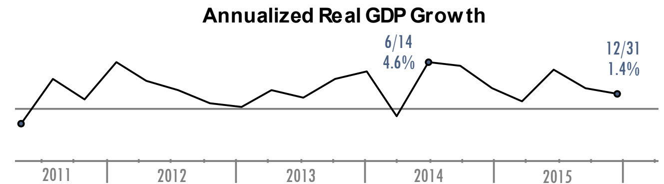
Bellwether
CONSULTING

Your Quarterly Update on the Financial Markets
March 31, 2016

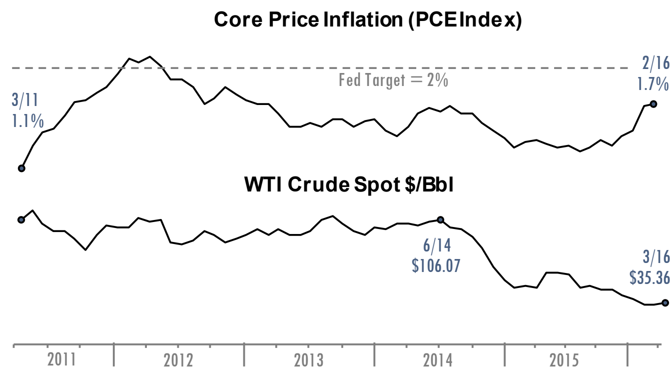
MARKET Recap

The US Economy: "Doves to the Rescue"



US economic growth continued to slow in Q4, albeit at a slower trend, settling in at a 1.4% annualized pace. Personal consumption expenditures slowed modestly leading to reduced imports, but exports fell more quickly yielding a net negative effect on the gross domestic product. Nonresidential fixed investment declined for a second straight quarter, as expectations of falling corporate profits were realized in the fourth quarter.

An undertone of concern about softening business conditions combined with wrong-footed policy action on the part of the Fed set the stage for dramatic market action and a re-test of the central bank's plan. For the doves, Chairman Yellen's semi-annual monetary policy report to Congress on February 10th did not disappoint. While confirming that the long-term expected path for interest rates is modestly higher, the Fed is in no hurry. Prominently featured in her discussion were concerns over global economic conditions, lackluster global growth, and the strengthening US dollar.

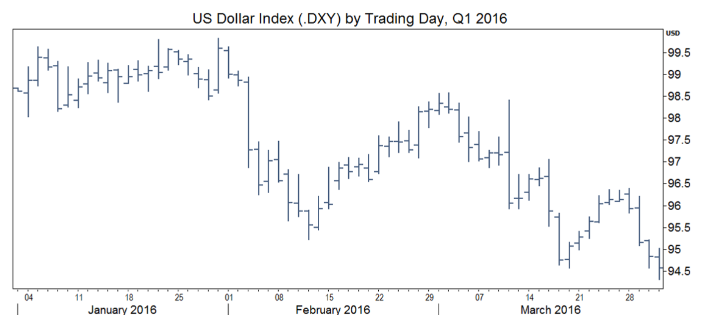


Inconveniently, these sentiments coincide with the long-awaited emergence of consumer price inflation. Core prices, measured by the price index of personal consumption expenditures (PCE) less food and energy, rose 1.7% year over year as of February. The increase in the Fed's favorite inflation measurement was clearly not a side effect of rising materials prices, which were flat to lower through February.

Rumors of an even kinder, even gentler Fed moved the markets dramatically, starting with currencies. The US dollar sold off sharply, starting a week before Ms. Yellen's testimony. Since its peak in November 2015 the US Dollar Index, which measures the buck against a basket of other major currencies, fell 5.6%. Battered US equites recovered their losses for the most part. Even the poor, lost souls sloughing through the ruined wastelands of the energy markets had some reason to cheer in March. Only the insurers, banks, and pension sponsors lost in the March madness, but by now they're used to the yield curve's lash.

This largely establishes the short-term view – slow growth and accommodative monetary policy placing downward pressure on the US dollar. Even if inflation modestly overshoots the Fed's 2% target level, at this time policymakers are more concerned with supporting growth than stabilizing prices.

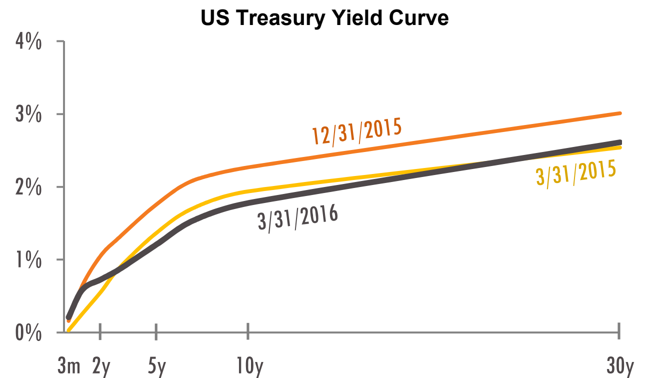
How sturdy is this short-term view? Hardly at all, because the US dollar remains the biggest shrimp in the sea. The rest of the world continues to ease at an equal or faster pace than the US. Europe faces turmoil over the Brexit vote, immigration policy, and the ongoing terror threat. A weak commodity rally does nothing to staunch the bleeding balance sheets in Latin America and the Middle East. China is tiptoeing through a credit minefield – deftly so far, but for how much longer? In a world full of tension, the dollar remains the safe best haven.



