How to build an emergency fund

Everyone needs one. Here's how to set money aside.

Many people hem and haw about creating an emergency fund—it's hard enough to put money away for retirement—but if the pandemic has taught us anything, it's that you never know what might happen next. At some point, an unexpected event will occur—whether it's a job loss, a roof repair, or a health issue, among other things. So, it's important to have some extra cash on hand to not only help cover potential surprise expenses, but also avoid the scenarios where you sell stocks from your investments at an inopportune time as a response measure. (You want to continue a compound investing strategy largely uninterrupted.)

Fortunately, many Canadians do have money set aside for emergencies: the 2019 Canadian Financial Capability Survey found that 64% have an emergency fund with enough money to cover three months' worth of expenses. If you aren't among them, it may be time to create one. Here's how.

Open a separate account

Many people keep emergency cash in their day-to-day chequing account, but that's not always ideal, since the money in there should be for more immediate needs. Instead, open a separate savings account where you won't be tempted to spend the money, and where it can remain out of sight and out of mind until you need it.

Maximize interest income

You won't earn much interest on your emergency savings, but you can still make a little bit of money depending on where you park your dollars. There are some high-interest savings accounts (HISAs), for instance, that pay near 2% rates. That's much higher than a basic savings account, which pays about 0.1% in interest. HISAs typically have no minimum balance requirements and you can remove money at any time.

Guaranteed Investment Certificates (GICs) are another way to earn a little bit on your savings. They typically offer higher rates of interest than savings accounts, but, in most cases, you have to lock your money in for a certain period of time. Choose a GIC with a short term that rolls over, such as a 30-day or 60-day one, since you never know when you'll need the money.

With all that said, it's important to keep in mind that the main purpose of your emergency savings is risk management, not necessarily another means of investment (i.e., be careful of focusing too much on the returns).

Set up monthly transfers

The hardest part about building up an emergency fund is putting money into it. People often forget to save because there are

more pressing things on their financial agenda. Consider automating the savings process by having small sums of money transferred into your emergency account each month. This is a great way to "pay yourself first." Automate your settings to withdraw money right after you get paid. That way you can build up your reserves without having to remember.

Redirect "found" money

Most people receive one-time payments during the year—whether it's birthday money, a workplace bonus, or tax refund. It's worth developing the habit of immediately depositing that cash into your emergency fund to grow the balance, rather than spending it—which is always tempting, and usually the default approach.

Pre-define withdrawal terms

At some point, you will need to dip into your fund, but for what reason? Is the need for a new TV reason to cash out? A cottage getaway? A new car? Maybe. But to avoid using that money on just anything, it's a good idea to write down a list of "acceptable" expenses to use that money for. That way, if something comes up that straddles that emergency line, you'll know right away whether to deplete the account or dip into a different source of funds.

While it's challenging to set aside money for a worst-case-scenario that may never take place, doing so will ensure you're in the best financial position possible when the next emergency hits.

Disclosure: Mawer Investment Management Ltd. provides this publication for informational purposes only and it is not and should not be construed as professional advice. The information contained in this publication is based on material believed to be reliable at the time of publication and Mawer Investment Management Ltd. cannot guarantee that the information is accurate or complete. Individuals should contact their account representative for professional advice regarding their personal circumstances and/or financial position. The comments included in this publication are not intended to be a definitive analysis of tax applicability or trust and estates law. The comments are general in nature and professional advice regarding an individual's particular tax position should be obtained in respect of any person's specific circumstances.