Devenir Viewpoints

HSA Investing: 3 Reasons Investing in an HSA is Not the Same as a 401(k)

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A comprehensive look into the benefits and considerations of investing in health savings accounts

The HSA market has grown rapidly since its inception in 2004, garnering comparisons to the early 401(k) market which has exceeded $5 trillion in assets according to the Investment Company Institute[1]. While the two accounts are often compared at a high level, we take an in-depth look at the benefits and limitations of each account highlighting three reasons investing in an HSA is more nuanced than its 401(k) counter-part.

Reason 1: HSAs are flexible

HSAs have unique traits that make them an effective tool for accountholders with a variety of objectives. To begin with, tax efficiency and investment capabilities differentiate HSAs, but other benefits like the lack of a “use it or lose it” limitation , individual ownership not tied to any employer, and the ability to select a provider while enrolled in an HSA eligible health plan set HSAs apart as a powerful bridge between health and retirement. To illustrate the primary uses of HSAs, it’s useful to think of accountholders as falling into 1 of 3 profiles:

- Spenders typically use their HSA for current expenses not covered by their health plan. This type of accountholder uses their HSA much like an FSA but without the “use it or lose it” limitation imposed on FSAs.
- Savers primarily utilize their HSA to save for future healthcare expenses. Some may use their HSA as an investment vehicle beyond the interest earned by the account.
- Investors typically invest their HSA dollars to fund future healthcare in retirement.

The table below shows some of the qualities associated with each account profile[2].

Figure 1:

Profile	Target Health Cost Coverage	Deposit Account Use*	Primary Features Used
Spenders	Today	Yes	Debit Card/Online Banking
Savers	Tomorrow	Yes	Online Banking/Investment Account
Investors	Retirement	Yes	Investment Account

*Note: According to Devenir Research, a typical HSA investor maintains more than twice the deposit account balance of a spender and twice as much as the minimum required to invest

HSAs profiles are fluid, allowing individuals to adjust how they use their HSA based on their current health and savings objectives. Additionally, individuals and families may have more than one HSA. For example, utilizing the banking features of one account and the investment options of another. The flexibility of HSAs give way to several appealing saving strategies, many of which call for paying a portion, or all, health expenses out-of-pocket. For healthy individuals and families, paying for current health expenses out of pocket lets investors pursue the full benefits of an HSA. The HSA balance is able to grow while remaining eligible for non-qualified distributions at a later date, on a tax-free basis, up to the sum of medical expenses paid out of pocket.

