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Near Retirement? You’re Headed For Trouble If You Don’t Have A Cash Cushion

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Why does it make sense for you to have a cushion of cash when you retire? Many financial professionals say that it’s a winning strategy. It helps smootl some of the inevitable rough spots. It offers peace of mind. In the end, it can mean the difference between a comfortable retirement and an anxious one.

If you’re already living a disciplined financial lifestyle, you probably have a cash cushion (although you may not realize it).

If other life priorities have gotten in the way of your financial plan, fear not. There still may be time for you to build that cash cushion before retirement.

In short, a cash cushion is a free ride to financial comfort. "Cash reserves are the ballast of any financial plan, used to cover unplanned expenses in a budget," says Angus Schaal, Managing Director of Phoenix-based Tandem Wealth Advisors. "Who doesn't need a financial cushion?"

What is this "cash cushion"? Think of it as a cross between the ever-popular "emergency fund" and the increasingly ubiquitous "bucket strategy."

You should have an "emergency fund" no matter what your age. While it can be used to handle unexpected expenses, the rule of thumb regarding an emergency fund is based on everyday living expenses. Most financial planners will suggest you have anywhere from 6 to 18 months of living expenses saved away in a safe, liquid account.

The reasoning behind this reflects the magnitude of the most unexpected of all unexpected of events: losing your job. With up to a year-and-a-half of your living expenses stowed safely in an accessible account, you have enough saved until you find a new job. At least that's the prevailing theory behind an emergency account.

At least while you're working.

When you retire, the calculus changes. You no longer have to worry about tiding things over between jobs. But there remains the possibility of surprise expenses popping up every now and then. "It definitely makes sense for people to have a cushion of cash when they retire for the unforeseen things that pop up in life: A broken washing machine, car repairs, a family member needing some money and just the peace of mind knowing you have some liquid funds in the bank available at a moment's notice," says Craig Kirsner, President at Stuart Estate Planning Wealth Advisors in Coconut Creek, Florida.

Remember, though, a cash cushion heading into retirement is not the same as an emergency fund. Whereas an emergency fund addresses unplanned contingencies, a retirement cash cushion is part of the plan itself. "Cash in tl retirement portfolio is for risk mitigation; not emergency funding," says Rol Drury, Executive Director of the Association of Christian Financial Advisors in San Antonio. "It is important to differentiate between an emergency fund and cash in a retirement portfolio. An emergency fund is something that should have been funded on an on-going basis for one's entire adult life; anc while this is not as separate an issue as when one was earning an income, it should still be set apart, as not doing so potentially upsets one's portfolio allocation."

Here's an example of where you might allocate retirement cash to a specific bucket.

"Planning for paying one's health insurance premiums until Medicare takes over is extremely important," says Timothy G. Wiedman, Emeritus Associat Prof. of Management & Human Resources (Retired) at Doane University in Crete, Nebraska, "If folks are planning to take an 'early' retirement, they should build a cash cushion that's large enough (at the very least) to cover their health insurance premiums until they become eligible for Medicare. And this cash cushion is above and beyond the emergency fund that they should already have. Paying those health insurance premiums are recurring monthly expenses that have nothing to do with 'emergency' spending! Thus, it would be wise to keep that health insurance cash in a separate checking account (preferably one that pays solid interest)."

Here's where it gets tricky, but this also helps clarify the difference between the role of the cash cushion and the emergency fund. While paying the insurance premiums is something you can plan for (and thus allocate the funds to that bucket), a medical emergency, by its very definition, is unplanned.

Guess where you get the money to pay for a medical emergency? Why, the emergency fund, of course.

"It's especially important to have an emergency fund during retirement," say Brian Fry a financial planner at Safe Landing Financial in Austin, Texas. "Emergency healthcare expenses are significant and more likely as time passes. There's always the potential to incur emergency costs with your hom and car among other things. You don't want to have to pull from retirement investment accounts and be forced to time the market. Facing sequence risk and withdrawing funds at the wrong time can have a devastating impact on your retirement plan."

