Devenir Viewpoints

Best-Practices:
HSA Investments & Menu Design

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Table of Contents

Summary

Health savings account (HSA) adoption has drawn wide-spread interest from stakeholders across healthcare, benefits management, and financial services. Each seeing 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 outlines best-practices criteria for HSA investments menu design. Menu design grows increasingly essential to plan outcomes as the number of HSA investors rises further each year.

Devenir is a leading investment consultant in the HSA market and has been an advocate for HSAs since their inception in 2004. Over the past 15 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 portfolios geared towards various HSA objectives.

Product Mix

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

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. The triple tax benefit unique to HSAs 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
Retirement	Roth IRA	Taxed	Not Taxed	Not Taxed
Retirement	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[1]

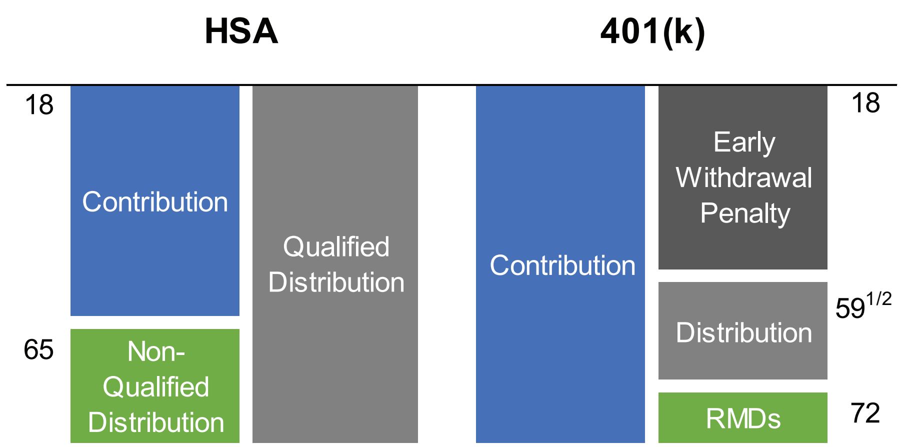
HSAs bring unique value that blends the tax benefits of traditional health accounts (FSAs, HRAs, MSAs) with the investment capabilities of retirement accounts like IRAs and 401(k)s. The result is a benefit that can be used throughout the entire life of the account holder to fund a variety of health expenses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

Valuable HSA Facts

- Individually owned
- Can be funded until owner enrolls in Medicare (or another ineligible health plan)
- Post-age 65 withdrawals can be used for non-medical expenses penalty-free (income taxes will apply however)

Due to their flexibility, HSAs can help bridge the gap between retirement and healthcare savings needs.

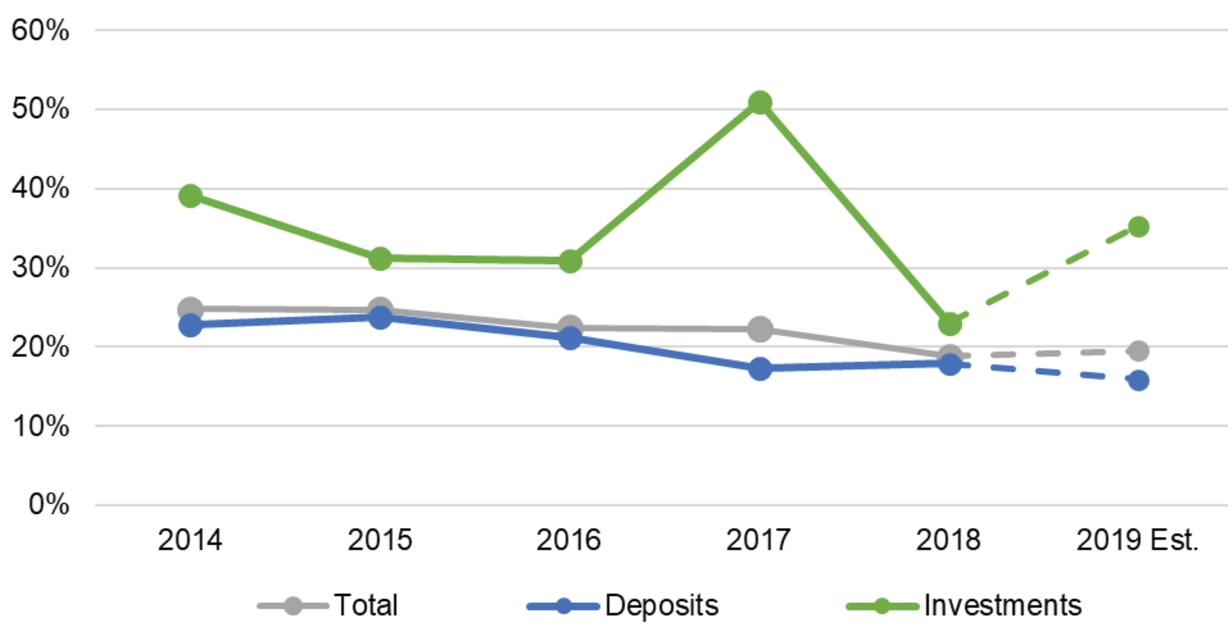
Figure 2: Age Milestones & HSA as a Lifetime Vehicle



