Devenir Viewpoints

Best-Practices:
HSA Investments & Menu Design

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Summary

Health savings account (HSA) adoption has drawn wide-spread interest from stakeholders across healthcare, benefits management, and financial services, who see HSAs as an opportunity to bolster services and improve healthcare outcomes.

This broad interest has put HSA investments in the spotlight. As part of our continuing effort to empower stakeholders in the HSA market, this Viewpoint highlights important concepts specifically related to HSA menu design. Menu design is increasingly essential to plan outcomes as the number of HSA investors grows each year.

Devenir is a leading investment provider in the HSA space and has been an advocate for HSAs since their inception in 2004. Over the past 19 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 help shed light on the HSA marketplace.

Highlights

Menu Size

It may be advantageous to include more funds in an HSA menu than a 401(k) menu due to the wider range of use cases for HSAs, among other factors.

Asset Class Selection

Menus should include a mix of asset classes that may contribute to the long-term upside potential of a portfolio without introducing excessive risk. The menu should provide the ability to create quality portfolios geared towards various HSA objectives.

Product Mix

The product mix should complement selected asset classes through active and/or passive options where appropriate and provide single-fund portfolio options such as allocation and target-date funds.

HSA Market Overview

HSAs have unparalleled tax benefits and the flexibility to suit the needs of families and individuals with a variety of healthcare and investment objectives. HSAs are the first account given a "triple tax benefit" by the IRS that provides an immediate discount on contributions and withdrawals for health expenses and a tax shield on investment growth for savers.

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**

*Tax treatment at the state level varies and is subject to change. A few states tax money in and/or gains as of this publication.
**If used for qualified medical expenses

Source: Devenir, for illustrative purposes only

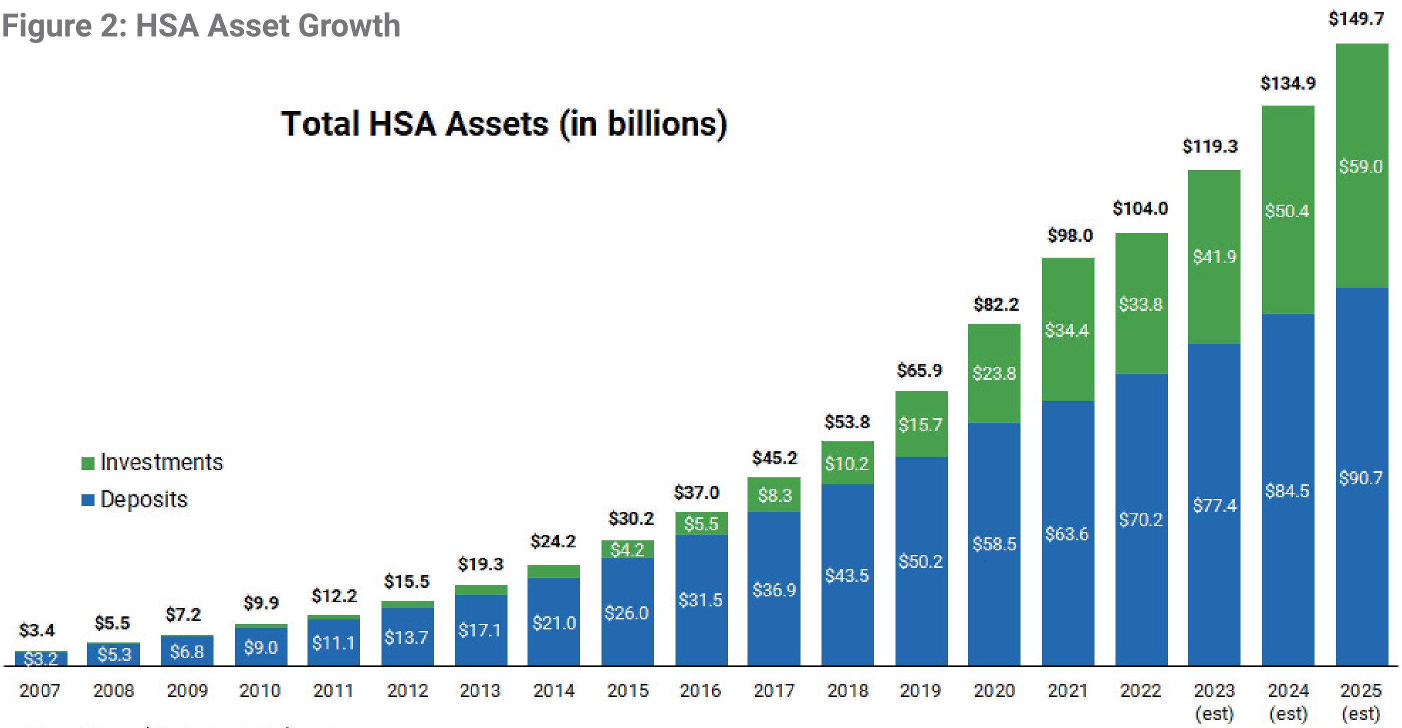
HSAs bring unique value that blends the tax benefits of traditional health accounts (FSAs, HRAs, MSAs) with the investment capabilities of retirement accounts like IRAs and 401(k)s. The result is a benefit that can be used throughout the entire life of the account holder to fund a variety of health expenses and retirement objectives.

