taxes, gifts for Christmastime, car repairs (whenever they come up) and all other expenses, both expected and unexpected.

We all have to make choices when it comes to spending – none of us has unlimited funds. As I joke with my clients, even Warren Buffett can only buy one super yacht a day. His choices are different than our choices, but he still has to make choices (side note – Mr. Buffett is renowned for being a modest spender. He still lives in the same house he bought in 1958 and buys a new car very infrequently. His cell phone was a flip phone until this year and gets an $18 haircut. One of my favourite personal finance books of all time is *The Millionaire Next Door*, which talks about similar habits amongst the wealthy).

Don't get me wrong, I think it's great to treat yourself when you get a bonus or a raise but getting carried away and raising your 'necessary' standard of living is where people start to get into trouble. Living on your pre-raise salary will help you live below your means and treating your extra income as 'free money' that goes to retirement savings, kids' education or paying down debt will help you achieve financial independence. Future you will thank present you!

Lastly, this COVID-19 crisis will cause many people to delay their retirement plans. I believe there are huge merits to postponing full-on retirement actually. Thoughts? What do you advise clients on when it comes to this subject?

This is a really interesting question with a LOT of facets. We should first define what ‘retirement’ means. For me, I prefer to talk to clients about ‘the age at which you would like to be able to choose to work or not’. A little long-winded, I know, but I just like to define that retirement doesn’t have to mean stopping work or sitting in a rocking chair. It’s about **being financially independent and having control over your time**. Want to keep working because you like it? Great! Want to stop working and volunteer or garden or travel? Great! There’s nothing written in stone about what retirement has to look like or even whether you retire in the traditional sense of the word. The smart thing though, is to be financially prepared to retire at a reasonable age (say, 60 to 65), because life happens. For more people than you would think, the decision to retire is made for them, usually due to downsizing, health reasons, or having to take care of a family member (normally an elderly parent or ill spouse).

This crisis may cause some people to delay retirement, and the advice that I’m going to give may sound like closing the gate after the horse has already bolted, and for that I apologize, but hopefully this will help the many people who are not at the point of retirement right now.

Ideally, if someone knows they want to retire in two or three years, they will have a plan so that they know how much they want to spend (a very important exercise) and where that money will come from (your income sources). I would recommend adjusting their investment strategy to include a cash or near-cash portion, so that something comes along (like COVID-19) and wrecks the world’s stock markets for a little while, they can still retire knowing they have enough cash to see out the storm. You’ve talked about sequence of returns risk, Mark, and you’ve also talked about how markets bounce back. Having a cash wedge mitigates or eliminates retirement plans being derailed by a major market correction and allows time for the inevitable bounce-back. Keep in mind that pensions, government programs, rental income, or other **guaranteed sources of income reduce the amount of cash required.**

To address folks who were planning on retiring now but are now not sure if they can or not, I would say that a personalized plan prepared by an advice-only CERTIFIED FINANCIAL PLANNER® (CFP) (like me) would be a really good idea. Getting unbiased advice *without getting sold anything* means recommendations that are in their best interests and a plan specific to their circumstances. Failing that, continuing to work is an option as well as figuring some of the aspects of their retirement out themselves.

Here are some important questions I help clients talk through and get answers to:

- What is your desired spending level in retirement?
- What will be your sources of income?
- When should you take CPP and OAS?
- Which investments will you take first?
- What should your asset allocation be?
- How is your health?

Here’s a simple but interesting example. If you have a defined benefit pension (I know there are a lot of those out your way in Ottawa, Mark!) that will pay you $60,000 per year for life and you determine that you want to spend $50,000 per year, you’re off to the races and have no worries at all. Your retirement plans are intact, and you may proceed with retiring (interestingly, someone can have a net worth of $0 and still be quite financially secure).

On the other hand, someone who is 61, ready to retire, had all of their money in weed stocks and has no pension is going to have to come up with a solid Plan B when something like COVID-19 and the accompanying correction hits.

At the end of the day, as you say, personal finance is personal. Some folks can invest and plan alone and others prefer some help to ensure they meet their goals.

What advice-only planners can provide is unbiased help to sift through all the needs and wants to arrive at a sound financial plan that covers those needs and wants today, a game plan for the future, safeguards against the next market emergency or anything in between.

I hope these answer your questions Mark! Your readers are welcome to ask me any questions in the comments section below. Happy to answer them.

Thanks Steve!

It's clear to me that Steve's client-focused energy makes him a good fit for the CFP role and framework. I've worked with Steve on a few articles on this site before and I hope to have him back again soon. In the meantime, if you want to reach out to Steve for anything you can find him here: https://moneycoachescanada.ca/about/steve-bridge/

For further reading, you check out these posts Steve made reference to above including his previous work with me on the 4% safe withdrawal rate:

Does the 4% rule still make any sense???

Like Steve, I also enjoyed these time-tested truths in *The Millionaire Next Door.*

Thanks for reading.

Mark