Source: Devenir

According to Devenir Research, a little over 4% (roughly 1 million) of HSA account holders currently take advantage of the investment capabilities of HSAs[2]. While the segment of accounts investing remains relatively small, HSA investment assets have grown rapidly in recent years, owing both to market gains and contributions.

Figure 3: HSA Asset Growth



Source: Devenir Year-End & Midyear HSA Research Reports 2014-2019

Menu Design

Offering a menu of mutual funds has become standard practice across the benefits continuum, including 401(k), 403(b), 529, and HSAs. Before this was the case (largely pre-dating the HSA market) investment plans in these accounts offered larger mutual fund windows with little emphasis placed on fund selection and scope, forcing 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.

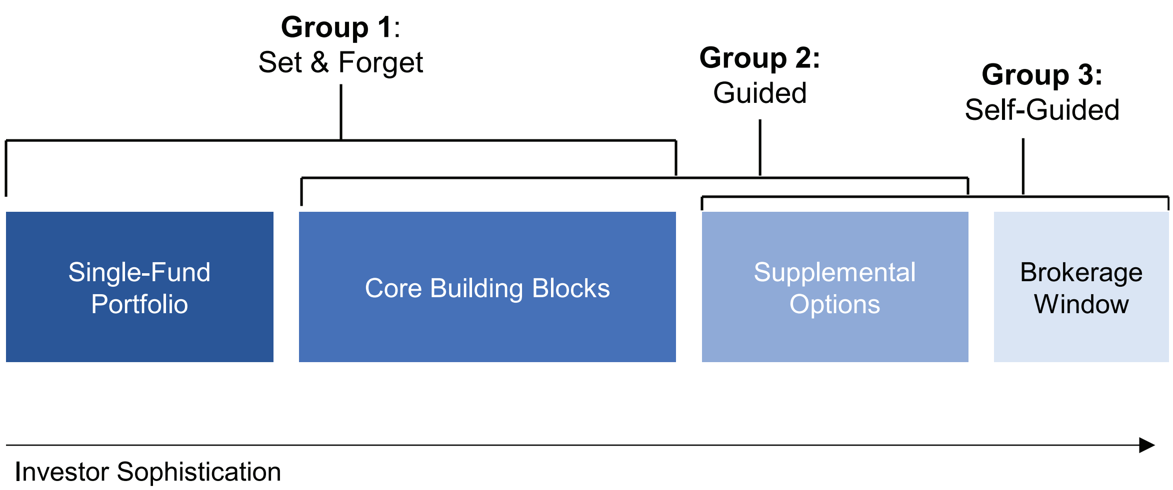
Most investors fall into one of three buckets in terms of their utilization of available investment options (see figure 4(a) below). An individual's specific bucket generally depends on two factors: past investment experience and ability/desire to allocate time towards building a portfolio.

Figure 4: Modern Menu Design Framework

4(a) Investor Categories

	Group 1: Set & Forget	Group 2: Guided	Group 3: Self-Guided
Benefits From:	Simplification	Portfolio Recommendations	Potential Outperformance
Sensitive To:	Complexity	Costs	Insufficient Choice

4(b) Menu Impacts



Source: Devenir, for illustrative purposes only

Over time, investment menus have become increasingly tailored to the users of the account (Ex. Target-date funds in 401(k) plans). However, simply replicating the typical 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, and
- Product mix, including:
    - Objective-based fund options and
    - Active vs. passive funds.

