The Advisor Introduction to Health Savings Accounts

By James LaFleur, CIMA®, CMA, CAIA®

Health savings accounts (HSAs) are being used in two ways these days—like checking accounts for medical expenses and like investment accounts for retirement. This article addresses the investment account aspect of HSAs. Based on industry data, roughly half of funds contributed to HSAs are utilized in a given calendar year for medical expenses, and investing what’s left in these accounts for the long term is becoming more common.

Investments held in HSAs received little attention from regulators until the new Department of Labor fiduciary rule was issued in April 2016. The rule, which targets advisors and brokers rather than plan sponsors, includes language that groups HSAs with other retirement savings. In short, advisors who advise on HSAs now are fiducaries.

Which leads to our question: How do advisors advise these plans?

Brief History and Background of HSAs

HSAs came into existence with the signing of the Medicare Prescription Drug, Improvement, and Modernization Act, enacted in 2003. HSAs allow taxpayers enrolled in high-deductible healthcare plans to set aside pre-tax earnings to pay for or reimburse themselves for a multitude of incurred medical expenses, and the Internal Revenue Service sets a limit on their maximum annual out-of-pocket expenses within the associated high-deductible plan. Tax-free distributions from HSAs cannot be used to pay for health insurance premiums, but they can be used to pay for qualified long-term care insurance premiums and Medicare premiums.

HSA proponents claim that HSAs are an efficient way to address rising healthcare costs, allowing patients to access the care they need and reducing the bother associated with seeking reimbursement through an insurance company. HSAs have similar structures and contribution limits to those of Roth individual retirement accounts (IRAs). Like IRAs, HSAs are portable and feature annual contribution limits. For 2016, participants younger than age 55 may contribute up to $3,500 ($3,400 for 2017) for an individual and up to $6,750 (no change for 2017) for a family. Once HSA holders turn 55, a catch-up provision allows them to save an additional $1,000 per year.

HSAs are federally triple tax-advantaged, although several states levy taxes for contributions, earnings, and/or distributions. Regardless, the federal-level triple tax effect makes these assets a powerful investment for the following reasons:

- Pre-tax contributions result in a reduction of taxable income.
- Earnings on the account compound tax-free, similar to IRA/401(k) assets.
- Distributions used for qualified medical expenses from the account are not subject to taxation.
- In retirement, distributions can be used for non-medical expenses and are taxed as ordinary income with no penalties. Distributions also can continue to be used tax-free for medical expenses through retirement.

HSAs: Part of the Retirement Solution

Until recently, HSAs have been regarded as similar to flexible spending accounts and used as checking accounts for medical expenses. Participants used the balances in a short- or intermediate-time period to pay for medical costs. However, in part because the account balances roll over from year to year—unlike a flexible spending account—a growing number of participants now are utilizing the accounts as an additional form of long-term savings. According to the Employee Benefits Research Institute, the average HSA deposit-account balance was $1,933 at the end of 2014, up from $1,408 at the beginning of the year.1 Devenir Research reported that the average investment account holder had an average total balance of $14,035 (deposit and investment account) at year-end 2015.2

Despite the increasing popularity of HSAs, the investment component of these long-term savings requires some development. Since they were introduced in 2003, health savings accounts have provided investment choices (mutual funds) to participants. According to Devenir Research, only about 14 percent of HSAs had investment assets (mutual funds) at the end of 2015, suggesting a significant opportunity for investment accounts to grow and participants to take advantage of this benefit.3

If more participants are using HSAs—and using them for long-term savings—shouldn’t advisors be more knowledgeable about the available investment options?
A number of recent studies have documented healthcare costs as one of the biggest concerns that employees face as they approach retirement. To address this concern, the cost of living should be combined with the cost of health care in retirement, leading to the inclusion of HSAs as one of the pillars of retirement savings, as shown in table 1.

HSAs differ from other types of retirement savings programs because future expenses may be hard to anticipate. Medical costs and life events, such as marriage, children, or job changes that cause a participant to switch from an HSA-compatible high-deductible healthcare plan to a lower-deductible traditional plan such as a preferred provider organization, health maintenance organization, etc., are nearly impossible to predict.

For illustrative purposes, the following two scenarios show the potential value of HSA investments to participants.

Using very simplified assumptions, figure 1 shows the value added of health savings accounts for today’s employee during the accumulation phase. Based on a return of 7 percent and about one-half of the annual HSA contribution maximum of $3,350 for 2016 (i.e., $1,750) rolled over year to year (i.e., not spent on health care), an HSA at retirement will have grown to more than $450,000.

When we use slightly different assumptions, however, such as a major chronic illness with the high cost of prescription drugs that requires an HSA distribution of $2,000 per year starting at age 45, a reduction in defined contribution plan (DC) contributions to $10,000, and a halt to HSA contributions after 20 years, we calculate a new value of about $190,000, as seen in figure 2.