You may recall reading about this "sequence of returns risk" earlier. It represents a big reason why you need a cash cushion heading into retiremen

"One issue retirees need to be concerned about is the so-called sequence of returns risk," says Stoyan Panayotov, Senior Advisor and Founder at Babylo Wealth Management in the San Francisco Bay Area. "The sequence of returr is the order of how your portfolio returns happen over time. If you are in you accumulation phase, the sequence of return doesn't impact your final outcome. You will end up with the same amount regardless of the order of your annual returns. However, if you are in your withdrawal phase, the sequence of returns can have a dramatic impact on your retirement income.

In this case, the strategy of the retirement cash cushion begins to take on the same purpose of a pre-retirement emergency fund. It's there to provide income during a particularly turbulent period. Before retirement, that turbulence occurs when you lose your job. After retirement, turbulence happens when the market drops dramatically.

"A cash cushion will protect you from having to sell investments to cover expenses," says Brandon Renfro, professor and financial planner, Brandon Renfro LLC, Hallsville Texas. "The reason this is so important is if the mark drops when you retire and you are forced to sell, you'll have to absorb those losses. With adequate cash savings, you can simply spend the cash and wait for the market to bounce back."

Which is why you can't get too fancy with your retirement cash cushion. In the old-style terminology of investment management, it's there for only one thing: safety. So, don't go worrying about investing it to maximize income or heaven forbid, growth. "It is important to have access to highly liquid assets that can be accessed quickly and without a loss of value to manage unexpected spending shocks in retirement," says Wade Pfau, Curriculum Director of the Retirement Income Center at The American College of Financial Services in King of Prussia, Pennsylvania.

The "bucket" half of the emergency fund/bucket strategy hybrid offers additional value to you. It allows you an ordered sense that matches your financial resources to your retirement goals. "It makes sense for people to have a cushion of cash when they retire because they will want to enjoy their retirement with the ease of already having money set aside ahead of time," says Kayse Kress of Physician Wealth Services in San Diego.

By assigning these assets to specific objectives, you can rest assured you can ride out the typically ups and downs of spending.

"A cash reserve is needed is to 'smooth out' spending," says Matt Sotir, with AXA Equitable Life in Wellesley, Massachusetts. "It is hard to spend the exa same amount every month and often there are large 'spikes' month to montl (for example, taking a vacation, an emergency home repair). The cash reserv allows the retiree to spend the money that is needed (without running a credit card balance) and then build the reserve back up when the spending reverts to normal."

Keep this in mind: there's a lot of uncertainty in those first few years of retirement. It's not an uncertainty related to what you'll be doing, it's more o an uncertainty of what it will really cost to do it.

"A larger cash reserve ahead of retirement can give retirees a sense of confidence as they head into one of the largest transitions of their lives," say Jon Anderson, Head of Retirement Plan Solutions at Cetera in San Diego. "Having a cushion of cash not only protects them through market down-tur or an emergency, it also allows retirees to spend on hobbies, traveling and important lifestyle changes they'll be making. Retirees who have cash funds set aside to invest in their new lifestyle tend to approach retirement with confidence and make an easier transition as it prevents them from tapping into investments or less liquid assets that may have tax repercussions."

This may be the best motive to build a cash cushion stockpile before you retire. "The primary reason it makes sense for people to have a cushion of cash when they retire is because there will be an adjustment period the first several months of retirement," says Bob Forrest, Financial Advisor at Jacobitz Wealth Management Group at RBC Wealth Management in Omaha "Yes, you have a plan for how much you'll spend, but that doesn't always line up with reality. Having some cash on hand will save you from having to draw more than you want from an IRA or 401(k) – which creates more income tax It will also save you from having to sell some highly appreciated stocks that you're not ready to let go of yet, which can also create more taxes."

Retirement, like any other change, brings with it worries and unease. This is natural. Still, there's a way to rationally mitigate those fears. That's what the retirement cash cushion does.

"A cash cushion provides certainty in uncertain times," says Riley Adams a Senior Financial Analyst for Google in the San Francisco Bay Area. "Having that ready supply of cash can buffer you against stock market volatility, disruption in cash flow or other financial events outside of your control. Cas on hand is peace of mind."

The best time to start building your retirement cash cushion is in the few years before retirement. It requires the same discipline it took you to build u and maintain your emergency fund throughout your working career. Even if you never had much of an emergency fund, it's not too late to begin saving fo your retirement cash cushion.

After all, who doesn't want a more comfortable retirement?

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