HSAs are nearing their 20th anniversary after being signed into law in December 2003 and the industry has seen incredible growth since then. Devenir Research recently released the results of the 2022 Year-End Devenir HSA Research Report and found that there were $104 billion in total HSA assets held among 35.5 million accounts as of December 31st, 2022[1].

Other key findings include:

- $33.8 billion held in HSA investment assets, accounting for 32% of total HSA assets.
- Almost 2.6 million accounts have a portion of their HSA dollars invested, up 189% over the last 5 years.
- Account holders contributed $47 billion to their accounts in 2022 and withdrew $34 billion from their accounts during the year.
- The average HSA balance for those accounts with a balance greater than $0 was $3,725.
- HSA investors had an average total balance (deposits and investments combined) of $16,397, 6.7 times larger than an average funded non-investment holder's account balance.

Figure 2: HSA Asset Growth



Source: 2022 Year-End Devenir HSA Research Report

As the HSA industry and the utilization of investments continues to grow, investment menu design becomes an increasingly important component for HSA programs that may not only lead to better outcomes for account holders but also become a differentiator among HSA providers competing for business.

Menu Design

Offering a menu of mutual funds has become standard practice across the benefits continuum, including 401(k)s, 403(b)s, 529s, and HSAs. Before this was the case (which largely predates the HSA market), investment plans offered expansive mutual fund windows with little emphasis placed on fund selection and scope. This forced the main-street investor to sift through a sea of investment options. This practice has been refined, and menus now generally offer a shortlist of pre-selected funds that remove the noise and simplify the investment experience for participants.

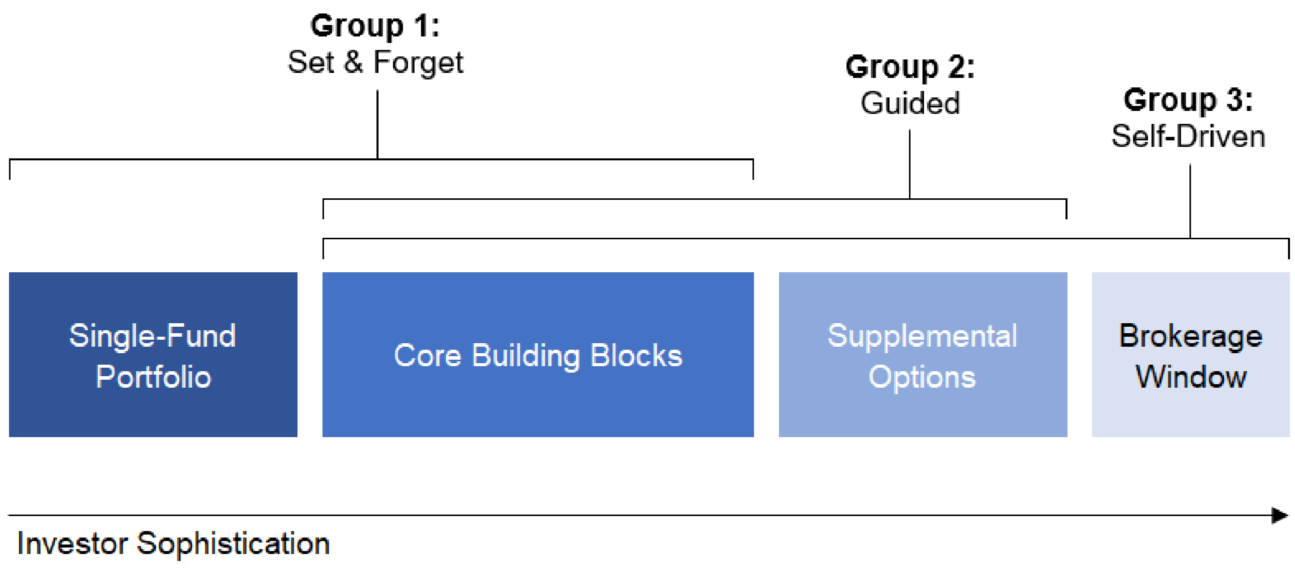
Most investors fall into one of three buckets in terms of their utilization of available investment options (see figure 3(a) below). An individual's specific bucket generally depends on past investment experience and the ability/desire to allocate time towards building a portfolio.