The US can neither afford to tighten nor loosen much without severe consequences, and as it stands, the prevailing winds support the dollar. Short it at your peril!

The US Bond Market

Broad de-risking in the financial markets bolstered prices of US Treasury bonds as a flight to quality and expectations of further rate hike delays pushed rates lower and flatter beyond T-Bills. Fed guidance remains discounted, with fed funds futures pricing in none to one rate hikes this year. The 10-year benchmark rate, which ended the year at 2.27%, fell as low as 1.53% intraday and closed the first quarter at 1.78%. Under this environment, fixed income investment posted strong returns across the board. Long-dated US Treasuries led the way; munis continued to underperform the broader bond market. AAA and AA spreads narrowed quarter-over-quarter by a few basis points. Lower-quality issues lagged and were subject to greater volatility as the broader market priced its way into, and then out of, global recession.

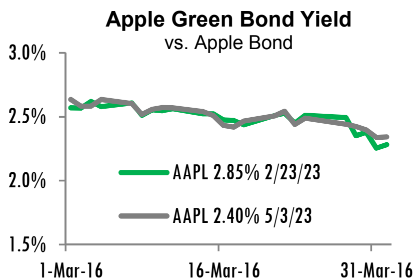


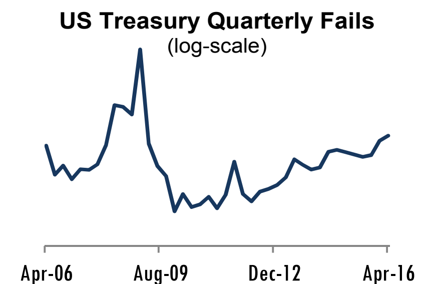
US Bond Index Returns

Barcap Indices	1Q16
Aggregate	3.03%
Interm. Gov't	2.28%
Long Gov't	8.06%
TIPS	4.46%
Municipal	1.67%
Interm. Credit	2.70%
Long Credit	6.82%
High Yield	3.35%
MBS	1.98%

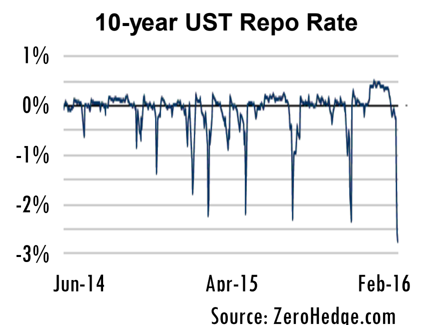
In the first half of the quarter, high yield spreads continued a dramatic climb that began towards the end of 2Q15. Reaching a high of 8.87% on February 11th, spreads on non-investment grade credit turned to a strong rally through the rest of February and first three weeks of March to close at 7.05% - up 10 basis points for the quarter (BAML HY Master II). Accordingly, high yield issuance was weak in January and February, totaling $16.4 billion. A March respite spurred $18.8 billion in new issues for a cumulative $35.2 billion, well-short of the $89.8 billion in 1Q15. Investment-grade issuance was robust at $359.4 billion versus $349.4 billion the same period last year.

In February, Apple and New York's Metropolitan Transportation Authority issued their first Green Bonds, adding to a growing trend toward socially responsible investing (SRI). Green Bonds have gained traction in global fixed income markets as climate change, sustainability, working conditions, and pollution garner increasing mindshare. Apple's $1.5 billion of 2.85% 7-year Green Bonds are a prominent, but incremental advance in the popularity of this fairly novel security, which saw $42 billion of global issuance in 2015. Fundamentally, Green Bonds are quite identical to their socially indifferent brethren and, in the US and most other countries, not subject to additional legal contraints or potential penalties. This presents a danger of *green-washing* – trumped-up sustainability claims. However, motivation to abuse the classification is limited as it does not seem to attach a premium. Also, most issues are reviewed or certified by an independent third party. Green Bond Principles drafted by BAML, Citi, Credit Agricole, and JPMorgan form the basis for voluntary guidelines in Green Bond issuance; alternatively, the Climate Bond Initiative has released its own framework for a "Climate Bond Certified" stamp of approval. Third party certfiers include big 4 accounting firms KPMG and Ernst & Young and several SRI institutions – notably Sustainalytics, Apple's Green Bond certifier. Still, lack of regulation, standardization, and transparency currently limit the usefulness and appeal of the Green Bond label. Through global discussion and cooperation efforts like the UN Conference on Climate Change (COP21) and subsequent Paris Agreement (upcoming), it may be a matter of time before the hurdles facing green bonds are cleared and issuance truly takes off.





