

Reserves

By Henry K. (Bud) Hebel
8/27/02

There are two fundamentally different kinds of reserves. The first is for things that are known to need replacement some day and the second for things that are completely unknown or surprise events.

Reserves for known future large purchases:

People that are in the part of a business responsible for maintaining equipment and building understand the concept of having a cash supply to replace things that wear out. If you have a building, and the roof will last twenty years, you know that you have to build a reserve over the next twenty years to pay for the job. If you have an automobile that costs \$20,000 that you can sell for \$10,000 in four years, then you need to build a reserve at roughly \$2,500 a year. A business would be in serious trouble if it had no reserves and had to borrow money for every maintenance item. In the case of our community, we own all of the roads, so if we had not built a reserve to cover the replacement, we would have had extremely large assessments which likely would have driven a number of people to sell their homes to cover the cost.

The same is true in people's personal lives, but most of the time people borrow to buy large items. That means they are paying interest as well as the initial principal. If, instead, they had a reserve, the reserve would be earning interest. Keep in mind that the financing part of many companies is often more profitable than the manufacturing unit so they encourage you to buy things NOW with "attractive" loan terms. Borrowing money to pay for something has become so common that the people regularly borrow money to buy automobiles and many items with credit cards knowing that it may be years before they can pay off any of those debts.

In my view, the best way to plan for large future capital replacement expenses is to use a financial planning method in which you can put discrete financial events in particular future years. (You can do this with all Analyze Now programs.) This gives you much more meaningful budgets for all other things and helps get you away from using a finance company for every major purchase. If you don't account for these future expenses, I can almost guarantee that you'll have an optimistic financial plan.

If you don't have a computer program in which you can enter large future purchases, you can use the old-fashioned method with a pencil and calculator. First you make a table of things that you know you are going to have to replace in your household. Perhaps it has the hot water tank, dishwasher, washing machine, dryer, furnace, roof, paint, carpet, automobile, etc. Divide the cost (less any salvage value) by its expected life. Add up the numbers. That's how much you should be putting aside each year into a reserve account.

Then you have to calculate how big the replacement reserve (not just this year's contribution) should be. Go back to the same table. Multiply the annual contribution for each item by the number of years of life already used. Now add those numbers. Lets look at the car example above where you should be saving \$2,500 each year if you want a new car every four years. If three years have already passed, your reserve should be \$7,500 right now. When you do retirement planning, that \$7,500 of savings can't be counted as part of your retirement savings.

Building reserves for replacement and other future goals gives you the ability to accumulate substantially greater wealth. Paying interest to yourself instead of a finance company is the key. Of course, if you don't have any savings already, you are going to have to forego a lot of near term purchases to start to accumulate those reserves.

Reserves for unknown events:

Unknown events are things like loss of your job, an uninsured accident, a major medical or dental event that's not covered, parents who have exhausted their retirement funds, a daughter who is getting divorced and doesn't know how she'll support her three children, some of your investments went belly-up, someone decides to sue you, you lose a hearing aid that's not covered by insurance, you discover dry-rot in your house structure, etc.

There are a number of arbitrary means of establishing a reserve for unknowns. The most common is probably to save enough money to live on for a certain period of time, anywhere from perhaps three months to one year depending on how hard it is to find work in your profession and locale. Another method is to set aside a certain part of your investments, maybe 5% to 10%. Some consider that the equity in their house is the ultimate barrier to poverty. Some people plan to rely on the government for help if they run out of money. But there are other ideas I've found from polling people.

These other ideas aren't necessarily based on unknowns in the future as much as they are based on defense of the family in troubled times. Some people keep a hoard of cash stowed away in a secret place in case they can't their bank becomes insolvent. I had a doctor who collected ancient armor of museum quality to convert to cash if he ever needed extra money. One family told me they buy gold coins for a reserve. Another has a bag of uncut diamonds.