A simplified approach to each of the above decisions can be to relate them to common objectives providers have when offering menus.

Figure 5: Common Menu Design Objectives

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

● Primary driver of objective

Source: Devenir, for illustrative purposes only

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

Menu Size

The case for limiting the number of funds on a menu often stems from research in retirement plans, some of which has shown investors may respond to overly large investment menus through lower participation rates, or greater acceptance of the default investment option[3]. However, we believe HSAs have the ability to offer a reasonably more sophisticated menu for several reasons 1) HSA providers do not auto-enroll participants into the investment account - so account holders have to take action to invest, which may lower default utilization, 2) HSA account holders have been shown to exhibit high levels of consumerism (according to Alegeus, consumers enrolled in HSAs are more fluent, engaged, and make savvier health and financial decisions than the general public[4]) meaning HSA investors are potentially more capable of navigating investments, 3) HSAs do not offer a 'QDIA" in the 401(k) sense as defaults are often set to money market funds, however money market investments may still produce a more favorable outcome than leaving balances in cash as HSA deposit rates remain low, 4) HSAs are less likely to be the first investing experience for participants (most HSAs are workplace benefits and thus participants often have access to retirement benefits).

The question remains, given these factors and their potential effect of supporting more sophisticated investment menus, are smaller or larger menus more effective in improving HSA investor outcomes?

Potential benefits of smaller menus:

- May realize quicker reduction in plan costs through share class enhancements
- Lower utilization of the default investment
- Simplification

Potential benefits of larger menus:

- Ability to create higher quality and potentially higher returning portfolios
- Greater selection of product types (active/passive, target-date etc.)
- Appeals to a wider range of investor sophistication and objectives

The short answer is, it depends. The range of funds that limits default utilization, minimizes plan costs, and allows investors to build quality portfolios will vary based on a number of factors including, but not limited to:

- Client objectives,
- Financial literacy of the participant population,
- User experience of technology platform (specifically, how the menu is presented to the account holder),
- And marketplace demand (investors may be more successful using products they understand) among others.

Technology platforms 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, such as portfolio recommendations and periodic rebalancing. This can help to reduce indecision and promote diversification, ultimately allowing menus to offer more funds as the investor is guided through the additional options.

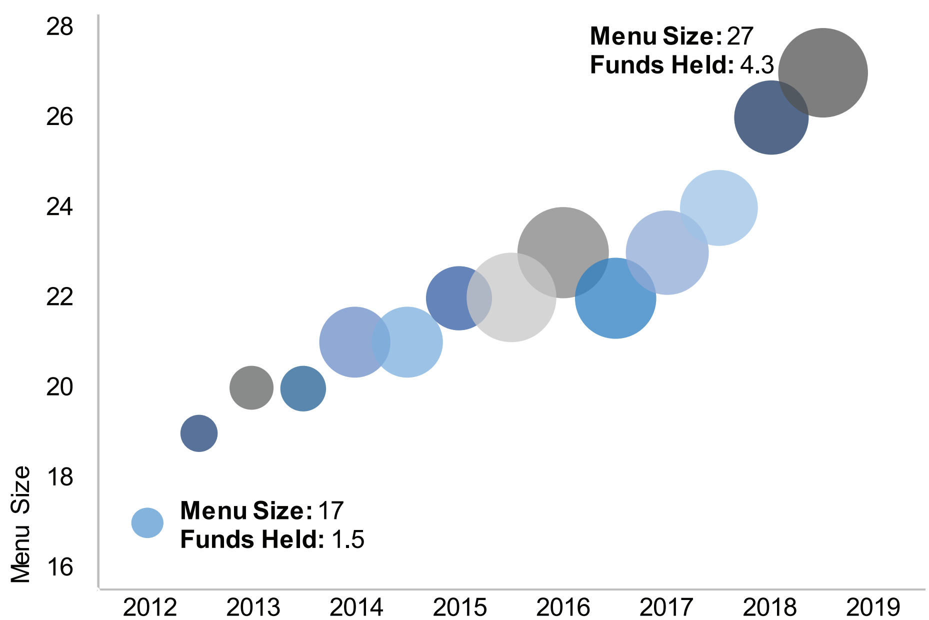
Market Context

Recent trends in the marketplace show the relationship between menu size and the number of funds held by investors has generally been positively correlated in HSAs. Fund line-ups have expanded over time, and investors have nearly tripled their average holdings from 1.5 funds in 2012 to 4.3 funds mid-way through 2019.