Also trending higher are US Treasury fails – when a seller fails to deliver the issue. Since 2009, failure to deliver Treasuries has been subject to a fails charge of 3% less the lower bound of the FOMC target rate, floored at 0%. With the target rate at 0.25% to 0.50%, the fails charge sits at 2.75% (annualized). This was a neccessary move to keep the repo market functioning as the overnight rate fell to 0%. It has always been common for the liquid key-rate Treasuries to trade *special*, or at a premium, in repo markets in the days or weeks around their auction. And, the 10-year has bumped up against (and through) the fails charge limit during the taper tantrum of June 2013 and again the following June. For the first time since implementation, the fails charge has become a frequent limiting factor as repo rates on the current 10-year repeatedly spike towards -2.75%. In other words, traders are



paying an annualized rate of 2.75% to *loan out* cash in exchange for receiving the current 10-year as collateral. Like cash, Treasuries can be borrowed and loaned many times over in what is termed *rehypothecation*, but not without limit. Yet, fails are far below levels indicating the repo market may seize up, as in 2008, when those holding US Treasuries stopped lending, or repoing, them out as counterparty risk skyrocketed. Today, demand outpacing supply more likely indicates short-sellers, hedge funds particulalry, driving demand for borrowing the 10-year. Other current issues on special are financing barely into negative territory, but the 10-year could be the canary in the coal mine or the tip of the iceberg – take your pick. Or, the confluence of a shorter outstanding supply of the current 10-year versus the old 10-year note (about two-thirds) and strong corporate bond buying (which Treasuries can serve to hedge) may point to a transient effect. If rates continue to rise, short-covering could add fuel to flame. And, with dealers less ready and willing to provide liquidity post-2008, further pain may await hedge funds and other institutional investors positioned ahead of the rise in rates, invevitable, but unpredictable as it is.

The US Stock Market

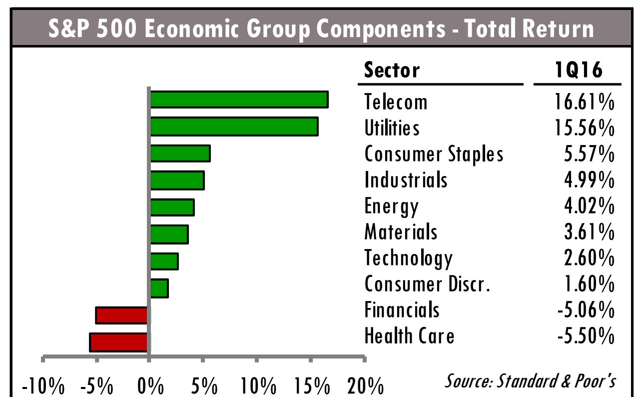
Despite a wild ride during the first two months of 2016, the quarter ended not so differently from where it began for US equities. Volatility, as measured by the CBOE Volatility Index (VIX), increased significantly during Q1 as the average daily index price rose to 23.10 compared to 17.03 in 4Q15 and the trailing 10-year average of 20.63. Drivers of elevated volatility included a wide array of issues: concerns over a potential US recession, central bank divergence, falling oil prices, and a decline (-2.9%) in year-over-year Q4 corporate earnings along with increased negative forward guidance. This led to a drop of -11.29% in the Russell 3000 index through February 11. However, the end of February and March provided much needed relief to badly damaged stock portfolios as US economic data improved, the Federal Reserve held overnight borrowing rates steady, and oil prices rebounded on talks of output curbs from the largest producers.

US Stock Indices - Total Returns

Large-cap Stocks	1Q16	Mid-cap Stocks	1Q16
S&P 500	1.35%	S&P Midcap 400	3.78%
Russell 1000	1.17%	Russell Midcap	2.24%
Growth	0.74%	Growth	0.58%
Value	1.64%	Value	3.92%
Broad Markets		**Small-cap Stocks**	
Russell 3000	0.97%	S&P Smallcap 600	2.66%
Growth	0.34%	Russell 2000	-1.52%
Value	1.64%	Growth	-4.68%
		Value	1.70%