Figure 3: Modern Menu Design Framework

3(a) Investor Paradigms

	Group 1: Set & Forget	Group 2: Guided	Group 3: Self-Driven
Generally Benefits From:	Simplification	Suggested Portfolio Allocations	Individualized Experience
Generally Sensitive To:	Complexity	Time and/or Ability	Insufficient Choice

3(b) Menu Impacts



Source: Devenir, for illustrative purposes only

Over time, investment menus have become increasingly tailored to the typical objectives of users of the account (ex. target-date retirement funds in 401(k) plans and target-date enrollment funds in 529 plans). However, replicating a retirement plan menu is a less compelling strategy for HSAs due to the potentially differing objectives of the end user.

This paper covers three key menu design decisions and how they relate to HSAs:

- Menu size
- Asset class selection
- Product mix, including:
    - Active vs. passive funds
    - Objective-based fund options

A simplified approach to each of the above decisions is to base them on the common objectives of providers when offering investment menus.

Figure 4: Common Menu Design Objectives

	Menu Impact:		
Primary Objective:	**Menu Size**	**Asset Class**	**Product Mix**
Simplification	Limited	Core	Active and/or Passive + Allocation
Minimize Cost	Limited or Intermediate	Core + Some Supplemental Options	Passive-Oriented + Allocation and/or Target-Date Funds
Alpha Potential	Intermediate or Expanded	Core + Supplemental Options + Potential Brokerage Window	Active-Oriented + Allocation and/or Target-Date Funds

Primary driver of objective

Source: Devenir, for illustrative purposes only

We evaluate the relationship of each of these considerations to HSAs in more detail in the sections that follow.

Menu Size

The case for limiting the number of funds in a menu may stem from research in retirement plans. Some of this research has shown investors may respond to overly large investment menus through lower participation rates or greater acceptance of the default investment option[2]. However, we believe HSAs can offer a more robust menu for several reasons.

1. HSA providers do not auto-enroll participants into the investment account. Account holders must take action to invest, which may lead to more engaged investors.

2. HSA account holders have been shown to exhibit high levels of consumerism (consumers enrolled in HSAs may be more fluent, engaged, and make savvier health and financial decisions than the general public[3]) meaning HSA investors are potentially more capable of navigating investment options.

3. HSAs do not offer a QDIA in the 401(k) sense, which is typically a target-date fund with an age-appropriate mix of stocks and bonds. The default investment option in HSAs is often a money market fund. The lack of a diversified QDIA may mean HSA investors could benefit from a larger selection of funds as they work to build a quality portfolio.

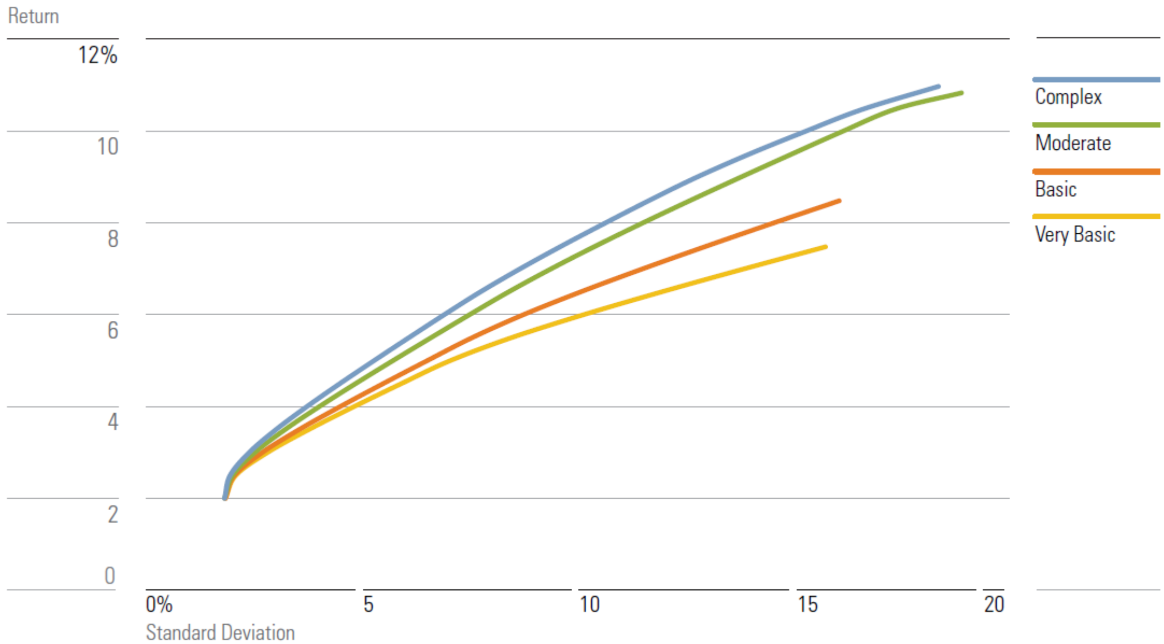
4. HSAs are less likely to be the first or only investing experience for their participants[4]. Most HSAs are workplace benefits and thus participants often have access to retirement benefits as well.

