Debt funds that are good for your Emergency Fund

For Emergency Fund most of us invest in bank fixed deposits and some of us who are confident about their skills they invest in equity mutual fund or stocks directly .

I completely disagree with him because he is working under the assumption that the emergency is many years away. The fact is that we do not know when an emergency creeps up; it could be later today, it could be 5 years down the line. Secondly, should he need the money when the stock market is in the doldrums, then he will lose out considerably. Thirdly, he is looking at wealth creation, when an Emergency Fund is simply a personal insurance of sorts.

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All assets cannot be part of an Emergency Fund. Only those which rank high on capital preservation (safety) and liquidity (quick accessibility).

Real estate and art are illiquid assets.

Fixed-return investments such as Public Provident Fund (PPF) and Employee Provident Fund (EPF) are extremely secure, but they are not very liquid. You will not get the money in 24 hours.

The Emergency Fund is not a wealth creation avenue. So returns must take a backseat and volatile investments must be avoided. Stay away from stocks and equity mutual funds. You may need the money during the depths of a bear market and would be forced to sell investments at a huge loss.

Consider debt funds.

Liquid and Overnight funds meet the prime requirements of safety and liquidity. Both are open-ended debt fund categories that invest in high credit quality instruments entailing minimal credit and duration risk. Both types of funds have portfolios diversified across high credit quality instruments with minimal duration risk.

They are typically accessible within T+1 days (T being date of redemption).

Your Emergency Fund can have the above debt funds and a bank deposit too. It need not be one to the exclusion of the other. It can be a combination of investments, but all should rank high on the safety and accessibility scale. I personally know someone who has a significant amount in his Emergency Fund as he has a wife and children as dependents, and also helps his parents. He has distributed the money between a bank fixed deposit, a liquid fund, an overnight fund and even an ultra-short term bond fund.

Safety and Liquidity are the key focus when it comes to Liquid and Overnight funds. Returns take a back seat.

Liquid funds invest in short-term instruments, certificates of deposits (CD), commercial papers (CP), treasury bills (T-bills), repo, and so on. The average maturity of such funds is typically around 1-2 months.

Given the short tenor of the underlying instruments, the yields (YTMs) offered by such funds closely track interest rates in the money markets as the maturity proceeds of underlying instruments are rolled over and invested at the prevailing market rates.

Evaluate the credit quality of the holdings and always check the expense ratio of the fund. A lower expense ratio results in higher returns assuming other fund attributes are similar.

There is no exit load but do look at taxation. Capital gains in case of holding periods up to three years are termed as short-term capital gains (STCG) and taxed at the marginal rate of income. Capital gains in the case of holding periods of more than three years are termed long-term capital gains (LTCG) and taxed at 20% with indexation.

This is important.

Ensure that nominees and joint accounts are in place. The money must be easily accessible to you and your immediately family. It will be a shame if the family members who need to access the money are not authorised to do so.

The amount could vary from 6 to 12 months of expenses. It all depends on how many dependents you have, if your spouse is earning too, and if you are servicing any loans. Evidently, the amount could vary over different phases of your life. If you are newly married with both spouses earning, the Emergency Fund could even be just three months of expenses. But over the years, if a parent moves in and you have a child, the Emergency Fund must balloon accordingly to take care of additional dependents.

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