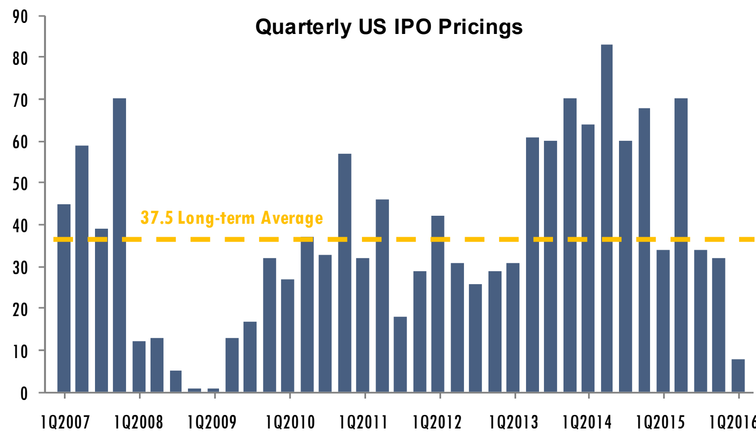
Interestingly, there was a significant difference in smallcap performance (4.18%) between the S&P 600 and the Russell 2000. The disparity is likely due to S&P's requirement that constituents have 4 quarters of profitability before inclusion in the index. This screening bias drives a smaller allocation to healthcare, the worst-performing sector in Q1, as new companies often have little to no revenue due to research and development costs and the lengthy drug approval process. Additionally, it creates a quality bias among the constituent base which can benefit from periods where investors favor companies with current profitability over those with expected profitability in the future. Such was the case this quarter as growth stocks underperformed their value counterparts for the first quarter since 4Q14. Investors have preferred high growth stocks, most notably Facebook, Amazon, Netflix, and Google which are being referred to collectively as the "FANGs". This spread between value and growth becomes much more pronounced when moving down in market capitalization where growth's multi-year outperformance has been significantly greater.

At the sector level, top performers included telecommunications and utilities, benefiting from their defensive nature and falling interest rates. The high-yielding stocks are often viewed as a proxy for bonds and tend to be inversely correlated to interest rate changes. Additionally, their stable, and often regulated, business lines tend to provide greater protection from market sell-offs. While performance for the two sectors outstripped the next best by almost 3x, their impact on the broader market was minimal due to their constituting only 6.2% of the S&P 500 index as of quarter-end.



Healthcare underperformed across all market capitalization segments as concerns amplified around lofty valuations, drug pricing, and slowing growth in both biotechnology and pharmaceutical companies. Reports attributed half the Nasdaq's Q1 decline to just 10 companies – 7 of which were biotech or healthcare names (although Amazon topped that list). The global sell-off of banks driven by negative interest rates and energy exposure had a spillover effect into the US this quarter, ultimately driving underperformance for large-cap financials. The financial sector fared better among mid- and small-cap stocks due to greater exposures to REITs, which benefitted from falling rates. Conversely, the energy sector was a noteworthy underperformer among mid- and small-caps, but outperformed in the large-cap space. Larger integrated oil and gas firms with stronger, cleaner balance sheets were better able

to weather low oil prices than their smaller counterparts who typically operate on greater leverage and have limited geographic and business line diversification.



Activity in initial public offerings (IPOs), which has been below average since volatility picked up greatly back in August, fell this quarter to its lowest level since 2009. The pullback is almost certainly the effect of a combination of increased volatility, stock market losses, and unsustainably high activity between 2013 and 2014. Going forward, lower expectations of US equity performance with the likelihood of increased volatility should lead to subdued IPO activity for 2016. This result will likely be magnified if growth-style investing remains under pressure, as the majority of IPO activity comes from sectors such as healthcare, technology, and consumer discretionary.

Overseas Markets

Foreign markets continued to see an increased level of volatility during Q1. The year started on a negative trajectory, but made up lost ground in March. News out of China continued to show slowing growth, geoplolitcial events spiked up, and the ECB threw a Hail Mary to try to spur expansion. Negative interest rates took hold in Europe and Japan, evoking investor concern. Emerging markets, particularly Latin America, remained mired in the morass of low natural resource prices and continued political corruption issues. However, a rebound in oil prices near the end of the quarter was the silver-lining that ultimately drove positive performance in the region.

Foreign Stock & Bond Indices - Total Returns

MSCI Broad Indices	**1Q16**	**Barcap Global Indices***	**1Q16**
World Index	-0.35%	Global Aggregate	5.90%
EAFE (Developed)	-3.01%	Pan-Euro	6.86%
Emerging Markets	5.71%	Asian-Pacific	10.54%
		Eurodollar	2.02%
MSCI Regions	**1Q16**	Euro-Yen	9.88%
Europe	-2.51%	Other Currencies	6.66%
Japan	-6.52%	**Unhedged*	
Pacific ex-Japan	1.81%		
Latin America	19.14%		

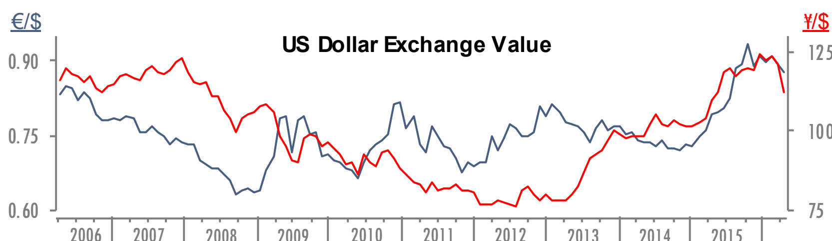
In a reversal from last quarter, the ECB announced a bigger-than-expected stimulus plan, but also signaled that policy makers aren't likely to further cut interest rates. Markets were initially jolted after the ECB cut its key interest rates and expanded the size and scope of the bank's QE program. The Bank also announced a new round of cheap, long-term loans for eurozone banks, as part of a plan to reflate an economy that continues to flirt with deflation.

