Emergency Fund is Crucial for Financial Security

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With an increasing number of investors starting their investment process with a financial plan in place, most of them have a clear map for the road ahead and the improved ability to achieve their investment goals. However, despite this newfound disciplined approach being adopted by investors, an important aspect that often gets overlooked is the need to plan for any financial contingency that may arise on account of various reasons.

Needless to say, a lack of preparedness to tackle such a situation can derail your long-term investment process since you may require a large sum of money to tide over the short-term cash flow issues. You could be compelled to either pull out money out of your long-term portfolio or stop your disciplined investment process through SIP for a certain period. Needless to say, this abrupt shift in priority can make a dent in the corpus being created for some of the most important long-term goals.

Therefore, it's absolutely necessary to set aside an adequate amount as an emergency fund. Ideally, an amount equivalent to at least six to nine months' worth of your living expenses as well as other commitments like children's education cost, EMIs, etc. should be earmarked for this purpose. There are a few other things that must be considered while creating an emergency fund. Investment earmarked for this purpose should be kept in a liquid form so that you can utilise this money when required without having to worry about the vagaries of the market.

Also, an emergency fund should be used for genuine financial emergencies rather than those expenses that may not qualify as financial exigencies. While an emergency fund created at the start of your investment process prepares you to cover unforeseen and unexpected expenses, it's equally important to know how to tackle a situation wherein you may need to dip into your emergency fund. There can be two scenarios here. First, the period of uncertainty is over and hence you would be required to rebuild the emergency fund. Second, the period of uncertainties continues and hence the need for additional emergency fund arises.

In the first situation, you must start rebuilding the emergency fund immediately by putting some money aside on a regular basis and even using a windfall as a lump sum investment. The second situation can be a little tricky as there would be no fresh inflows that could be used for this purpose. In such a situation, you need to consider alternatives that may help you tide over it. For example, you can try to reset your money-spending patterns by cutting certain expenses. If you follow this process in a disciplined manner, the gap between what you have and what you require can be narrowed to an extent.

You must avoid easier but costly options like excessive use of credit cards as that can be a sure-shot recipe for getting into a debt trap. Also, relook at those short-term goals that can either be postponed or avoided completely. As is evident, having a robust emergency fund is a must. Here are a couple of options that can help you earn higher returns than a savings bank and that too without compromising on the liquidity.

Overnight Funds — Overnight mutual funds invest predominantly in overnight assets and securities. At the start of every business day, the funds are held in cash. Being open-ended, you can enter and exit these funds by putting in your redemption request before the cut-off time on working days.

Liquid Funds — Liquid funds aim to provide easy liquidity, preservation of capital and moderate income by investing in short-term instruments such as treasury bills, certificates of deposits, commercial papers and inter-bank call money, government securities, etc. The returns on these schemes may fluctuate more than overnight funds but much less compared to debt funds that have portfolios with longer duration.