5. While 401(k)s are designed as retirement savings vehicles where investors typically know their time horizon with a high degree of certainty, HSAs have a much broader range of use cases and time horizons tend to be more uncertain. A larger menu may help HSA investors design portfolios tailored to their unique objectives.

While not exclusive to HSAs, technology platforms in general are becoming increasingly effective in simplifying the investment experience for account holders. Decision support tools, such as robo-advisors, often break up seemingly complex investment decisions into bite-sized pieces. This can help reduce indecision and promote diversification, ultimately allowing menus to offer more funds as the investor is guided through the additional options.

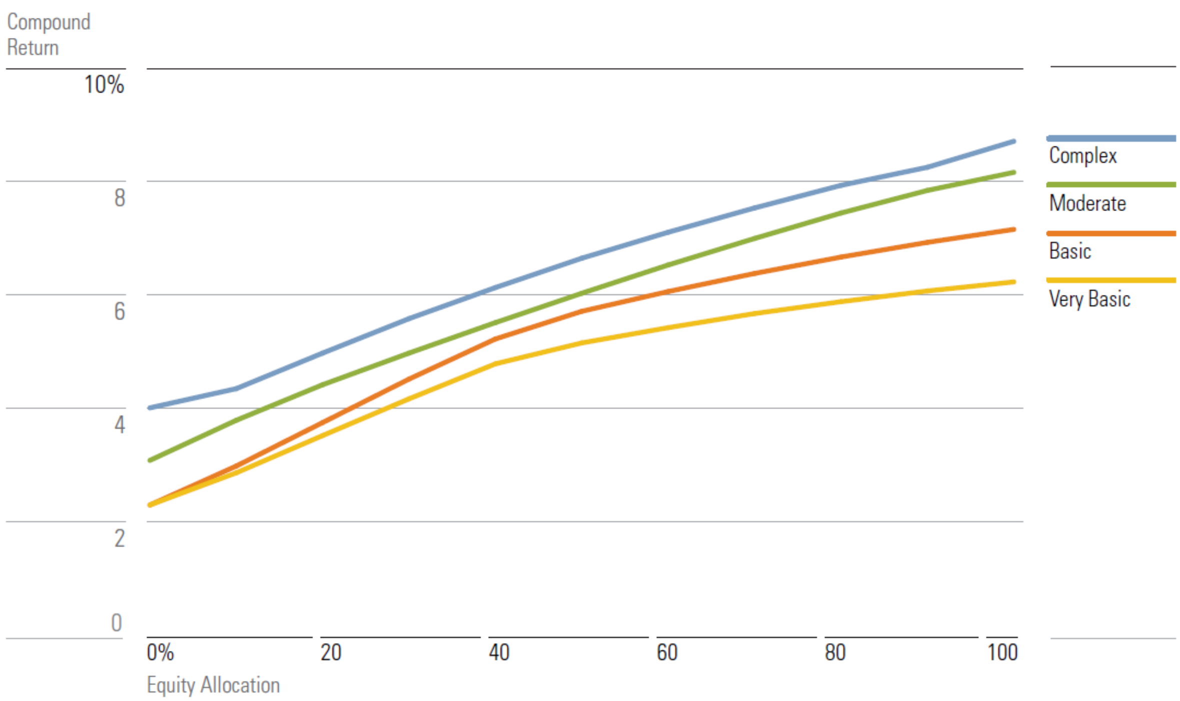
Lastly, research by Morningstar® suggests that increasing the complexity of menus not only leads to investors holding more funds in their portfolio[5] but can also translate to more efficient portfolios and higher returns[6].

Figure 5: Impact of Core Menu Complexity on the Efficient Frontier



Source: Morningstar®, for illustrative purposes only

Figure 6: Compounded (Geometric) Return at Each Equity Level for Various Menu Complexities



Source: Morningstar®, for illustrative purposes only

The question remains, is a smaller or larger HSA menu more effective in improving investor outcomes?

Potential benefits of smaller menus:

- May realize a quicker reduction in plan costs through the consolidation of assets in fewer funds and creating the opportunity for share class enhancements
- Possible lower utilization of the default investment option
- Simplicity

Potential benefits of larger menus:

- Ability to create more objective-based and potentially higher returning portfolios
- Greater selection of asset classes and product types (active/passive, target-date etc.)
- Appeal to a wider range of investor sophistication and objectives

Considering the various deciding factors, a range of menu sizes may make sense for an HSA. We believe the ideal menu size is between 15 to 30 funds (counting an allocation series or target-date series as one fund). The most appealing menus will strike a balance between limiting 'analysis paralysis' and default utilization, while still offering the complexity to build quality portfolios. The right menu size for each provider will vary based on several factors, including, but not limited to:

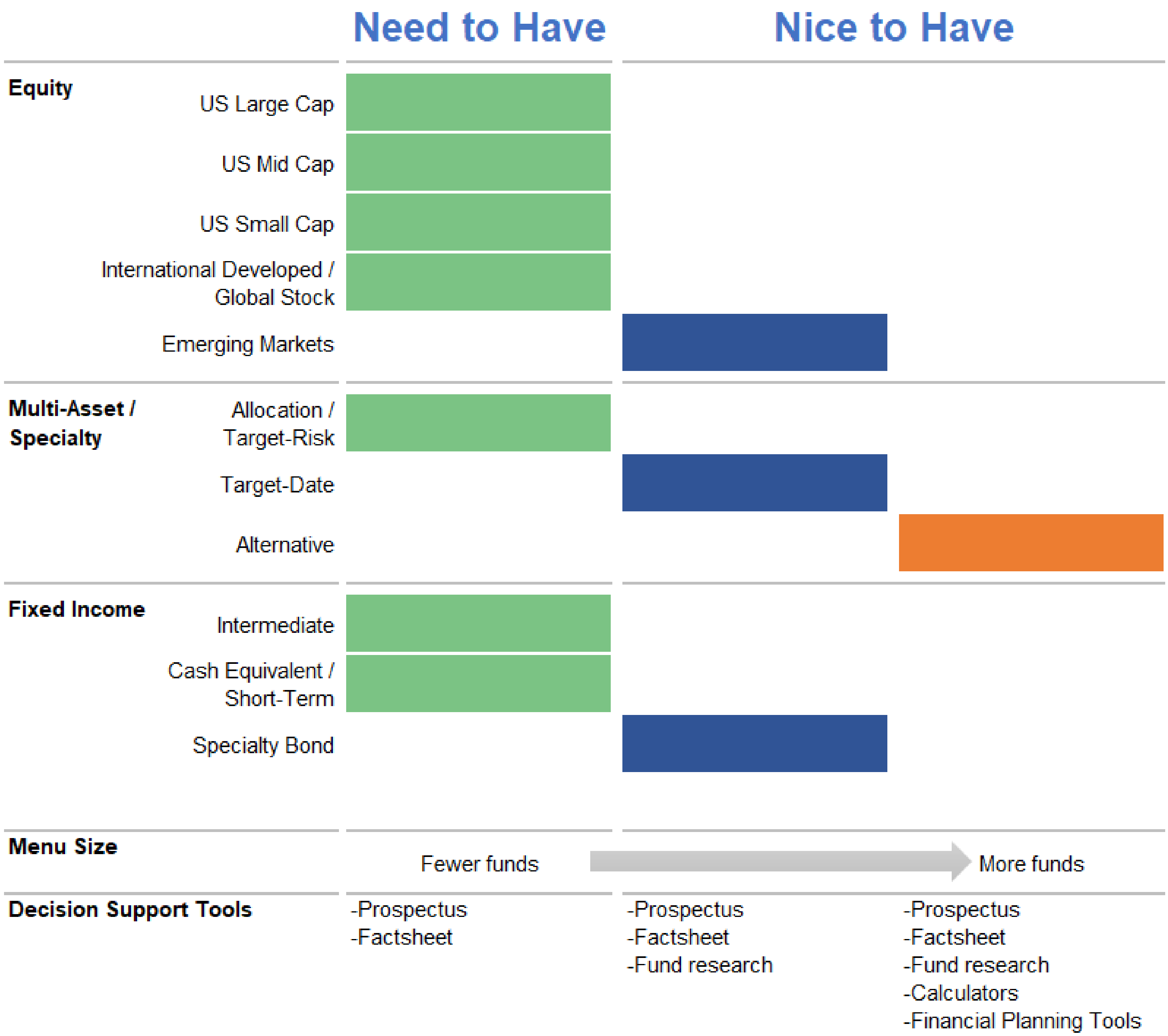
- Provider objectives
- Financial literacy of the participant population
- Technology platform (specifically, how the menu is presented to the accountholder and availability of decision support tools)
- Marketplace demand

Asset Class Selection

Asset class selection is a key component when designing menus of any size. If offering a more complex menu, providers should be thoughtful about the type of funds that are added. It may make sense to prioritize broad asset class coverage over depth of options in any single asset class. The decision to offer an additional asset class should hinge on whether the potential benefits of adding the asset class are greater than the risks it presents. For example, a provider should examine if the asset class may be complementary to a typical portfolio of existing funds, or if the potential risks outweigh any added diversification benefit. This process may be repeated until the menu reaches a reasonable range (based on the factors discussed previously) and no more asset classes fit the criteria.

HSA menus may take the retirement plan core menu framework and expand on it to account for the wider range of potential use cases. In addition to the core or "Need to Have" asset classes required to build a well-rounded portfolio, we lay out a basic prioritization for "Nice to Have" asset classes below. As mentioned earlier, "Nice to Have" asset classes offer the opportunity to build more sophisticated portfolios that can be tailored to a wider range of investment objectives.