The ECB plan calls for four rounds of targeted longer-term refinancing operations, or TLTROs, for banks to jump-start lending activity. The larger a bank's outstanding loan book, the bigger the loans. Initially, banks borrow at 0%, but that will drop into negative territory, as low as -0.4%, the more the bank lends. In essence, the ECB ends up paying banks to lend. Clearly, increasing lending activity is crucial to spurring and reflating the eurozone economy. The ECB also significantly expanded its bond-buying program. The decision to increase the size of its monthly purchases to €80 billion ($89.1 billion) from €60 billion wasn't a surprise. However, less widely anticipated was a decision to expand the eligible assets to include investment-grade, euro-denominated corporate bonds from outside the financial sector. It appears that the central bank is willing to take on credit risk to raise inflation to its target. Finally, the ECB cut its benchmark lending rate to 0% from 0.05% and lowered its deposit rate to -0.4% from -0.3%. The cut in the deposit rate was smaller than some economists had expected. Negative deposit rates mean banks pay the ECB to park funds overnight at the central bank. Negative interest rates have been anathema to economists and investors. While designed to fight disinflationary pressures by discouraging money hoarding, many fear negative rates do more damage than good in that they can hurt bank profitability and undercut lending activity.

Japan has encountered similar issues with negative interest rates. After the BOJ's decision in January to impose an annual 0.1% charge on some deposits held by commercial banks, there were intense debates among the members around the potential effectiveness of the policy. The move has added doubts around the BOJ's ability to expand its QE program, causing concerns among both banks and depositors. Members who were supportive of the policy pushed back at the doubters with weak economic indicators showing that it was the right decision to launch negative rates. The debate around the March meeting, in which the BOJ kept its policy on hold but lowered its overall assessment of the economy, underscored a divide among central bankers and policy experts across the globe over the virtue of negative rates.

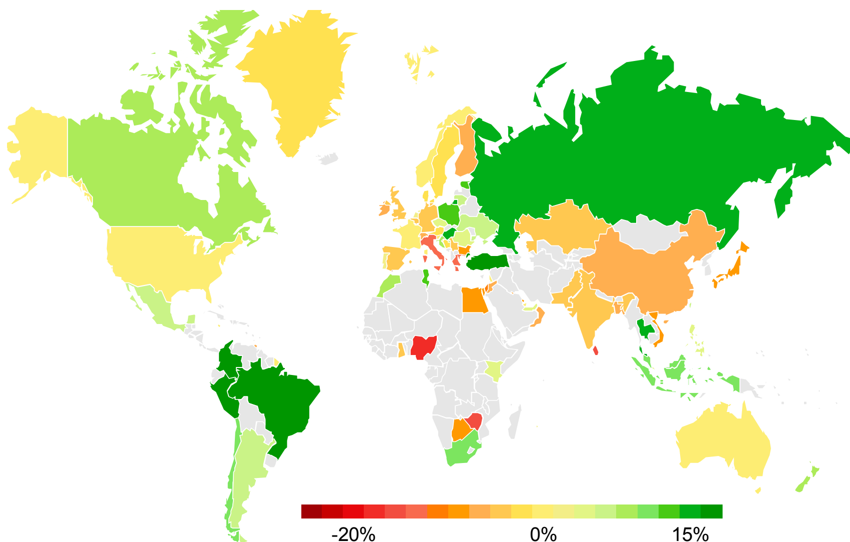
Japan's industrial output fell sharply in February according to government data, weighed down in part by a nationwide output shutdown at Toyota Motor Corp. Output dropped 6.2% from the previous month, based on data released by the Ministry of Economy, Trade and Industry. Economists had expected a drop of 6.0%. The data suggest output is weighing

on growth, adding to signs of weakness in the economy in Q1, following a 1.1% annualized contraction in real GDP in 4Q15. Still, the slide in output was likely exaggerated by Japan's largest automaker halting production at all its factories in Japan in early February. Production stopped due to a problem with parts supplies stemming from an explosion at affiliated steel maker Aichi Steel Corp. on January 8. The shutdown added to already sluggish production in Japan as companies remained cautious amid financial market turbulence during the month and uncertainty over the global economic outlook.



Near the end of the quarter the dollar weakened against nearly all of its developed and emerging market rivals after Fed Chair Janet Yellen expressed a cautious approach to raising interest rates. Investors interpreted her outlook as decidedly dovish, sending stocks higher while bond yields briefly touched one-month lows and the dollar fell. The US Dollar index, a measure of the dollar's strength against a basket of six rival currencies of its major trading partners, slipped after Yellen's comments and was on track to post its biggest quarterly percentage decline in five years, falling around 4%. Other currencies rallied against the dollar as well. The Australian dollar, which is closely correlated to commodity prices, soared to a roughly nine-month high as oil prices - which are US dollar-denominated - rose and became cheaper for holders of other currencies.

