Executive Summary

Best-Practices:
HSA Investments & Menu Design

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DEVENIR

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Summary

Health savings account (HSA) adoption has drawn widespread interest from the healthcare, benefits management, and investment worlds. Many are compelled by HSAs, both as an investment vehicle and as an opportunity to improve healthcare outcomes.

Widespread interest has put HSA investments, an important aspect of HSAs, in the spotlight. Several recent reports, publications and articles have featured HSA investing as a promising tool for improving health and wealth. While these reports have often made compelling points and offered insight, most have viewed HSAs through external lenses and failed to capture important nuances of the HSA market. As we wrote in our inaugural Viewpoint: HSA Investing: 3 Reasons Investing in an HSA is Not the Same as a 401(k), HSAs are unique in a number of different ways. By offering best-practice marketplace conventions, stakeholders can form more comprehensive and healthier assessments of the HSA investment landscape.

Devenir is a leading investment consultant in the HSA space and has been an advocate for HSAs since their inception in 2004. Over the past 14 years, the marketplace has evolved, and Devenir has led the way in offering investment solutions tailored to the unique needs of HSA investors. Devenir Research continues to generate sound baseline statistics that shed light on the HSA marketplace.

As part of our continuing effort to empower stakeholders in the HSA market, our latest Viewpoint outlines ‘best-practices’ criteria for evaluating an HSA mutual fund offering and competitive HSA investment plan design.

Highlights

Menu Design

Well-designed investment menus typically offer broad asset class coverage that provides for various HSA strategy objectives. Offering both active and passive options with minimal strategy overlap allows for choice without presenting a “paradox of choice” for investors.

Investment Quality

When evaluating investment quality two important considerations include:

Performance – Typically, offer funds that outperform peers and appropriate benchmarks.
Cost – Take a holistic approach to understanding the total costs to investors.

Plan Design

Menu Changes and Transitions – Maintaining an investment menu is an ongoing process. When implementing change, there are considerations around transfers-in-kind, mutual fund mapping, the discontinuation of under performing funds, and other factors that are unique to HSAs.
Features in Demand – Investment account features such as auto-rebalancing, sweeps, investment elections, and tools & calculators. Other features, including a brokerage window may add value.

HSA Basics

Health savings accounts (HSAs) have unparalleled tax benefits and the flexibility to suit the needs of families and individuals with differing healthcare and investment objectives. HSAs are the first account to be given a "triple tax benefit" by the IRS. This means contributions, investment growth, and withdrawals are not taxed if used for qualified medical expenses.

Figure 1: Triple-Tax Benefit of HSAs

		Money In	Gains	Money Out
Retirement	Traditional IRA	Not Taxed	Not Taxed	Taxed
	Roth IRA	Taxed	Not Taxed	Not Taxed
	401(k)	Not Taxed	Not Taxed	Taxed
Health / Retirement	Health Savings Account (HSA)	Not Taxed*	Not Taxed**	Not Taxed***

*Except in California, New Hampshire, and New Jersey

**Except in Alabama, California, and New Jersey

***If used for qualified medical expenses

Source: Internal Revenue Codes Publication 590, Section 223

Menu Design

Offering a menu of mutual funds has become standard practice across the 401(k), 403(b), 529, and HSA landscape. Before this was the case (largely pre-dating the HSA market) these types of investment plans offered expansive mutual fund windows with little emphasis placed on fund selection and scope. This practice had been refined and menus became more concise to remove the “noise” and simplify the investment experience for participants.

Over time menus have continued to evolve to tailor the investment offering to the respective users of the account. For example, 401(k) plans are utilized as a retirement savings vehicle and menus have responded with target-date products that offer the ability to potentially improve participant retirement outcomes. When HSAs were introduced in 2004, it became evident that replicating 401(k) menus in an HSA might not be an ideal solution. As with 401(k)s, HSA menu design should continue to evolve over time to account for the various needs of these accounts.

We believe an HSA menu should consist of the core asset classes required to build a well-rounded portfolio while avoiding unnecessarily risky or illiquid assets. In addition to these “need to have” HSA asset classes, the flexibility of HSAs may introduce the need for complementary or “nice to have” asset classes.