Advisors should anticipate this scenario by tailoring investment policy statements to allow for rather quick and drastic asset allocation changes. In the case of the unfortunate major chronic illness, the individual’s HSA may need to be moved quickly to cash or a principal-protecting option for liquidity and reducing risk, because funds may need to be distributed at an above-average rate. Broad asset allocation ranges also may be required.

In both examples, the HSA savings potential is powerful, provided participants start contributing early.

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### Table 1: Pillars of Retirement Savings

<table>
<thead>
<tr>
<th>Social Security/Medicare</th>
<th>Employer Programs</th>
<th>Personal (outside investments)</th>
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<tbody>
<tr>
<td>Social Security/Medicare</td>
<td>Defined benefit</td>
<td>IRA</td>
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<td>Social Security/Medicare</td>
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<td>Social Security/Medicare</td>
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<td>Social Security/Medicare</td>
<td>Retiree medical insurance</td>
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<td>Social Security/Medicare</td>
<td>HSAs (through employer programs)</td>
<td>Real estate (home equity)</td>
</tr>
<tr>
<td>Social Security/Medicare</td>
<td>HSAs (set up individually)</td>
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</tbody>
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Note: HSAs are not required to be connected to an employer. An individual needs to meet the requirement of having a high-deductible health plan. Individuals have the option of opening HSAs with third parties not connected to their payroll accounts.

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![Figure 1: HSA Value at Retirement (assuming 7-percent return, half of annual HSA maximum contribution, rolled over year to year)](image1)

- **Total Contribution**
- **DC Balance**
- **Health Savings Account Balance** = ~$465,000

![Figure 2: HSA Value at Retirement (assuming quick and drastic asset allocation changes, e.g., a major chronic illness with meaningful outflows)](image2)

- **Total Contribution**
- **DC Balance**
- **Health Savings Account Balance** = ~$190,000

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**Fees**
The investment industry is seeking to provide enhanced transparency to investors and participants, but the fees associated with a particular HSA account remain opaque. HSA fee structures for the investments offered to employees often include both an account fee and some type of revenue sharing within the investment products offered. The result of this structure is that the investment fees associated with HSA accounts often are significantly higher than similar investments offered through defined contribution plans. Considering the negative impact fees can have on returns, advisors should review fees carefully.

After reviewing several HSA lineups, it appears that most programs include higher-priced mutual funds than their DC counterparts. However, some lower-cost HSA providers are in the marketplace today. For instance, HSAs may be invested in A share classes that could be 10 to 30 basis points higher in cost than the institutional share classes often found in DC plans, which again undercut investment returns.

Table 2 shows mutual funds offered within a large-employer HSA program relative to Mercer’s universe medians for institutional share classes. Fees are higher than the institutional share class median fees in almost every asset class. The difference in the average expense ratio for the sample program and the median is 12 basis points.

**Fund Lineup Structure**
Most investment fund lineups offered to employees through HSAs have been determined by the providers. It appears that relatively little analysis is conducted to determine whether or not the investment structure within the plan will best meet the needs of participants, i.e., expected healthcare costs and use of the HSA as a checking account versus as a long-term investment account haven’t been accounted for.

Should advisors become actively involved in structuring the investment lineup within the HSA offering? To answer this question, advisors should consider the following:

- Target-date and income-based funds may be appropriate for your participants because they serve two different purposes for long-term savings in premixed options. Target-date funds are appropriate for a majority of healthy individuals who are using HSAs as long-term savings vehicles. The glide path provides participants with a professionally managed asset allocation that becomes more conservative as the employee nears retirement, essentially...

<table>
<thead>
<tr>
<th>Fund Lineup Structure</th>
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<th>Long-Term Investment</th>
<th>Long-Term Investment</th>
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<td>Cash</td>
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<tr>
<td>Tier 1A</td>
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<td>Cash Component</td>
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<td>Objective-based</td>
<td>Tier 2A</td>
<td>Tier 2B</td>
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<tr>
<td>Target-Date Funds</td>
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<td>Income-Based Funds or Capital Preservation</td>
<td>Active &amp; Passive Core Options</td>
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moving in line with the individual’s health profile.
- Income-based funds (including both fixed income and some equities) are appropriate for those individuals who would like to reduce risk exposure with a more conservative option, because they may have a better indication of their healthcare costs.
- The cash portfolio within the HSA could be a fitting place for some of the new innovations coming to DC plans for principal protection and inflation sensitivity because these assets commonly are used for the checking account portion of the portfolio.
- The current investment lineups look like DC plans of the past—too many funds, with considerable overlap, potentially resulting in poor investment decisions made by participants due to anxiety and confusion.

Figure 3 shows a design that takes the above points into consideration.

Conclusion
HSAs are a powerful and growing element of the U.S. financial landscape. More employers are offering this benefit and more people are using high-deductible healthcare options. To help clients optimize this benefit, however, advisors need to understand HSAs, how they can be used in the short and the long terms, and the investment lineups and fees that accompany them. Advisors who are at the forefront of addressing these issues will be better positioned to help clients maximize both the health and wealth benefits of HSAs and provide for secure retirement.

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Endnotes