After a shaky start to the year the Chinese economy began to show some signs of improvement at the end of the first quarter. In an effort to calm investors' nerves mid-quarter, the People's Bank of China once again cut the reserve requirement ratio (RRR) by 0.5 percentage points in February to 17%, its fifth cut since February 2015. The cut is expected to release an estimated $108 billion into the financial system. The RRR cut, a higher target for the nation's fiscal deficit of 3% of GDP, along with pronouncements at China's annual legislative session in March that growth will remain a priority, helped boost investor optimism. For the first time in 8 months, China's official manufacturing purchasing managers index (PMI) was above 50, the level separating expansion from contraction. The PMI increased to 50.2 in March from 49.0 in February according to the National Bureau of Statistics. Most economists however are still skeptical about the health of the Chinese economy. Weak external demand, significant industrial overcapacity, a shrinking labor force and increasing wages all continue to weigh on China's growth rate. The economy grew at just 6.9% in 2015, its lowest annual expansion in 25 years. The country targets a growth rate between 6.5%-7% this year. Additionally, S&P cut its outlook to negative from stable for the Chinese government's credit rating on March 31st but kept its AA- rating on China's sovereign debt. The firm cited expectations for corporate and government debt metrics to worsen and concerns that China may be over-reliant on credit growth to jump-start its economy. Earlier this month, fellow ratings agency Moody's also lowered its outlook to negative on China's debt.



Despite the late rebound of oil prices in March, Latin America still faces a significant risk of recession in 2016 as uncertainty around commodity prices, a sustained slowdown in Chinese economic growth and political upheaval continue to weigh heavily on the region. The 70% drop in oil prices over the last year has reshaped Latin America's landscape. In several countries oil was contributing from 20% to 50% in government revenues and 50% to 96% of exports. Venezuela has been particularly hurt by falling crude prices. The nation's economy is expected to shrink by about 7% this year as inflation soars. iMF direct, the International Monetary Fund's global economy forum, expects inflation in Venezuela to rise to a shockingly high 720% this year following inflation of about 275% in 2015. The LatinFocus Consensus Forecast cut Latin America's GDP projections by 0.2% over the previous month and they now believe that the region will contract by 0.1% in 2016.

Argentina continues to make positive strides. Newly elected President Mauricio Macri has wasted no time; less than three months after taking office Mr. Macri has already delivered on many of his primary campaign promises. He has lifted capital and trade controls, cut inflated power subsidies and, most notably, his new government struck an historic preliminary agreement in late February with a group of the country's "holdout creditors." Argentina's payment of $4.65 billion will end up being 25% less than the holdouts were demanding, but it will still be a significant pay-off for investors who originally bought the debt at a deep discount. If the agreement is approved, Argentina will have settled with creditors who hold about 85% of the disputed debt. The country still faces significant hurdles as inflation is running at about 30%, jobs are being cut in the public sector and the country experienced a large budget deficit last year. However, the landmark debt deal along with President Macri's other pro-business reforms could help improve investor confidence and move Argentina back towards the global economic stage.

Elsewhere in South America, Brazil's political climate continued to deteriorate. Citizens gathered on March 13th in one of the largest political protests in Brazil's history, calling for the resignation of President Dilma Rousseff. Impeachment proceedings against Rousseff are in the works, providing hope to some economists that a new administration may be able to come in and turn things around. The Brazilian real has strengthened 9.9% already this year, and Brazilian stocks were up 20% in March alone, the biggest one month gain in 16 years. Impeachment, however, does not guarantee an end to recession. Unemployment in Brazil is still on the rise, jumping from 6.9% in December of 2015 to 7.6% in January of 2016. Retail sales are down, salaries are falling, auto sales dropped by 27% last year, and inflation is at around 12%. The volatile state of the economy combined with the ongoing Petrobras corruption scandal and impending presidential impeachment make the outlook for Brazil look quite uncertain.

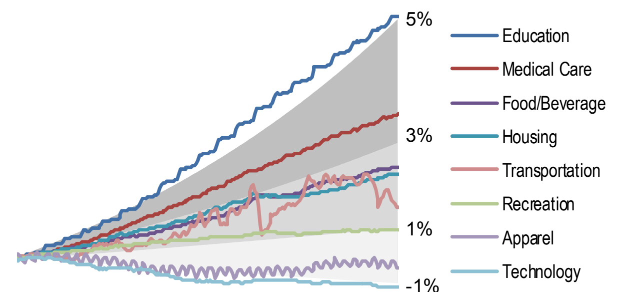
Focus On: *HSAs – A New Era of Saving*

Inflation is a critical factor to consider when formulating investment strategies and planning for retirement. In recent years, average inflation has been very low when looking at the Consumer Price Index (CPI) as a whole. For the 12 months ended February 2016, the US inflation rate was 1.0%. While the CPI is one of the most closely watched economic statistics, what is often overlooked is the variation across individual components of the index. Three sectors that tell a much different inflationary story are education, housing and medical care. An important issue for employers, increasing costs in the healthcare sector also present significant concerns for individuals as they save and pay for healthcare, both pre- and post-retirement.