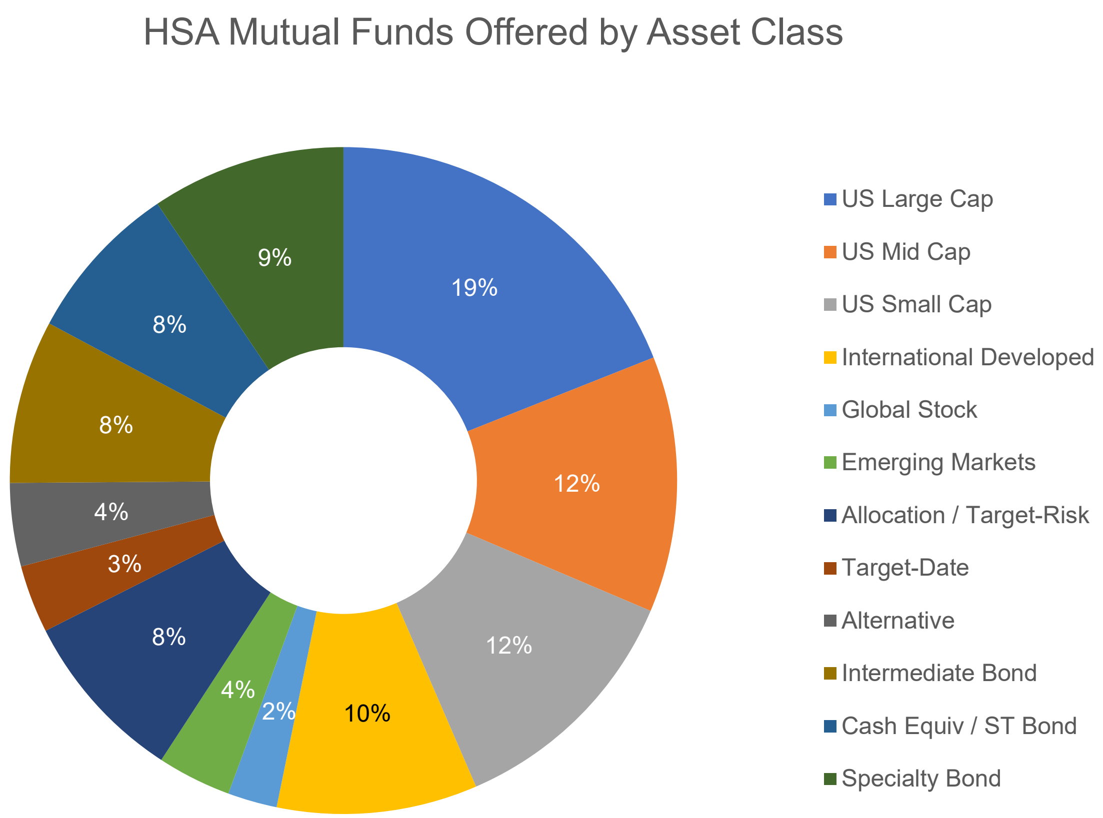
Figure 7: HSA Menu Asset Class Prioritization



Source: Devenir, for illustrative purposes only

The chart below provides a breakdown of the mutual funds offered in HSA investment menus by asset class (as a reminder, an allocation or target-date series counts as a single fund).