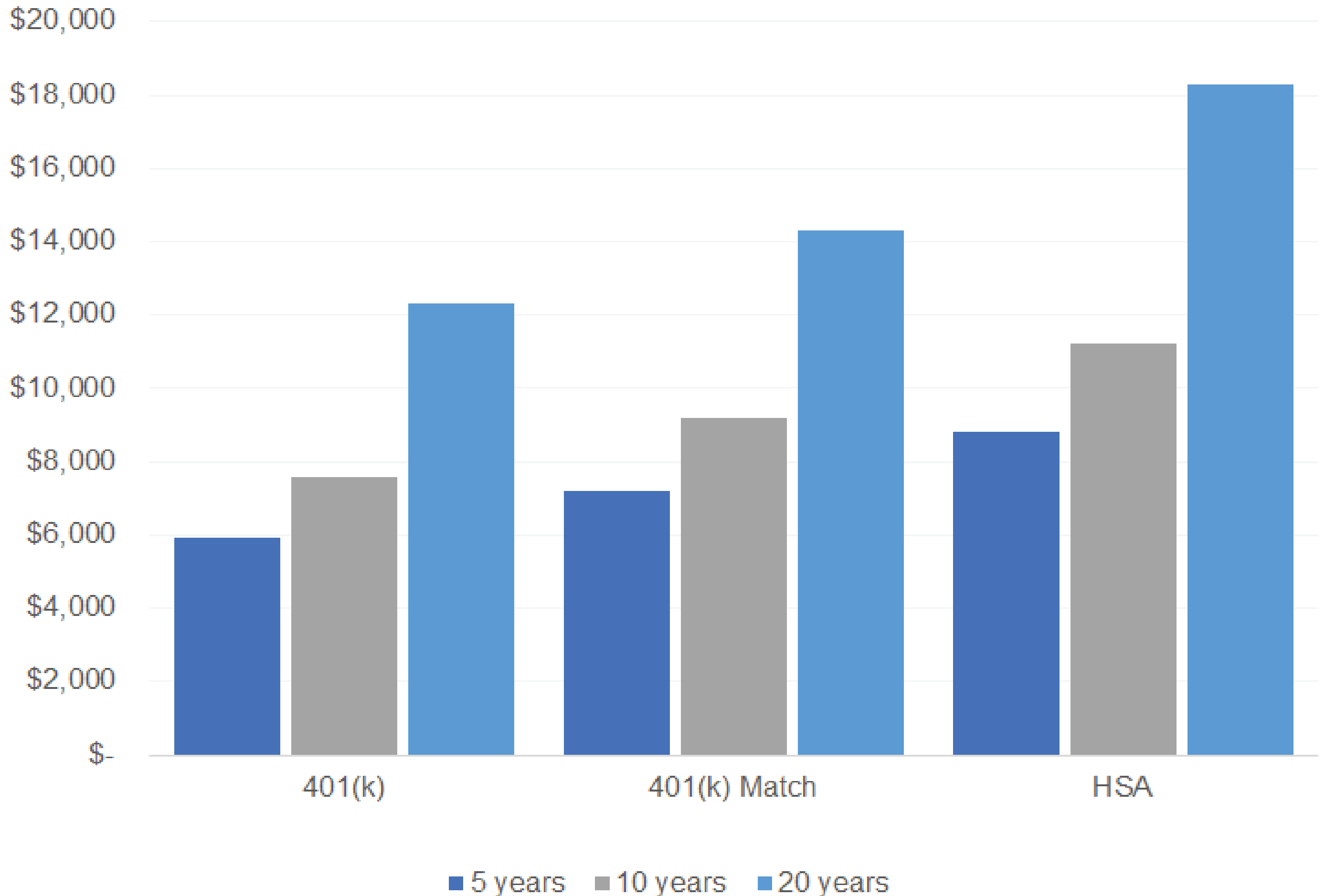
In comparison, 401(k)s are limited to use as a retirement savings vehicle, and while contributions are tax-deductible, distributions are required when you reach the age of 70 ½ and may be taxed as income. Prior to age 59 ½, distributions from a 401(k) will be taxed and subject to a 10% penalty. HSA funds are neither taxed, nor penalized, so long as distributions are used for qualified medical expenses (QME). After age 65, HSA distributions can also be used for expenses other than QME without penalty but are subject to income tax. And non-QME HSA distributions before age 65 are taxed as income and subject to a 20% penalty.

Given the multiple applications for HSAs, accountholders must consider how they plan to primarily use the account and the respective implications of investing. HSAs have the potential to be most compelling when the benefits associated with investing are being utilized. A useful way to compare the effectiveness of investing in an HSA and a 401(k) is to compare the tax implications on both accounts. The after-tax future value ("ATFV") research framework provided by Dr. Greg Geisler in his analysis of HSAs is a useful resource that can be used to evaluate long-term savings objectives. In his findings, Dr. Geisler suggests an order in which to contribute to various accounts[3]:

> *"first, contribute the maximum to an HSA and contribute enough to a 401(k) to get the maximum employer match; if money is still available, next, pay down high-interest-rate debts; if money is still available, next, contribute to a 529 account if it produces state income tax savings and if funding future higher education costs of a loved one is important; and, if money is still available, contribute the maximum allowed for the year to unmatched retirement accounts."*

Consistent with Geisler's research, Figure 2 demonstrates that HSAs can provide more value over time than a 401(k) when accounting for taxes.