Figure 6: Average HSA Menu Size & Funds Held by Investors

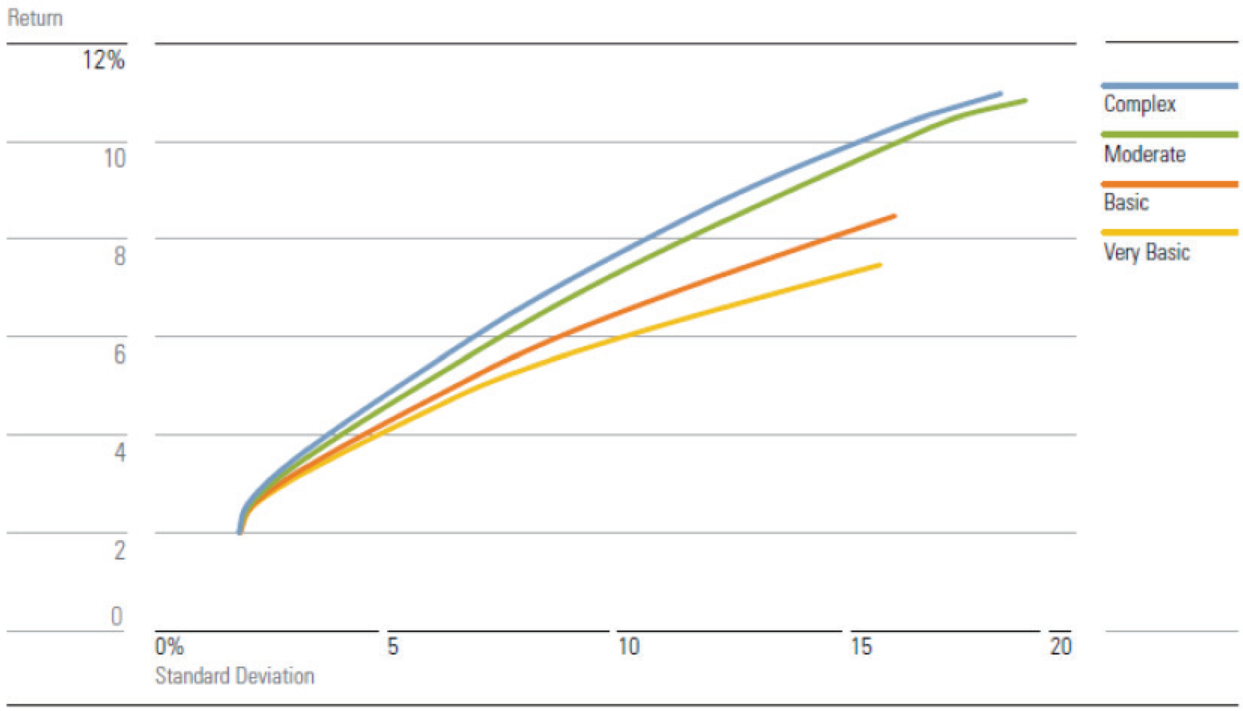
Source: Devenir Research

Note: Bubble size reflects number of funds held, semi-annual data 12/31/2012 – 6/30/2019



The greater average number of holdings suggests investors are taking advantage of the additional investment options and asset classes. Such trends have been shown to lead to higher quality portfolios and outperformance[5]. In addition, the net result of more complex menus may be "higher returns for each unit of risk" according to Morningstar®.

Figure 7: Impact of Core Menu Complexity on the Efficient Frontier



Source: Morningstar®, for illustrative purposes only

Considering the various deciding factors, a range of menu sizes may make sense for an HSA. The most appealing menus will strike a balance between limiting investor 'analysis paralysis' associated with the already cumbersome topic of health benefits, while offering the complexity to allow investors to create powerful portfolios.

