The Basics

The $0 emergency fund

Six months' expenses in the bank? Yeah, right. Turns out that it's not the cash you need so much as the financial flexibility. Here's how to get it.

By Liz Pulliam Weston

Contrary to popular belief, Americans actually do a pretty good job of heeding sound financial planning advice. Most households:

Are saving at least something for retirement. Eight in 10 workers participate in their company retirement plan, according to an Employee Benefit Research Institute study, and that number is expected to rise as more companies institute automatic enrollment in 401(k) plans for new workers.

Avoid credit card debt. One-quarter of the nation's households have no credit cards, according to Federal Reserve statistics, while another 40% pay their balances in full every month. Of the rest, half owe less than $2,000.

Have their total debt under control. Only about 11% of households, the Fed says, owe more than 40% of their incomes to debt payments.

Sure, many of us could be doing better on all these fronts. We could be investing more and spending less. But there's one area where Americans are really falling down: emergency funds.

Most households ignore the oft-heard advice that they have savings equal to at least three and preferably six months' expenses. The majority of households don't even come close:

43% of households have less than $1,000 in liquid savings, according to SMR Research, a market research company.

28% live literally paycheck to paycheck, an ACNielsen poll found, with no savings whatsoever.

Just three in 10 households have a cash hoard that would tide them over for a minimum of three months, according to Ohio University researchers.

Disgraceful, right? Well, not necessarily.

The whole idea that everyone needs a big pile of cash, and needs it right now, should be rethought. In reality, the failure to have a fat emergency fund isn't inevitably a crisis. At the same time, those who feel safe because they have three or even six months' expenses saved up might be kidding themselves.

What really counts is your overall *financial flexibility* -- the resources you can command to help you withstand a crisis, even one that's unexpectedly severe or long-lasting.

Why it's so hard to save six months' pay

I talk about financial flexibility a lot in my book "Deal with Your Debt: The Right Way to Manage Your Bills and Pay Off What You Owe."

And that's precisely because so many families don't have it, or they're trying to get it the wrong way.

Here are some of the problems with the traditional idea of emergency funds:

Emergency funds take a long time to accumulate.

Let's say your take-home pay is about $4,000 a month. Although you have been spending every dime, you make a concerted effort to trim your expenses by 10%. This not only frees up money for your emergency savings but lowers the total amount you need to save from $12,000 to $10,800.

Still, it will take you 27 months -- more than two years -- to scrape together your emergency fund. And that assumes nothing comes up that forces you to raid your cache. Even the most diligent families often find it can take several years to pile up the requisite three months' store. In the meantime, they can be pretty vulnerable.

For many families, saving for emergencies has an unacceptably high opportunity cost.

Opportunity cost is, essentially, what you give up in order to get something else. If you make saving for emergencies your top priority over debt payoff or retirement savings, the opportunity cost you could pay might be enormous.

It makes no financial sense, for example, to have money sitting in a savings account earning 2% or 3% for years while you have credit card debt accumulating at double-digit rates. Paying down your credit cards not only lowers your interest costs, it also frees up space on your credit lines that you could use again in an emergency.

Another common, and unfortunate, bit of bad advice is that folks should put their retirement savings on hold while they save for emergencies. But such a short-sighted approach can quite literally cost you a small fortune.

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Are you saving too much for retirement?

MSN Money's Liz Pulliam talks about one expert's controversial theory that you'll need less money than you thought.

Let's assume you're single, you're making $50,000 and your company would match 50% of your 401(k) contributions up to 6% of your salary (the most common match). By not contributing 10% of your salary, you're forever giving up $1,500 in free money (the match) plus paying an unnecessary $1,250 in extra income taxes each year (assuming you're in the 25% federal bracket).

The biggest cost, though, is the future tax-deferred earnings you've forgone. Each year you don't contribute, you're costing yourself $65,000 in future retirement money (assuming your contributions, plus the match, grow at an 8% annual rate for 30 years).

Once they're gone, you can't get back those opportunities to receive a match or to set your money growing for you as early as possible.

Some people don't want to have cash sitting idle.

Jonathan Clements of The Wall Street Journal drew a lot of heat a few years ago when he confessed to keeping only a month's worth of expenses in his emergency fund.

He wanted his money working for him in the markets, not disappearing inch by inch as taxes and inflation took their toll.

But Clements' view is shared by many financially sophisticated folks who would rather take more risk -- in stocks, in real estate, in their own businesses -- to get better returns. And that approach can be perfectly legitimate, *as long as you can quickly get your hands on enough money when you need it*. More on that in a minute.

Continued: When cash isn't enough

A big pile of cash still might not be enough.

Consider that the average length of unemployment in 2006 was 16.8 weeks, or more than four months. While there's no way to predict how long you might be out of work should you lose your job, you should prepare for the possibility that it might be longer than you think.

You also want to get ready in case you're hit with more than one crisis at a time.

Hundreds of thousands of people discovered that reality after Hurricane Katrina. It took more than a month just to drain the city, and the reconstruction effort will take years. Many lost their homes and their jobs, with no idea when they'd see their next paycheck or how much it would cost to rebuild their lives.

Having some cash can help you enormously in the first days or weeks of your crisis. But having access to credit can tide you over the rest of the way.

Those who eschew debt in any form may recoil from this advice, but the truth is that credit can be an incredibly helpful tool. Like any tool, it can be misused. But properly deployed, it can be a lifesaver.

Borrowing for emergencies

For most families, the best borrowing for emergencies comes in two forms: credit cards and home equity lines of credit (HELOC). That's because these two kinds of credit are:

Readily accessible. Credit cards are useable virtually everywhere; even in disaster zones, merchants will start accepting plastic as soon as the power and phone lines are restored. If you've already got your HELOC in place, you can start writing checks against it immediately.

Unlikely to disappear overnight. Stocks or bonds can quickly lose value, but you'll typically lose access to your credit only if you misuse it.

Relatively inexpensive to have and to use. HELOCs typically cost nothing to set up, and most have relatively low annual fees ($50 to $100 is typical). The interest rate is low, and you don't have to pay any principal during the first 10 years or so you have the line. So if your interest rate is 7%, you can take about $70 of every $1,000 you borrow and use it to make your payments until the crunch passes.

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Credit cards typically come with higher interest rates, but their minimum payments are likewise pretty low, usually 2% to 4% of the balance monthly. And credit cards have a feature that home equity lines lack: If you wind up filing for bankruptcy, balances on unsecured debts like credit cards may be erased, while secured debts like mortgages and HELOCs can't be discharged.

Of course, you'll want to be extremely judicious about how you use your credit. In a crisis, you'll need to cut your expenses to the bone before you do anything else. You don't want to drain away your precious equity, pile up massive credit card debt or wind up filing for bankruptcy simply because you refused to adjust your lifestyle. You also need to realize that this advice isn't for everybody. If you're a chronic overspender who can't be trusted with credit, you're better off going the all-cash route. All the lines of credit in the world won't help you if you've maxed them out before the crisis comes.

But most people should at least think about the alternatives to tide them over as they're building their traditional emergency funds. Let's hope you never need them, but if you do, you may be very happy you have them.

Liz Pulliam Weston's new book, "Easy Money: How to Simplify Your Finances and Get What You Want Out of Life," is now available. Columns by Weston, the Web's most-read personal-finance writer and winner of the 2007 Clarion Award for online journalism, appear every Monday and Thursday, exclusively on MSN Money. She also answers reader questions on the Your Money message board.

Updated Jan. 18, 2008