Figure 2:

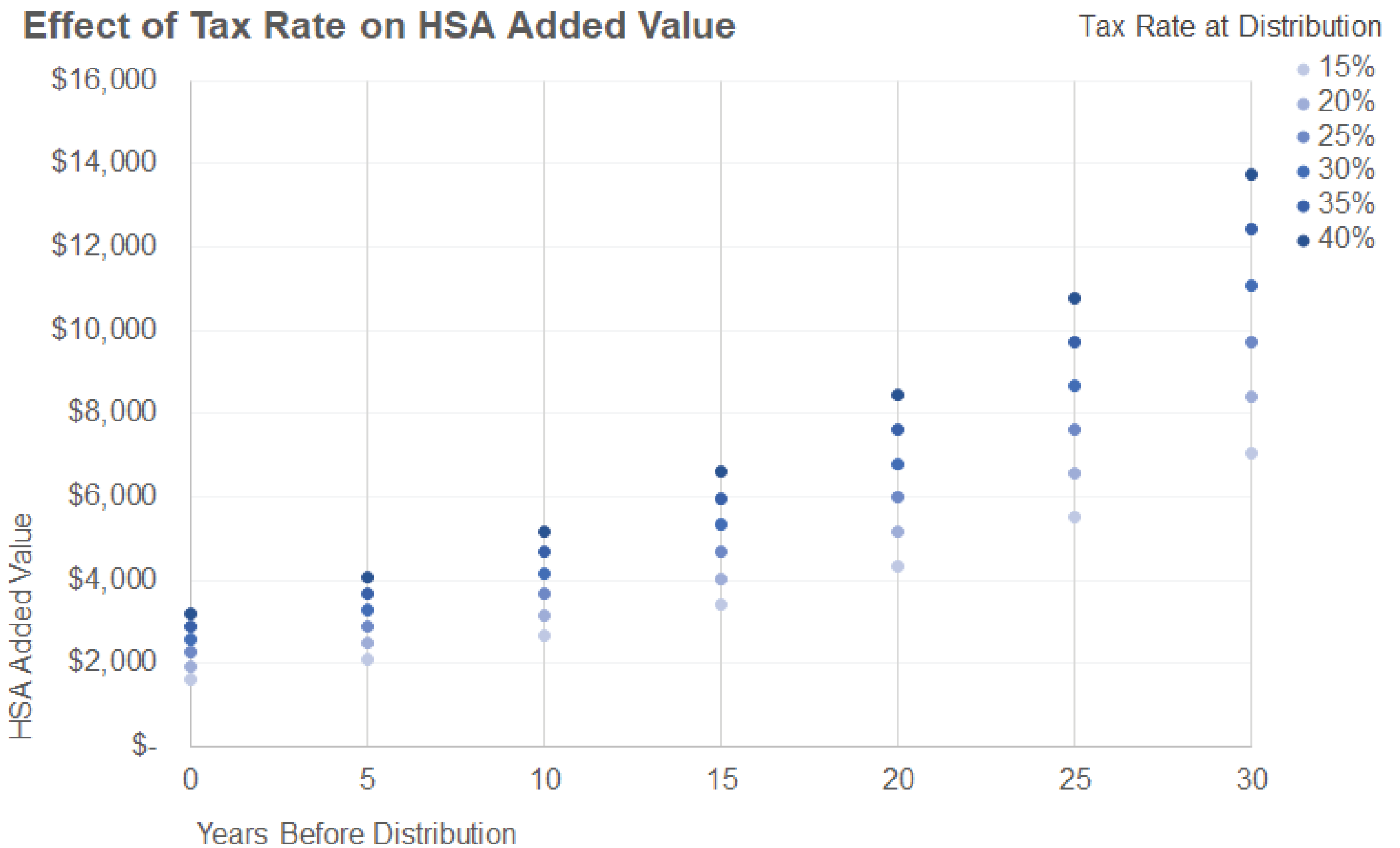


Assumes all distributions are used for Qualified Medical Expenses; tax rate is the same at both contribution and distribution t0=tn=25%. 401(k) contributions may be subject to FICA and FICA-Med which are not reflected in the model. Initial pre-tax contribution equal to $6,900 for each account. Employer match of $1,000. Annual return of 5% used in the model may not reflect actual market conditions and is not a recommendation to invest in any specific security.

The added value of HSA investing in this example amounts to nearly $6,000 over a 20-year investment horizon. Additional plan specific considerations such as vesting restrictions in 401(k) plans and any employer contributions to an HSA may affect the take home pay associated with contributing to each account but were not included in the analysis.

The value created by HSAs is amplified when taxes increase over the holding period of the account. Figure 3 shows the difference in ATFV between HSAs and 401(k)s across various tax rates.