As most readers have probably noticed, medical costs have been on a sharp upswing since the new millennium. Healthcare inflation has consistently outpaced the CPI since 2001, primarily due to increases in the prices of drugs, hospital care and medical devices. These cost increases show no sign of abating. According to data released by Centers for Medicare and Medicaid Services in August, spending on healthcare is expected to grow at an average annual rate of 5.8% over the next decade. As healthcare costs increase, employers are looking for new ways to manage expenses. Enter the high deductible health plan (HDHPs) - a popular and growing solution among many employers. According to Towers Watson, 75% of employers offer HDHPs, up from 53% five years ago. An HDHP is the sole option at 22% of employers, and almost half of employers plan to make an HDHP the only option available by 2018. The move to HDHPs has also been spurred by the passing of the "Cadillac Tax." While not effective until 2020, the Cadillac Tax will be an annual excise tax on employers who sponsor high-cost health plans. The tax is 40% of the cost of health insurance that exceeds $10,200 for individual coverage and $27,500 for family coverage.

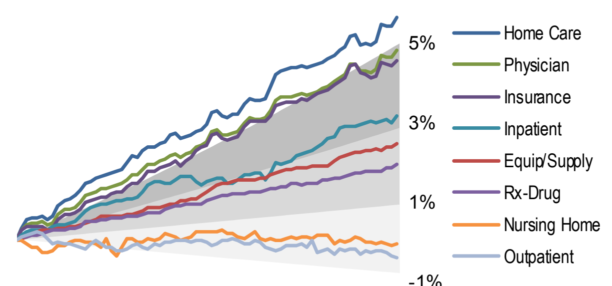
CPI Component Inflation

January 1996 - January 2016



Medical Care Select Component Inflation

January 2010 - January 2016



What is a High Deductible Health Plan?

An HDHP is a health insurance plan with higher deductibles and lower premiums than a traditional healthcare plan. For 2016, out-of-pocket maximum limits are $6,550 for self-only coverage and $13,100 for family coverage, and the minimum deductible levels are $1,300 for self-only coverage and $2,600 for family coverage. Many HDHPs feature little to no out-of-pocket costs for preventative screenings and office visits, however many patients are not aware of this. These plans typically save insurers and employers money by shifting more costs onto consumers. In addition, in covering more of the

cost themselves, patients are incentivized to shop around for lower-cost providers and limit doctor or emergency room visits to those truly necessary. While sound in theory, several studies show that rather than shopping around for cheaper care many are delaying or postponing care due to cost concerns. Patients with HDHPs are also more likely to forego needed prescribed medications, which could exacerbate long-term health problems and ultimately increase healthcare expenses down the line. In an effort to mitigate some of these issues and help defray the added out-of-pocket costs that come along with an HDHP, many employers are now offering a Health Savings Account (HSA) in conjunction with their HDHP.

Health Savings Accounts

Established in 2003, HSAs are rapidly growing; the number of Americans with HSAs has tripled since 2008 to almost 20 million in 2015. To qualify for an HSA one must be enrolled in an HDHP, have no other health coverage, must not be receiving Medicare, and cannot be claimed as a dependent on someone else's taxes. Accounts can be started with banks, insurance companies, credit unions and brokers, with such parties referred to as custodians or administrators.

An HSA combines features of a flexible spending account (FSA), an IRA and a 401(k). Just like FSAs and 401(k)s, an employee can have their employer put a portion of their pretax paycheck automatically into an HSA. Similar to an FSA, an employee can then use that savings to reimburse qualified out-of-pocket healthcare costs, until their deductible is met and the health insurance policy steps in. As long as withdrawals from the HSA are used to pay for qualified medical expenses, they are not subject to capital gains or income taxes. Insurance premiums are not treated as qualified medical expenses unless the premiums are for long-term care insurance, healthcare continuation coverage such as COBRA, healthcare coverage while receiving unemployment compensation, or Medicare and other healthcare coverage if 65 or older. If an employer does not offer an HSA or an employee simply feels that their employer has picked a poor custodian/administrator, the employee can open an HSA on their own, as long as they are enrolled in an HDHP and claim the contribution as an "above the line" deduction on their tax return. Unlike an FSA, but more like a 401(k) or IRA, the funds in an HSA do not expire at year-end. So, while expected qualified expenses might reasonably cap FSA contributions for a given participant, they would more appropriately form a floor to HSA contributions.

