Creating and Maintaining Reserves

"You Never Know When They Will Be Needed"

By: Doug Horn, CFP®.

The steps to become financially fit are rarely fun like a trip to *Walt Disney World* or spending time and money on a hobby or the family. However, the world often throws curve balls; and just when it may seem everything is right in the world, an unexpected expense shows up. Those who are unprepared may have to put the expense on a credit card, and then it may be months or years before the expense is actually paid in full. In the event it takes years to pay off, potentially thousands of dollars are lost to interest payments. For those who are unaccustomed to carrying a balance on their credit card, a natural focus to pay off the balance may exist. For others, the increased balance on the credit card may not even change the amount paid each month. To be financially fit, it is ideal not to be paying interest on any purchase which is consumed or no longer exists. Thus, the model structure is where credit card balances are paid in full monthly and the only long-term debt is for the purchase of a home or perhaps other assets like an auto.

Creating and maintaining reserves provides several benefits, including the sense of security and the availability of funds to meet most unexpected expenses. The question may be how much and where should the funds be kept? I have always encouraged two types of reserves be maintained. The first, a *Put-and-Take* account. This should be maintained at the credit union or bank, where the primary checking is located for easy access and can be a savings account. The amount depends upon the family and type of expense which may occur. Those who own a home could face a failed hot water heater, refrigerator, or HVAC system, and then a balance enough to cover the most expensive of these would be a great place to start. In the event money is spent from the *Put-and-Take* account, the focus should become on replenishing the account back to its target value, so it is available for the next need.

The second type of reserve account is what I refer to as *Second-Tier*. The balance in this account should be enough to meet those expenses which may occur once every five to ten years. This could include an unexpected loss of a job, a major expenditure on the home, or a legal expense such as a lawsuit. These funds, since they may be accessed rarely, should be invested but allocated conservatively. These funds should not be part of a retirement account, which may limit their accessibility.

The investment account for the *Second-Tier* funds must be a taxable account, and the investments can be mutual funds or individual securities. The account should be linked to the checking via ACH services, so when the funds are needed they can be direct deposited into the checking. If the account is opened as a brokerage account, margin can be added to the account which makes the funds immediately available. Margin is means to use the investments as collateral and is debt, so it should be used cautiously. When it is used, the interest expense is considered investment interest and is deductible on Schedule A for those who itemize deductions. When funds are needed for a short period of time, margin debt could be created by borrowing on the account instead of selling the investments and recognizing a gain or taking a loss. At the end of the short term, the borrowed funds could be deposited back into the account which pays off the margin debt. In the event the debt cannot be paid back as quickly as first thought, just enough of the investments can be sold; so when they settle, the margin debt will be paid from the proceeds of the sells.

For those who have a cash value insurance policy, the cash value in the policy can be an additional source for *Second-Tier* funds. The cash value in the policy is growing tax-deferred either earning interest or invested in various sub-accounts with variable life policies. Like all cash value life policies, the cash value may be borrowed, but the interest rate on the loans varies with the type of policy. The value in these policies can serve two purposes. First, financial security for the family as life insurance. But when an emergency occurs, the cash value in the policy can be another source of funds to meet the emergency by borrowing on the policy. However, like all debt, the borrowed funds must be paid back to the policy, so the policy remains in force to continue to protect the family. Many insurance policies offer discounted interest rates on policy loans. While this may appear beneficial, the policy is incurring interest expense while the loan exists and may not be earning at the same levels prior to having the funds borrowed. We encourage those who have borrowed on their policies to pay themselves back at a reasonable interest rate, so the policy's cash value is restored and with interest.

Those who have taken time and the discipline to create reserve accounts may also benefit from rarely paying consumer interest due to an emergency expenditure. Creating and maintaining reserve accounts are the first steps to financial security and fitness.