Figure 3:



Assumes one-time contribution of $6,900 is funded through payroll deduction, and distribution is used for Qualified Medical Expenses ("QME"). 20 year holding period where "HSA Added Value" = ATFVHSA – ATFV401(k). t0= 25%.

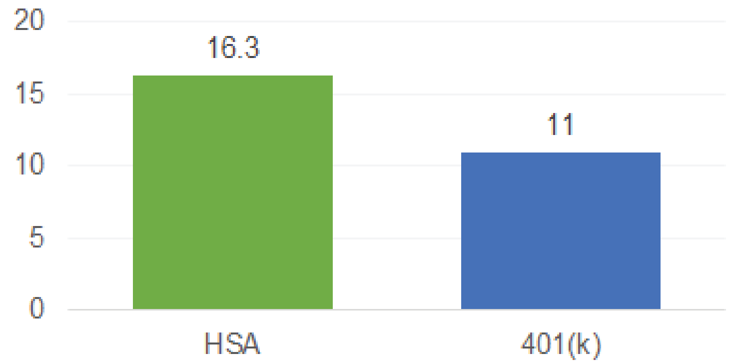
Although the HSA added value is largest at high tax rates, there are immediate benefits to paying for healthcare using an HSA when taxes are low as well.

To illustrate the potential impact an HSA can have on healthcare savings using a real-world example, it is helpful to determine how long each account could cover healthcare expenses in retirement. Assuming a 15-year retirement period, $275,000 in health expenses as provided in Fidelity's most recent estimate[4], and $300,000 saved in each account, Figure 4 estimates the life of an HSA and 401(k).

Under these assumptions, the HSA paid for an extra 5.3[5] years of health costs and lasted through the full 15-year retirement period.

HSAs offer the flexibility to accommodate a wide range of savings goals and the practicality to save tax-free. When compared to a 401(k), the tax benefits of investing in an HSA make it hard to ignore as a viable part of the retirement picture. For those who invest, HSAs may offer a way to add value to a retirement portfolio.

Figure 4



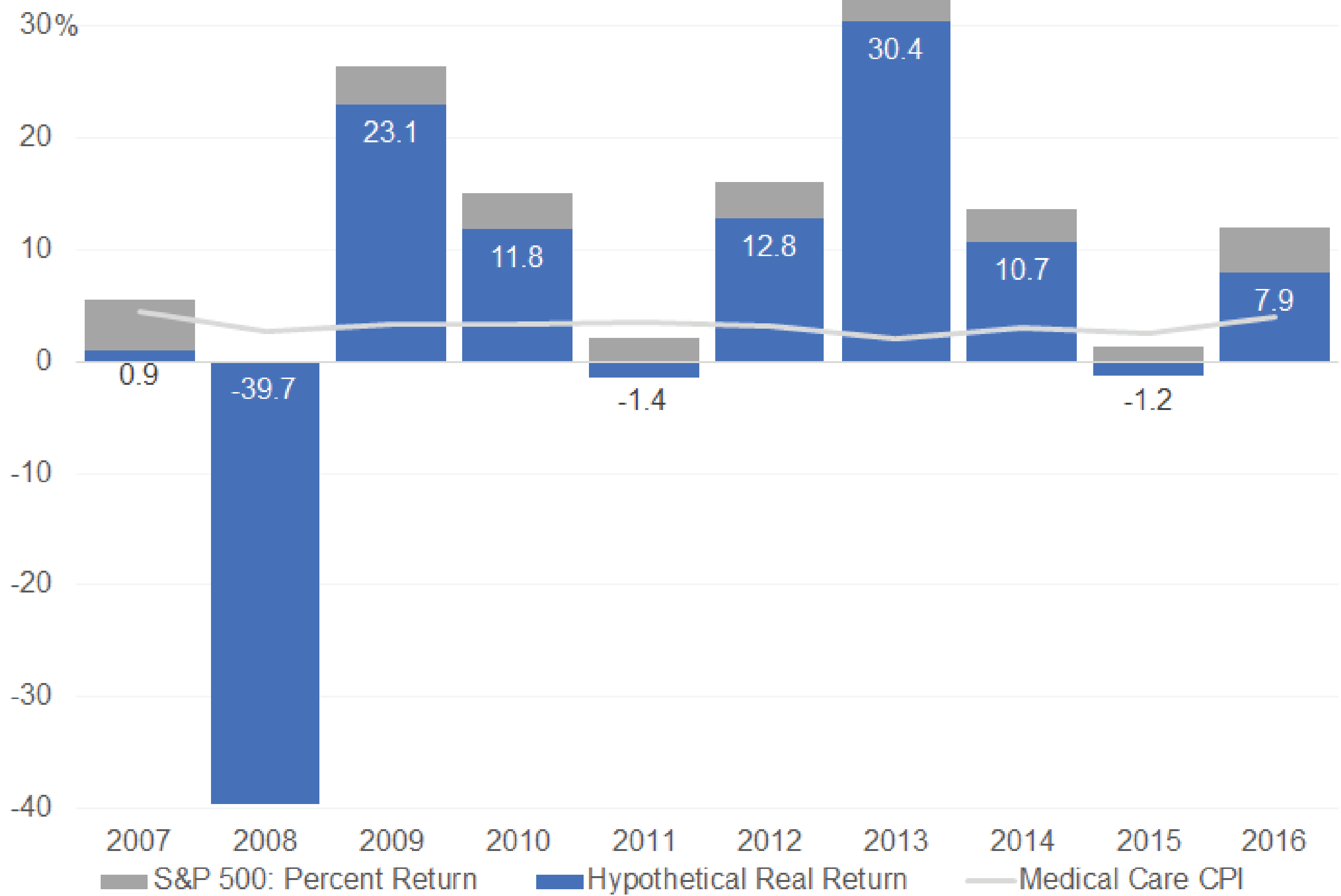
Reason 2: Healthcare costs can be unpredictable