Figure 2: HSA Menu Asset Class Prioritization

Source: Devenir

Investment Quality

Quality of investments is an aspect of HSA investments that is highly relevant to investor success. We discuss two criteria for evaluating quality of investments, past performance and cost, and how they can be most effectively used to compare and administer fund offerings.

Performance

Measuring performance through several different lenses can help improve performance comparisons across line-ups. Performance rankings relative to peers are optimal for identifying outperforming funds within an asset class and risk-adjusted return can help filter out funds that take excessive risk to outperform peers. Understanding a fund's underlying risk is a highly important factor to HSAs as well as other tax-advantaged accounts. Investors may not be comfortable holding more volatile assets with their dollars saved for healthcare. Overly risky investments could result in cash flow constraints should investors have an unexpected healthcare event (large enough where HSA investments must be partially or entirely liquidated).

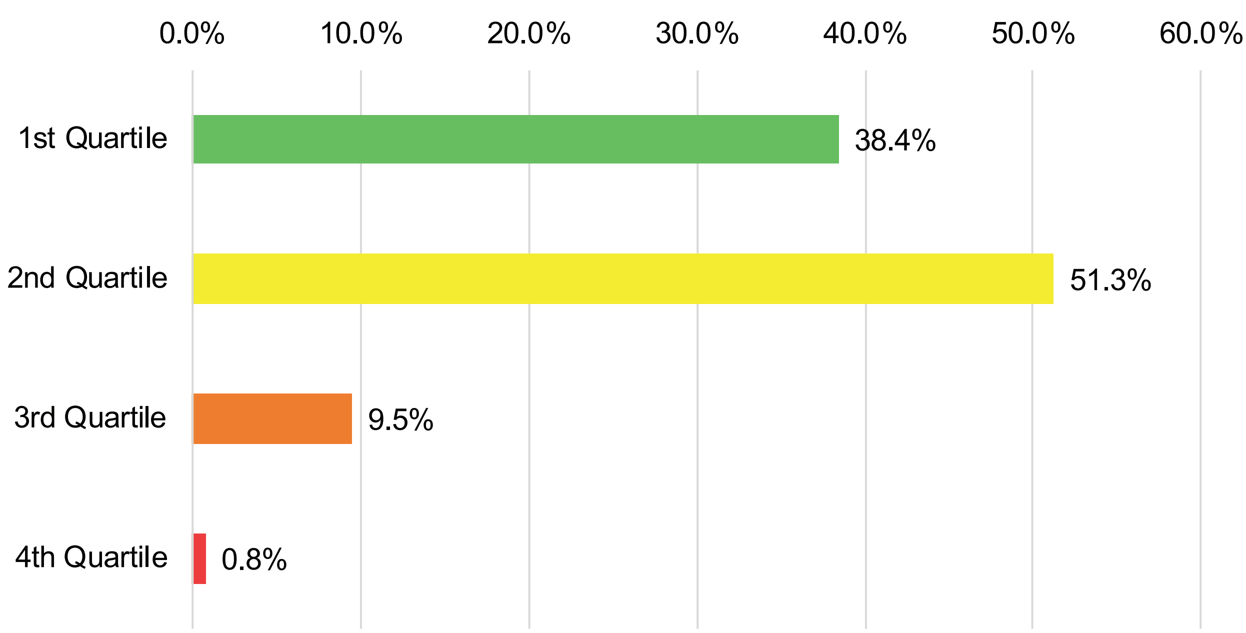
Cost

Cost can be an important predictor of future investment success and a main consideration for investors when choosing a provider as well as individual investments[1]. In general, the total fee an investor in the HSA marketplace will incur is made up of a provider related component, and a fund related component.