Asset Class Selection

Asset class selection is a key component in 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, an advisor 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.

Below are two real world examples of potential scenarios where investors may benefit from a wider selection of asset classes to choose from:

Figure 8: More Choice May Help HSA Investors

Scenario:	Need:	Potential Asset Classes:
Investor with recurring qualified expenses as a result of a common medical condition	Higher level of investment income to cover recurring expenses	International Bond, Core-Plus Bond, High-Yield, Equity-Income
Young investor with a family history of heart disease and a higher likelihood of lump sum costs later in life	While the investor is currently healthy, they may look for additional diversifier asset classes to reduce the risk of not having saved enough for a higher likelihood of acute medical costs.	Real Estate, Emerging Markets, International Small/Mid Cap, International Bond

Source: Devenir, for illustrative purposes only

HSA menus may take the retirement plan core menu framework and expand on it to account for this potentially wider range of 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 a given degree of "plus" or "nice to have" asset classes below. As mentioned earlier, "plus" asset classes offer the opportunity to build more sophisticated portfolios that can be tailored to a wider range of investment objectives.

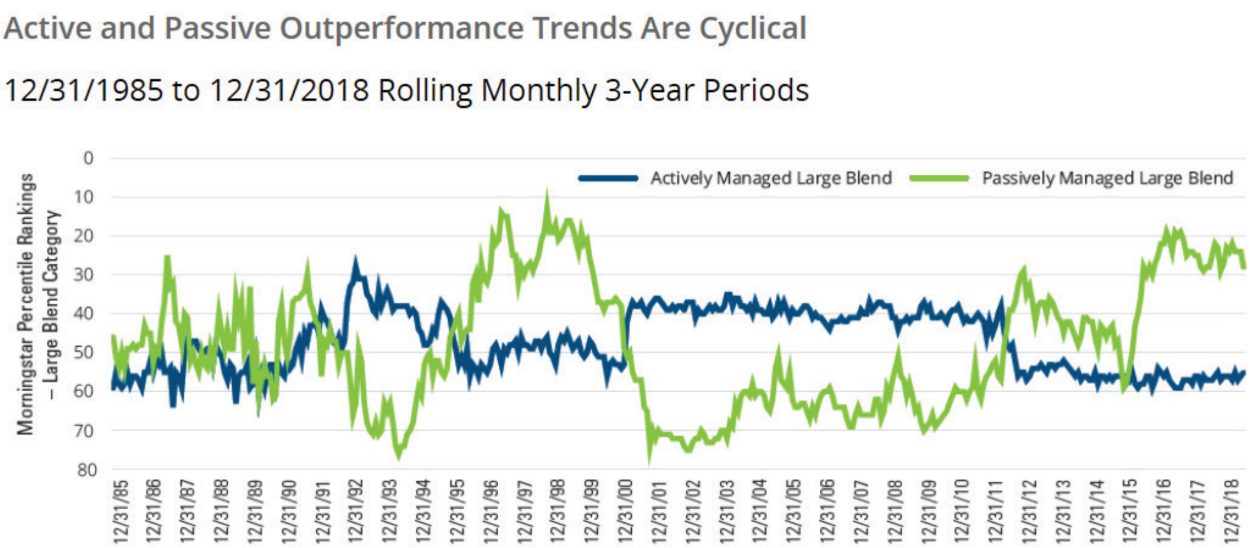
Figure 9: HSA Menu Asset Class Prioritization

Source: Devenir

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 2008, 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[6]. Considering the historically cyclical relationship, we believe investors should have an option to avoid a black and white decision between an entirely active or passive portfolio.