HSAs differ from 401(k)s in setting savings goals as HSA distributions are tied to healthcare costs, whereas 401(k) distributions are primarily used for retirement income. Longer time horizons allow for some reversion to the mean, making health costs easier to predict, but the possibility of large withdrawals forces investors to ask themselves how various medical expenses could affect their savings plan. All else constant, these are things 401(k) investors are less likely to think about, absent substantial expenses.

This means 401(k)s have a shorter window of time where an accountholder can expect to begin taking distributions. The recent popularity of investment products such as Target-Date mutual funds support this idea, as they provide investors an easy way to "set and forget" their retirement portfolio. In contrast, distributions from HSAs may be less predictable. Though medical expenses generally go up with age, year to year costs may vary significantly, both pre and post-retirement. As a result, HSAs often require a minimum deposit balance before investing, so investors have a safety net should they incur any unexpected costs. For an HSA investor, this safety net of deposits can be helpful in avoiding cash flow constraints during periods where investments perform poorly, and healthcare costs increase.

Investing within an HSA gives accountholders a tool to potentially counter rising costs over the long run, but with added risk. If an HSA is used solely for qualified medical expenses (QME), it can be helpful to consider the real return of investment in an HSA[6]. Figure 5 shows the historical real return of investing in the S&P 500 Index after healthcare inflation

Figure 5:

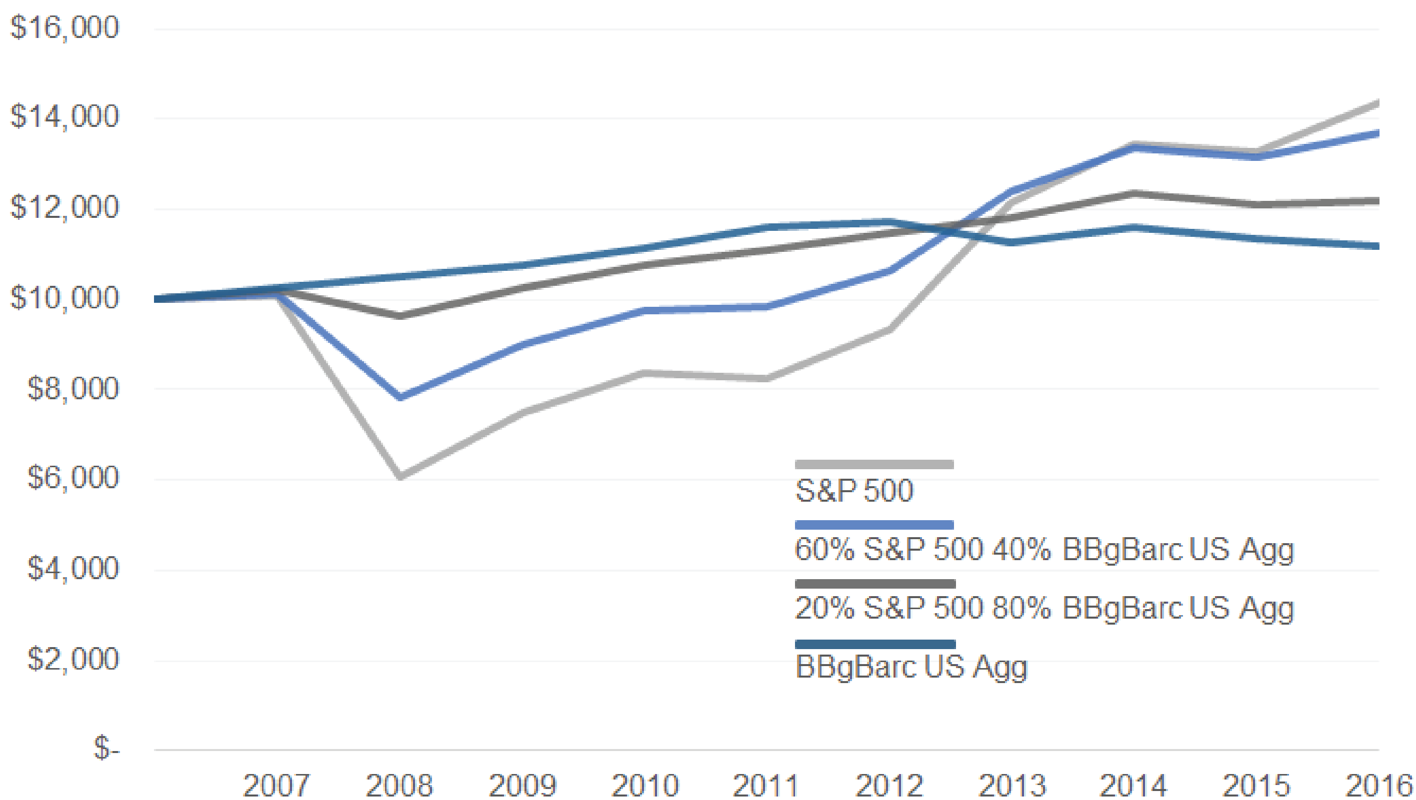


	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
S&P 500	5.5	-37.0	26.5	15.1	2.1	16.0	32.4	13.7	1.4	12.0
Medical Care CPI	4.6	2.7	3.4	3.3	3.5	3.2	2.0	3.0	2.6	4.1
Hypothetical Rate of Return	0.9	-39.7	23.1	11.8	-1.4	12.8	30.4	10.7	-1.2	7.9

Assuming the HSA is used for QME, inflation can eat away at the buying power of the balance. In 2008, 2011, and 2015 the real return of an HSA investor fully invested in the S&P 500 Index would have been negative due to rising medical costs. Considering some point along the line investors may need to take distributions from their investment balance to cover unexpected costs, real return can be a useful tool when making savings decisions.

Those who choose to invest in an HSA may also benefit from tools and allocation calculators that simplify investment decisions and help accountholders choose investments that align with their risk tolerance. Historically, various investment styles have produced a wide range of outcomes after adjusting for healthcare inflation[7].

Figure 6:



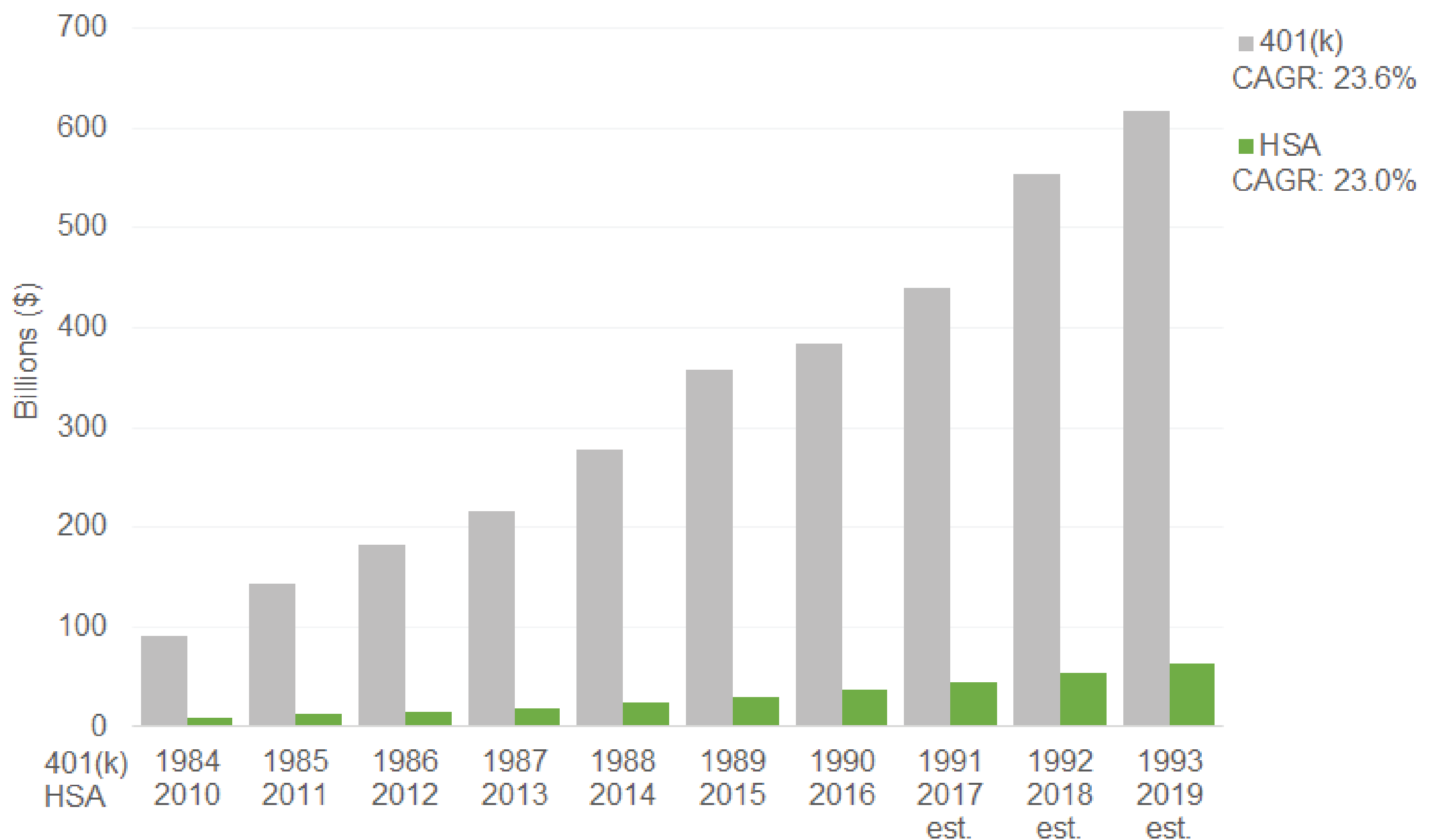
HSA investors have some additional factors to consider when making savings decisions that 401(k) investors may not. Year to year variance in health costs is a reason for HSA investors to pay attention to their investments and for providers to offer an assortment of decision-making tools in an investment solution.

Reason 3: HSAs are still new (to many)

While they have been around for 14 years, many Americans still hadn't heard of HSAs until their recent prominence in proposed healthcare legislation. As a result, the HSA marketplace has not yet enjoyed the economies of scale of the more established 401(k) and 529 plans. However, the number of HSA accounts has grown dramatically since their inception in 2004 to just over 21 million as of June 30th, 2017. For perspective, 401(k)s had roughly 19 million accounts in their 14th year[8].

The rapid adoption of HSA plans seems to be on a similar path to 401(k)s in terms of accounts, despite relatively fewer assets. At their respective 14-year marks, 401(k) assets were roughly 10 times higher than 2017 estimated HSA assets[9]. This is due to various asset headwinds that 401(k)s were not subject to, such as lower contribution limits, an HSA eligible health plan requirement, and a small segment of investment assets[10].