Figure 8: HSA Industry Asset Class Dispersion

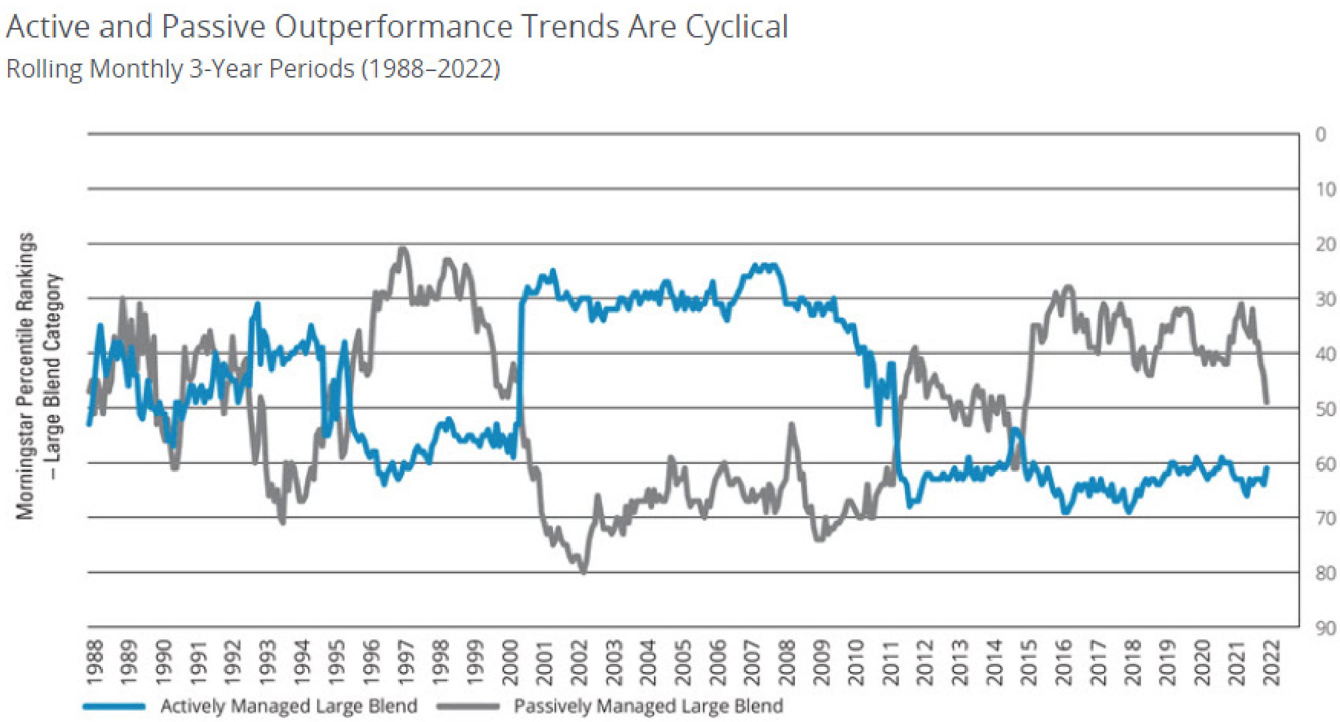


Source: Devenir Research, data as of 12/31/2022, asset classes based on Morningstar® categories

Product Mix: Active vs. Passive

The choice between active and passive investments is at the forefront of the financial services industry. Passive strategies have largely outperformed higher-fee active managers since 2011, which has made it more difficult for many funds to justify their management fees. While this is a topic that has continued over the past several decades, there is strong evidence to support the idea that the relationship between active and passive outperformance is cyclical[7]. Considering the historically cyclical relationship, we believe the ideal HSA menu offers a balanced mix of active and passive options.

Figure 9: Cyclical Nature of Active / Passive Outperformance



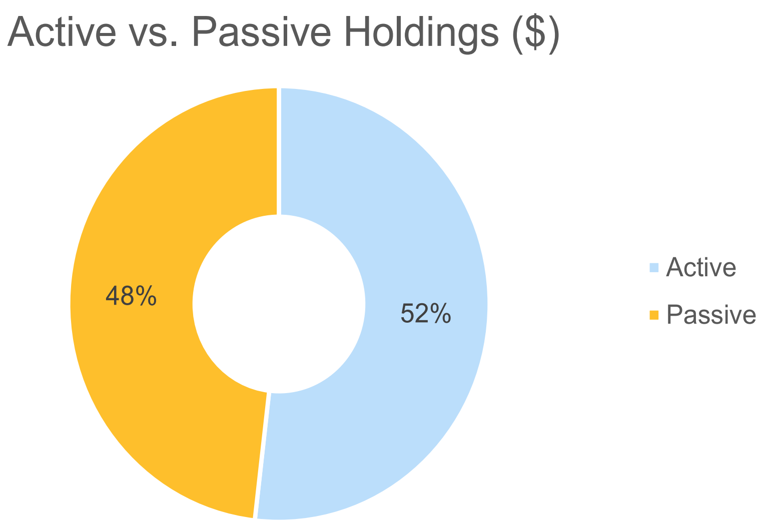
Source: Hartford Funds

Certain areas of the investment menu may be more or less suited to offering either active or passive funds, or a combination of the two. According to Morningstar®, active funds have had higher average success rates in asset classes such as real estate, international, US small cap, and fixed-income[8]. In addition, history suggests that active funds may also be able to provide better downside protection during market corrections as managers often have more flexibility in managing their risk exposures. There have been 27 market corrections in the past 33 years and active funds within the U.S. large cap blend category outperformed passive category peers in 20 of those periods[7].

As investors continue to be more cost-sensitive, most menus have adapted to offer index options. Index funds are based on the belief that markets are efficient and information is already reflected in the stock's price, thus outperformance from active management is difficult after adjusting for fees. Whereas active funds may outperform in certain markets, the same can be said for passive options. For example, in stable markets where securities tend to move together, a passive strategy may be poised to outperform its active peers. Lastly, passive funds can also be structured to focus on fundamental factors, such as quality or low-volatility, which may add value through differentiated portfolios and the potential for outperformance.

A 12/31/2022 snapshot of the HSA market shows that on an asset weighted basis, HSA investors currently hold slightly more in active funds than passive[1].

Figure 10: HSA Active / Passive Investment Mix



Source: 2022 Year-End Devenir HSA Research Report, Devenir calculations of Morningstar® data

No matter what the active and passive mix is, it is important to focus on minimizing menu overlap. This occurs when a menu has multiple options within the same asset class that have similar exposures and investment strategies. An example would be including two actively managed, high conviction strategies in the U.S. large cap growth category. Menus should simplify the investment decision for participants by offering the option that provides the highest likelihood of success and matches menu objectives. As mentioned earlier, some asset classes may be better suited to offering both an active and passive option. We do not consider this menu overlap as the strategies are different - one is actively managed and the other tracks an index.