Figure 10: Cyclical Nature of Active / Passive Outperformance



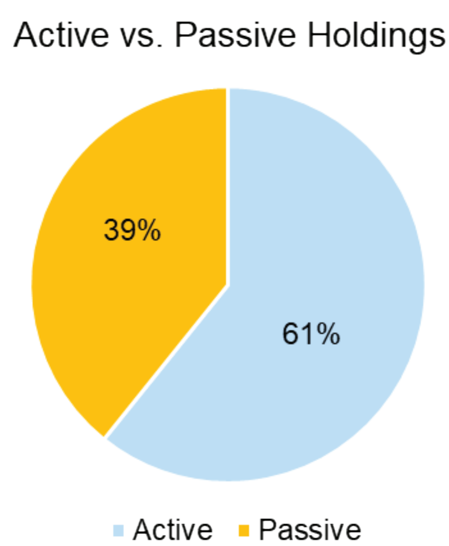
Source: Hartford Funds[6]

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, domestic small cap, and fixed-income. Morningstar® research also points to skilled active fixed-income managers having a higher likelihood of outperforming their passive peers during certain market environments[7].

As investors have become more cost-sensitive in recent years, most menus have adapted to offer index options. Passive funds do however pose their own risks. They do not have the same flexibility as active funds and their portfolios can drift over time as a result of secular trends or potential “bubbles” in the underlying index. In addition, passive strategies may create portfolios that emphasize past performance by focusing on the largest companies. Alternative options may include passive funds that focus on fundamental factors which can add value through differentiated portfolios and the potential for outperformance.

A 6/30/2019 snapshot of the HSA market shows that on an asset weighted basis, HSA investors currently hold more active than passive dollars.

Figure 11: HSA Active / Passive Investment Mix (asset weighted)



Source: 2019 Midyear Devenir HSA Research Report

Product Mix: Objective-Based Funds

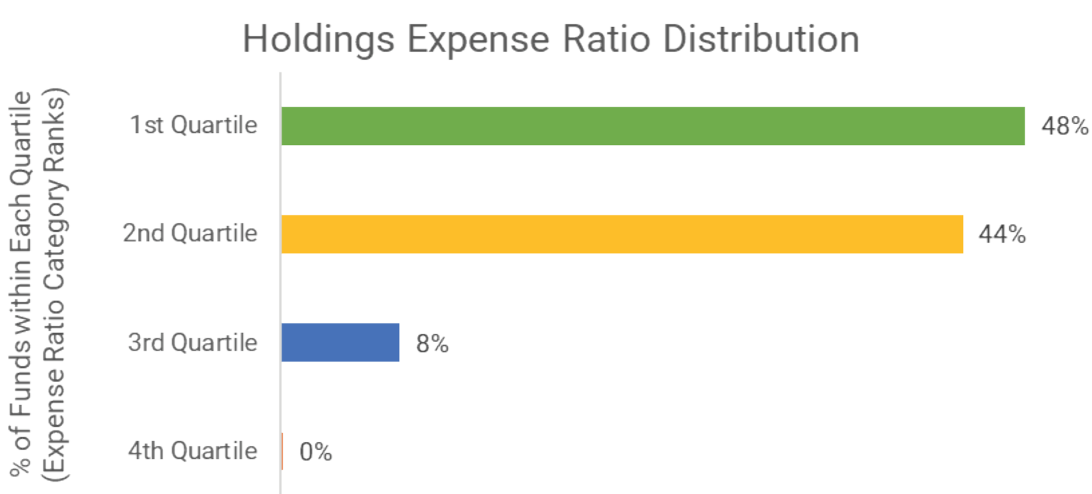
Given the greater variation in use cases for HSAs, it may make sense to include objective-based fund options that simplify the portfolio decision process for investors with straightforward investment goals. Our asset class prioritization places Target-Risk/Lifestyle funds in the “Need to Have” category 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.

As an alternative to Target-Date funds, investors looking for a simplified approach to investing may be able to utilize objective-based allocation or Target-Risk funds. Offering an assortment of these funds provides a spectrum of risk levels for investors to choose from. Target-Risk funds allow investors to easily align their portfolio risk with their own health or general preferences with a more hands-off approach.

Note on Cost

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. The HSA market offers relatively inexpensive funds compared to fund category peers. The below table shows the gross expense ratio (as stated in the fund’s prospectus) breakdown of funds offered in the HSA market by quartile rank within peer group.

Figure 12: HSA Market Expense Ratio Distribution



Note: Distribution of mutual funds held in the HSA marketplace

Source: 2019 Midyear Devenir HSA Research Report, Devenir calculations of Morningstar® data

Closing Comments

The practices outlined in this Viewpoint stem from observations over Devenir's 16 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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