Figure 7:



While total assets are much lower in HSAs, asset growth measured by the compound annual growth rate ("CAGR") is expected to be similar over the selected years above. As assets and average balances rise, HSA accountholders should have access to the educational resources, guidance and tools that simplify the investing process and enhance user experience.

Conclusion

The flexibility of HSAs, unpredictability of health costs, and need for education certainly create a unique environment for investing in HSAs. Their persistent adoption could represent the second leg of the shift to consumer directed benefits, which saw 401(k) assets balloon to where they are today. And while employers rethink their benefit plan design, consumers must equip themselves with the tools to make the most of their health and retirement decisions

End Notes

[1] Sources: Investment Company Institute, Federal Reserve Board, and Department of Labor.

[2] Source: 2017 Devenir Midyear HSA Research Report.

[3] Geisler: "This assumes distributions from the HSA are for QMEs. If an HSA distribution is taken after reaching age 65 but it is not for reimbursement of QMEs, the entire distribution is subject to income tax. In such case, the ATFV formula becomes the same as investment model 2 in Table 1 (the tax deferred retirement account) and contributing to an HSA moves from the first or second recommendation to the fifth recommendation. Part of this hierarchy is adapted from Geisler (2006)".

[4] Estimate based on a hypothetical couple retiring in 2017, 65-years-old, with life expectancies that align with Society of Actuaries' RP-2014 Healthy Annuitant rates with Mortality Improvements Scale MP-2016. Estimates may be more or less depending on actual health status, area of residence, and longevity. Estimate is net of taxes. The Fidelity Retiree Health Care Costs Estimate assumes individuals do not have employer-provided retiree health care coverage, but do qualify for the federal government's insurance program, Original Medicare. The calculation takes into account cost-sharing provisions (such as deductibles and coinsurance) associated with Medicare Part A and Part B (inpatient and outpatient medical insurance). It also considers Medicare Part D (prescription drug coverage) premiums and out-of-pocket costs, as well as certain services excluded by Original Medicare. The estimate does not include other health-related expenses, such as over-the-counter medications, most dental services and long-term care.

[5] Assumes all distributions will be made for qualified medical expenses (QME); 401(k) is subject to 32.5% tax. Assumes no additional contributions are made in retirement and assets are held in a non-interest earning cash account for simplicity.

[6] Sources: Morningstar®, Bureau of Labor Statistics. Data Includes: S&P 500 Index, Medical Care CPI.

[7] Assumes investor return is equal to the Index as listed in the legend. It may not be possible to replicate such returns due to fees and other considerations. For educational purposes only, not to be construed as investment advice. Consult a financial professional when making investment decisions. Source: Morningstar, Bureau of Labor Statistics. Data Includes: S&P 500 Index, BBgBarc US Agg Bond Index, Medical Care CPI. Investment Style represents a mix of weights to the S&P 500 Index and the BBgBarc US Agg Bond Index, for example "100/0" represents a 100% weight to the S&P 500 Index and a 0% weight to the BBgBarc US Agg Bond Index.

[8] Form 5500 filings with the U.S. Department of Labor, Table E20. "Number of 401(k) Type Plans, Active Participants, Assets, Contributions, and Benefits: 1984-2012".

[9] 2017 Midyear Devenir HSA Research Report, Investment Company Institute. 2017. "The US Retirement Market, Second Quarter 2017" (September).
(CAGR: Compound Annual Growth Rate)

[10] According to Devenir Research roughly 16% of HSA assets were invested as of 6/30/2017

Citations

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About Devenir

Devenir is a national leader in providing customized investment solutions for HSAs and the consumer directed health care market. When health savings accounts first emerged in 2004, Devenir built its expertise around delivering cutting-edge investment solutions. As the consumer driven health care industry grew, so did Devenir's reputation as a leading researcher and award-winning investment consultant. Today, Devenir continues to lead the way in the rapidly growing HSA market. A research driven perspective makes Devenir the go-to investment advisor, HSA investment platform and consultant to employers, banks, third party administrators, health plans and technology providers. Learn more at devenir.com.

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