Then there are reserves that aren't financial. When gasoline shortages threaten, many fill up some spare gasoline tanks. Some people have Franklin stoves that they occasionally exercise. Lots of families still maintain a cord or so of logs to burn in the fireplace and keep a heavy pot to cook on the embers. Others have kerosene lamps available and a stash of warm clothes. Almost everyone has a basic first aid kit. A few people have a country place where they could grow crops if necessary. Mormons encourage their members to maintain a one-year food supply.

The most interesting case I've run into is a Vietnamese lady who escaped from North Vietnam during the war days. She was able to work her way to the US by using her mother's jewels to bribe people to take her to the border, and ultimately on a boat. The jewelry was sewn into her clothes and plucked out one piece at a time to buy passage and lodging. There was enough so that she hoped to get a head start in America. Instead some pirates boarded her boat and demanded money from all the escaping passengers. Most had nothing left, so this Vietnamese lady purchased the freedom of everyone on the boat with all of the jewelry she had left.

So what do I think makes the most sense. First, I think being able to get some money in emergencies is pretty close to the top of the list, but I personally don't think that you'll have to be able to get to the money when a bunch of gun toting guerillas break into your home or that the banking system will collapse. So I don't think you have to do much to prepare for the kind of emergency where you would have to go into the back yard and dig up a can full of cash.

Cash under your bed or in the back yard isn't earning you any income. Besides, it's like storing a lot of commodities: it loses its value over long periods of time, not because it breaks down like fish in your freezer, but because inflation continues to nibble away at it.

The need for reserves for unknowns that are most likely in our future are a temporary loss of a job, an uninsured loss of property or health, or the desperate cry for financial help from a close relative like aging parents or adult children with marital problems. To cover unknown future events, I like the idea of setting aside about 10% of your investments or an amount to cover a period without paychecks, whichever is the greater.

Investing reserves:

There is a lot of merit to using savings or I bonds as the vehicle for financial reserves. The great thing about savings or I bonds is that you have a very safe investment that is still earning some money. Storing valuables in your home is certainly not safe, particularly in some communities. Neither raw cash nor gold coins nor any collectible earns interest along the way. And, in the case of collectibles, you have to consider whether anyone within shouting distance has the money to purchase pretty things anyway.

The savings or I bonds are actually part of your portfolio. However, as reserves for unknowns, they don't count when you make an estimate of your annual budget for retirement purposes, but they do count in your allocation when you make a risk assessment. You don't pay any taxes until you actually cash them. When they no longer pay any interest thirty or so years ahead, you often can convert them on a tax free basis to series H bonds that make regular interest payments until they get cashed. So they are safe, earning interest like cash and collectibles don't, and enjoy tax deferral on the income. When you get old and gray, you can use the interest or cash them in to fund your last days.

Other kinds of reserves:

I like some of the other ideas too. Some amount of food storage is an attractive concept. The trick is to get things you like and rotate the supply. You might maintain at least enough for one month and once every two weeks or so, enjoy a meal from it. Or raid the food supply when you can't get to the grocery store. Just make sure you replace what was taken and place it at the end of the queue for rotation. A good and usable food supply will reduce your need for emergency cash as well.

A lot of people are concerned that a war in the mid east will bring severe fuel shortages. I don't like the idea of storing gasoline. It's not just that it's dangerous. After a while it loses its oomph and can clog modern automobile fuel filters. Perhaps you could get through a month or so without buying any fuel if neighbors got together and pooled the remaining supply of gasoline in their cars. Or maybe you could ride a bike or walk.

I like the idea of keeping a garbage can full of emergency things so that you could survive outside your house if there was an earthquake (a distinct possibility in some areas) or if you had to evacuate an area because of a local or national tragedy. Such supplies will also help for a prolonged power shortage that is probably a more likely event.

Summary:

Give some thought to reserves for both known and unknown events. Do a little back of the envelope analysis for known replacement events. Ask your family what they think makes sense for unknown events. Consider savings & I bonds as an investment for your reserves. Think about some food storage. Fill a garbage can (preferably on wheels) that can provide some warmth, light, and other necessities if you have to evacuate quickly or when the local transformer blows or you lose your cable services, Heaven forbid.

And don't forget to check out that first-aid kit and fire extinguisher. Chances are they are long past their expiration date.