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VOYA FINANCIAL ADVISORS

Factors to Consider When Determining a Cash Reserve Goal

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What factors should be considered when determining a cash reserve goal?

It takes some work to determine the ideal amount to be held in a cash reserve . This amount should reflect several important aspects of your current personal and financial situation--aspects that must be considered simultaneously and many of which are difficult to quantify.

Begin this process by listing your present sources of financial risk. To simplify this process, separate the associated risks into two categories based on whether they pertain to income or to expense. Income risk arises from various sources, such as job loss, investment market declines, or even the temporary loss of rental property tenants. For expense risk, think about the potential impact of unforeseen events that might suddenly increase costs.

Among these you could encounter are a personal disability, an uninsured property loss, a large insurance deductible, or expenses relating to an elderly and increasingly dependent family member. After listing the relevant risk factors, rate them individually with a plus (+) or minus (-) sign to indicate whether the respective factor suggests a larger or smaller cash reserve. You can double or triple the sign to give stronger weight to a particular factor.

Finally, add the number of plus and minus signs. The number of each will suggest whether a larger or smaller cash reserve is advisable. Having several more plus than minus signs, for example, suggests you need a larger cash reserve. Here are several important factors to consider (but recognize that there may be others that pertain to your own unique circumstances):

Job security--does it still exist?

If you rely on your employer for your primary income source, job security is the most critical factor to consider. Here, you should think about your industry's volatility, your employer's financial health, its recent success within its industry, any competitive threats it faces, and the level and nature of your own position within the organization.

Example(s): *Hal is a computer programmer who recently left a major manufacturing firm to accept a better paying position with a start-up venture he considers well funded. By contrast, Martha is vice president of a large mutual fund company that has a long history of success. While Martha has a solid track record of several years with the firm, Hal's higher income risk suggests he should maintain a larger cash reserve than Martha.*

Income stream--steady or highly variable?

Many people have income that is highly variable. Those working in sales, for example, are commonly paid commissions based on their sales success in each pay period. Those who are self-employed or working in the arts or construction industry also can have income that fluctuates. Even when high for a sustained period, their income can decline or end abruptly. If this describes your own primary income source, a larger cash reserve is probably in order.

Example(s): *A long-running bull market enabled Bob, a young stockbroker, to enjoy a dramatically improved lifestyle. Celebrating his success, Bob acquired a beautiful waterfront estate plus a new sports car, his true pride and joy! Yet, a strong market downturn could rapidly shrivel his paycheck, or even worse, leave him without one. Despite current high income, Bob clearly should maintain a substantial cash reserve, perhaps equal to six months or more of his current living expenses.*

Occupation or profession and where you live

Employment demand varies substantially between occupations and professions. These, in turn, respond to changes in local economic conditions. What you do for a living and where you do it significantly affects your ability to replace your job if you lose it and your income stream as well.

Example(s): *Jennifer is an oboe player and member of a small, local orchestra. While she is among its most respected members, the orchestra has fallen on difficult times. Compare Jennifer with Ron, who boasts a Ph.D., teaches physics, and is faculty chairperson at a well-known prep school. Jennifer may be a talented musician, but replacing her income and benefits could take many months. Ron's credentials, on the other hand, place him in high demand locally.*

Accounting for uninsured and uninsurable risks

A vital part of the planning process is seeing that insurable risks are adequately covered. However, some significant risks may be too costly to cover or are uninsurable. In such cases, a larger cash reserve provides vital added protection.

Example(s): *Gary is a highly successful author who works at home. Despite Gary's success, the nature of his work and variability of his income prevent him from obtaining disability insurance. If he becomes temporarily disabled, a substantial cash reserve would greatly help him and his family through the difficult period.*

Example(s): *Lisa's father, now in his nineties, has developed a painful condition for which doctors say there is no cure, but her dad has just learned of a costly new procedure having potential to greatly relieve his discomfort. Unfortunately, the procedure is considered experimental and therefore is not covered by his insurer. A larger cash reserve might enable Lisa to fund the procedure and ease his pain.*

What health insurance does not cover

Good health is not guaranteed, whether for the primary breadwinners or those who closely depend on them. In addition to children, this can apply to an aging parent or other family member who may be at greater risk of ill health. Sudden health problems can affect not only job security but future employability and peace of mind. An uninsured health problem can be financially devastating.

Example(s): *Liz and Frank's daughter Carol suffered tremendously as her parents struggled through a difficult divorce. Carol has now lost interest in her friends, and the quality of her schoolwork has dropped from honors level to barely passable. Her guidance counselor recommended a child psychologist to help overcome her problems. Liz and Frank's insurance, however, will cover only a limited portion of the cost. An adequate cash reserve could be used to pay for the portion of Carol's treatment that insurance doesn't cover.*

Available credit

Although not a first line of defense, credit can be used to fill the gaps in your cash reserve. Keep in mind, however, that borrowed money must be repaid, often at high interest rates. Avoid using secured credit (e.g., home equity loans and lines of credit) unless you are absolutely certain you will be able to repay it. Failure to do so could cause you to lose your collateral.

The 3-6 months rule

The 3-6 months rule is a general guideline for determining your cash reserve needs. Many advisors start with the assumption that you need the equivalent of three to six months of ordinary expenses in your cash reserve and then expand or reduce this amount to fit your individual needs.

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