	HSA	FSA	Traditional 401k	Traditional IRA
Contributions	Pre-tax	Pre-tax	Pre-tax	Pre-tax
2016 Contribution Limits	$6,750 family coverage $3,350 single coverage $1000 catch-up starting age 55	$2,550 for self	$18,000; $6,000 catch-up starting age 50; excludes employer contributions	$5,500 $1,000 catch-up starting age 50
Distributions	No tax on qualified health costs	No tax on qualified health/other costs	Taxed as income	Taxed as income
Penalties	20% penalty on non-qualified health costs prior to age 65 unless owner is disabled or deceased	No IRS penalty; employer penalty on non-qualified withdrawals	10% penalty on non-hardship withdrawals before age 59 ½	10% early withdrawal penalty (with several exceptions)
Required Distributions	None	Must use in Plan year; employers may offer grace period or carry-over up to $500	Required minimum distributions at later of retirement or age 70 ½	Required min. distributions begin at age 70 ½
Account Ownership / Portability	Employee owned; portable	Employer owned; not portable	Employer owned; limited portability	Employee owned; portable
Do Funds Roll Over?	Yes	Up to $500 per year, varies by employer	Yes	Yes
Permitted Funding Sources	Employer, employee, and any other individual	Employer and employee	Employer and employee	Employee only

The tax advantage of an HSA over a 401(k) when used for qualified medical expenses could be especially impactful for retirees (and those planning and saving for retirement). According to Fidelity's Retirement Health Care Cost Estimate, a couple aged 65 and retiring this year can expect to spend about $245,000 on healthcare throughout retirement, an increase of 29% from 2005 estimates. HSA assets can also be used to pay for things other than eligible medical expenses, but only after age 65 if you want to avoid penalties. Money not used to pay for medical expenses will still be taxed at your current tax rate when taken out after age 65, just like a traditional 401(k). The ability to make lump sum contributions from sources other than yourself and your employer is another HSA advantage.

The Next Generation of Retirement Savings?

So why not just replace the 401(k) with an HSA? While an interesting thought experiment, HSAs would require a number of modifications before they would be on par with 401(k)s for retirement savings. It took decades for the 401(k) landscape to evolve into its current form, but many of these advantages could be incorporated into HSAs with a bit of focused legislation and product development. Currently, yearly minimums for HSAs are much lower than 401(k) limits, likely because HSAs were originally designed to supplement healthcare expenses through modest deposits followed by frequent small withdrawals. Most HSA accounts are still administered through banks and credit unions and often default into sav-

ings accounts or money market funds. While cash investing may be appropriate for funds earmarked for immediate use, those intended for use further out in the future likely warrant a wider range of investment options. Additionally, most online brokers do not offer an HSA account option, making it difficult to find a custodian/administrator with diversified investment options at reasonable fees. Many administrators also require minimums to participate in certain types of investments, which tend to be more difficult to achieve in an HSA due to low contribution limits. Finally, plan sponsors who want to promote the enhanced investment opportunities of an HSA must tread lightly as the DOL currently allows little latitude in this area if the employer wants to avoid having the plan fall under ERISA.

Given the current state of the market and general unfamiliarity with HSAs on the part of employees and employers, plan sponsors may be tempted to dismiss the opportunity to offer an HSA themselves as an unwanted burden that shifts new responsibilities onto the employer. However, many benefits of an employer-offered HSA are not otherwise replicable. Direct payroll contributions can only be made to an employer-sponsored HSA plan. These pretax contributions provide a greater benefit compared to tax-deductible post-tax contributions, which are subject to FICA and Medicare taxes, and may be limited by the Alternative Minimum Tax or other factors. Additionally, by offering an employer-contribution or, better yet, a match on contributions, plan sponsors dramatically increase the likelihood that participants will open and use an HSA. Since employer contributions are generally a deductible business expense for the employer, this can be an efficient way to share some of the savings of moving to an HDHP with employees, and ultimately ensure that employees are left better off by the change.

As with any other financial services arrangement, it is important to consider the range and type of investments offered and the fees associated with an HSA, including set-up fees, annual administration or maintenance fees, and other transaction-based fees. HSAs can have limited to no investment options. Generally, HSA participant assets are defaulted into standard cash instruments, and the vast majority stay in cash. Of the HSA-holders who elect to invest, most choose money market funds. With sufficient supplemental participant education focused on making suitable horizon-based investment choices, HSAs would be positioned to better realize their potential value for participants. And if custodians/administrators expanded their HSA investment options, HSAs would likely take the lunch of traditional IRAs and, to a lesser extent, gain ground against the 401(k), FSA, and other tax-advantaged savings and spending plans.

As insurance costs continue to outpace inflation by a sizable margin, triple tax-advantaged investment via HSAs offers a powerful potential remedy for both employees and employers. Yet, the onus should be on plan sponsors to engage an HSA provider with suitable investment options on a user-friendly platform accompanied by exhaustive (not exhausting) education and communication, especially at transition. HSAs are increasingly becoming an important part of the retirement planning industry. If nothing else, they suggest a way to drive more thoughtful and specific planning when it comes to saving and spending in retirement. In that way, combining HDHPs with HSAs can offer significant benefits to individual employees while simultaneously helping employers and insurers combat rising medical care expenses.

Bellwether Consulting LLC
PO Box 31, Millburn, NJ 07041
www.bellwetherconsulting.net
Copyright © 2016 All Rights Reserved.