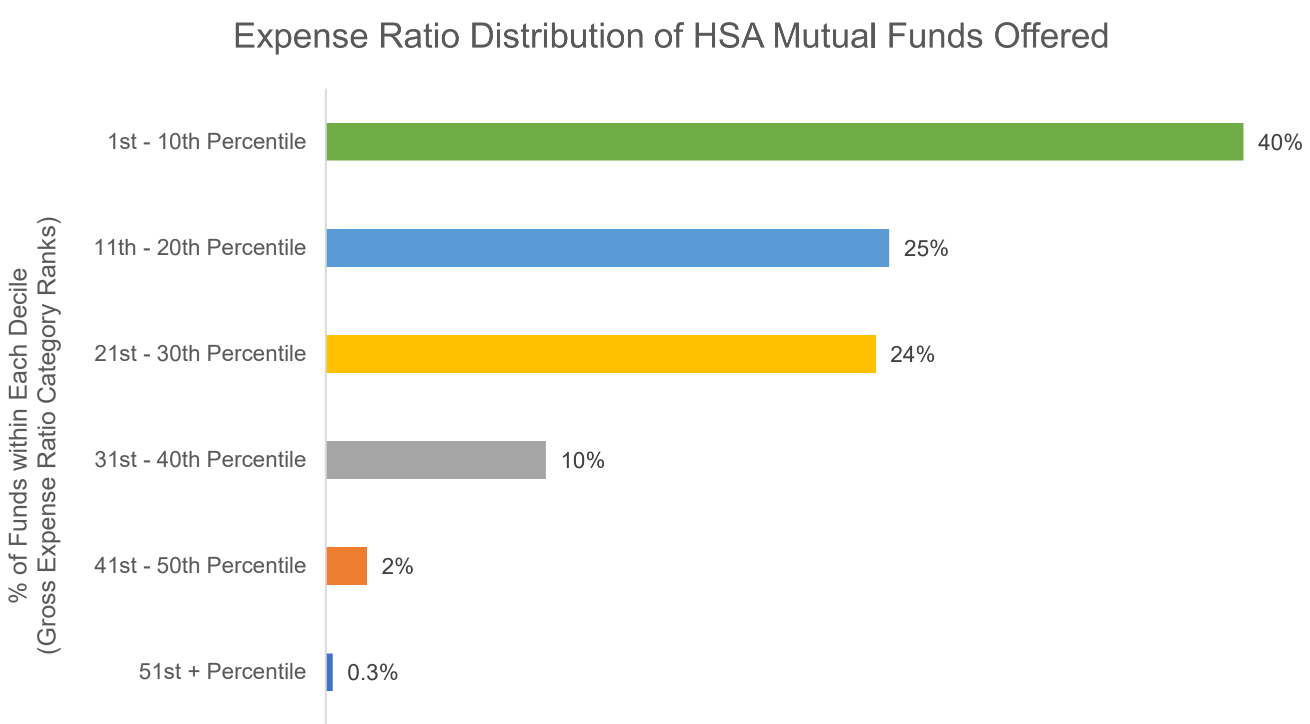
Product Mix: Objective-Based Funds

Given the greater variation in use cases for HSAs, it may make sense to include objective-based fund options that simplify the portfolio decision process for investors with straightforward investment goals. Our asset class prioritization places allocation/target-risk funds in the “Need to Have” category while target-date funds fall in the “Nice to Have” slot, largely because the typical target-date fund glidepath may not adequately represent the less predictable withdrawal patterns in HSAs when compared to 401(k) distributions. However, investors targeting health costs in retirement may find the familiarity and ease of use worthwhile. For more information on target-date funds in HSAs, check out our blog post we published in January 2022.

Note on Cost

In general, the total fee an HSA investor will incur includes a provider related component and a fund related component. As mutual fund companies continue to better understand HSAs and their benefits, many have updated their policies to allow HSAs to use their lowest cost share class. As a result, the HSA market offers relatively inexpensive funds compared to fund category peers. In fact, the average gross expense ratio (as stated in the fund's prospectus) of HSA provider fund lineups has continued to come down over the years and sits at 0.28% as of 12/31/2022[1]. The table below shows a breakdown of the gross expense ratio of funds offered in the HSA market based on their peer group percentile rank.

Figure 11: HSA Market Expense Ratio Distribution



Source: 2022 Year-End Devenir HSA Research Report, Devenir calculations of Morningstar® data

Closing Comments

The practices outlined in this Viewpoint stem from observations over Devenir's 19 years of experience as a leading consultant, recordkeeper, and researcher in the HSA market and are intended to help stakeholders benchmark their product offering in the context of the broader marketplace. At Devenir, our goal is to equip these 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

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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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