Provider fees include all fees that are related directly to the HSA investment account itself as opposed to fees and expenses related to individual holdings. These may include investing and/or maintenance fees providers collect to offer an investment program. Provider fees can vary depending on the suite of tools and features offered or by employer relationship. In some cases, an employer may elect to pay all or a portion of the provider fee for their employees. In other cases, large employers bring enough scale to negotiate lower costs for the plan. Provider fees may be assessed annually or as often as monthly and are frequently charged as either a flat fixed-dollar fee, or as a percentage of assets. An asset-based fee is usually calculated from the account's average daily balance during the specified period or balance as of a certain date. Additionally, providers may have the ability to pull the fee from either the investment account or the deposit account of the HSA. To calculate the provider component of the total fee, investors will need to determine all fees charged by their HSA provider and whether they are fixed-dollar or asset-based fees. As mutual funds generally charge asset-based fees, fixed-dollar provider fees may need to be adjusted to reflect a proportion of the balance. Once standardized, investors can combine the provider fee and the mutual fund fee to determine their cost exposure.

Mutual fund fees (expense ratio) are collected by all mutual funds and represent the portion of fund assets dedicated managing the fund. Due to the varying costs associated with managing certain types of funds, the optimal way to evaluate fund costs is by peer ranking. For example, an emerging markets equity fund lends itself to higher costs than say, a domestic large cap equity fund. This is due to various structural factors like higher international transaction, research, and currency hedging costs. Certain mutual funds may also charge fees in addition to the expense ratio, such as loads (commissions) or redemption fees. Redemption fees are generally charged by funds where transaction costs are significant and frequent, short-term trading can increase expenses for all shareholders of the fund. Fund expenses may be reflected in the share price (NAV) and are not directly paid by the investor as an HSA provider fee would be. Investors should be instructed to review fund prospectuses before investing, to be fully aware of the possible fees associated with the investment. When calculating the mutual fund component of the total fee incurred by investors, the asset-weighted average expense ratio of the funds held, and any additional fees should be considered.

Figure 3: HSA Market Expense Ratio Distribution



Note: Distribution of mutual funds held in the HSA marketplace

Source: Devenir Research, Devenir Calculations of Morningstar® data

The HSA market offers relatively inexpensive funds compared to fund category peers. Peer ranking limits inconsistencies when comparing dissimilar funds and provides a more comprehensive view of menu expenses.

Plan Design

Ongoing monitoring and enhancements are an important consideration for investment menu management. Discontinuing underperforming investments and expanding the menu offering may be necessary functions over time. In addition, due to a variety of reasons such as acquired HSA business or custodial changes, providers may need to transition accountholder assets from one platform to another. Facilitating these transitions can be done in two ways, liquidation and re-investment or through transfers-in-kind (TIK). The HSA marketplace presents unique challenges and considerations for ongoing management of HSA investment programs.

Features in Demand

Self-Directed Brokerage

A brokerage window can add value to HSAs by expanding the list of investable securities beyond mutual funds to include securities such as stocks, bonds and ETFs. Experienced investors may utilize the larger investable landscape, however self-directed brokerage may not be desirable for less experienced investors. Closing the brokerage window behind a minimum balance threshold is a solution that many providers implement to help mitigate use of the account by less experienced investors. However, a minimum balance threshold alone may not be the end-all solution as account balances are often not sufficient to determine investor experience and familiarity with non-diversified securities like individual stocks and bonds. In which case, it may not be desirable to make these securities available. At a minimum, a provider's investment consultant should be able to assist in determining the appropriateness for the HSA and if so, the operational aspects to consider when implementing a self-directed brokerage solution.

Closing Comments

Devnier's Viewpoints stem from observations made over Devenir's 14 years of experience as a leading consultant, recordkeeper, and researcher in the HSA market. The views offered are intended to help stakeholders benchmark their product offering in the context of the broader marketplace. At Devenir, our goal is to equip stakeholders with leading investment solutions and sound research. Devenir Viewpoints will continue to cover relevant topics and areas of interest to the HSA market.

References

[1]Asebedo, Gabriel and Grable, John E., "Predicting Mutual Fund Over-Performance Over a Nine-Year Period" (2004). Journal of Financial Counseling and Planning, Vol. 15, No. 1, 2004.

Available at SSRN: https://ssrn.com/abstract=2256589

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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