

HSAs: An Expanding Mutual Fund Sales Opportunity

Growth Potential is Comparable to IRAs and 401(k)s

The benefits of health savings accounts (HSAs) are frequently being compared to those of retirement vehicles. As a result, HSAs are being marketed as “supplementary retirement products.” FRC believes this comparison is valid for three primary reasons:

- The longevity and growth potential of HSAs are projected to be comparable to that of IRAs and 401(k) plans due to the similarity in tax treatment and the expectation that as product adoption and asset growth continues, the HSA will also become a standard investment account.
- HSAs are an apt fit for the needs of the baby boomer demographic, as they can be used for present or future eligible medical expenses, with unused funds receiving the tax advantages of a retirement account after the participant turns 65.

- The product offers distribution opportunities through existing channels: direct to investors, through advisors, and on investment platforms similar to existing defined contribution platforms.

In this issue of *FRC Focus*, we concentrate on the third factor, specifically the emergence of HSA-specific investment platforms and the potential for long-term fund sales through this new channel.

Similarity to DC Platforms

Though fund firms continue to show caution in entering the HSA market, select funds from seven of the 10 largest mutual fund firms are now offered to HSA participants (see Exhibits 2 and 3 for a list of mutual funds and investment options). In most cases, mutual funds are being sold through HSAs that are established and administered by third-party administrators (TPAs), recordkeepers, and banks.

A review of the developing HSA investment platforms shows distinct similarities to existing DC platforms. The number of investment options currently offered through HSA platforms is similar to the average DC plan, 13 in HSAs compared to 15 on DC platforms.

As with DC platforms, HSA platforms include an appropriate range of equity, fixed-income, and asset allocation funds (Exhibit 1) that would appeal to any employer concerned about fiduciary responsibility in an arena where, due to ERISA guidance, they are restricted from choosing the funds. Already, many fund options are available to investors, with the average fund held in an HSA platform being a Large Blend offering in an A-share with a Morningstar rating of 3.6 stars.

Another similarity between HSA and DC platforms is that they may be built either by a back-end solution provider or directly by the provider. Firms with well-established 401(k) platforms, such as BISYS, offer an open-architecture platform, available to all fund families. This enables the HSA provider to select investment options based solely on business objectives.

Key Points

HSA investment platforms offer a new sales channel for fund firms. Participating fund firms are already reaping the rewards of the enhanced fund sales and branding opportunity available through HSA plans.

- Mutual funds from seven of the largest 10 fund companies are available in HSAs.
- About 200 mutual funds are offered to participants through HSA investment platforms, with 21% of these from top-10 firms.
- Of the 87 health savings account providers, 39% offer access to long-term mutual funds, with 20% via investment platforms.
- HSA providers offering mutual funds on investment platforms and requiring no minimum balance prior to investment report over 70% of assets held in long-term funds—with some as high as 90%.

Exhibit 1

Categories of Mutual Funds Available on HSA Platforms

As of August 2005

Category	Number of Unique Portfolios	Number of Providers ¹
Equity		
Large-Cap Value	11	8
Large-Cap Blend	18	12
Large-Cap Growth	12	7
Mid-Cap Value	5	3
Mid-Cap Blend	9	5
Mid-Cap Growth	12	7
Small-Cap Value	3	2
Small-Cap Blend	10	7
Small-Cap Growth	10	7
Index ²	13	5
International	16	10
Specialty	7	4
Fixed Income		
Corporate	24	13
Government	6	3
Municipal	6	3
International	0	0
Asset Allocation		
Target-Date	5	1
Target-Risk	11	4
Balanced	7	7

1. Number of plan providers carrying funds in this category. Not all providers offer all funds in the category.

2. Index funds are also included in other categories.

Source: FRC IMPACT database.

Platform Types

HSA providers that build their own investment platforms use one of several strategies, including: 1) proprietary funds, 2) a mix of proprietary and non-proprietary funds, or 3) non-proprietary funds from one fund family. The most common types of platforms to date

are the second and third. Investment platforms offering funds from larger firms, such as Vanguard and Fidelity, have been of particular interest, as many smaller firms are watching them to determine their own strategic initiatives.

Vanguard was an early entrant to the market, with fund sales through multiple TPAs, most notably Health Savings Administrators, a firm that offers the largest platform of Vanguard funds—some 20 funds in Admiral and Investor share classes. John Vellines, CEO of Health Savings Administrators, stated that 93% of the firm's assets are currently held in the Vanguard mutual fund program, with an average balance per account holder of more than \$4,300.

Fidelity Advisor funds are now available in HSA accounts such as that offered by the Synovus banking network, which provides HSAs through nearly 40 banks in the Southeast. A cross-category lineup of seven Fidelity Advisor funds is offered on the investment platform.

HSA investment platforms with multiple fund families often focus on overall Morningstar rating for the platform as a key differentiator.

“Success on an HSA-specific investment platform is defined by two factors. Having an interest in participating in the HSA market, and having a best-in-class fund are the qualifications required to be on one of our investment platforms,” according to Eric Remjeske, partner and co-founder of the Devenir Group, an investment advisory firm that chose the 12 funds for the Blue Cross Blue Shield of Minnesota HSA.

Overall, some 20% of HSA plan providers offer long-term fund investments through investment platforms. Investment minimums range by provider from no minimum to \$4,500, with an average of \$1,370 for long-term funds. Due to the various minimums required prior to investment, providers report differing percentages of allocation in mutual funds. HSA providers offering direct access to mutual funds with no minimum report over 70% of assets held in long-term funds—with some as high as 90%. On the other hand, providers offering access to funds through self-directed brokerage accounts average about 20% in funds.

In general, mutual funds offered through omnibus accounts require low or no minimum balances, while those that are offered through individually administered accounts require the traditional fund investment minimums. The use of omnibus accounts underscores the advantage of mutual fund sales through investment platforms and TPAs, which allow for greater incremental sales without the high costs of individual account management.

Since regulations differ and fund firms are not necessarily well-versed in the requirements for an HSA-specific platform, a number of TPAs and HSA solution providers have sprung up to provide tax reporting and regulatory advice to fund firms.

“There is not a lot of mystery and mystique around HSAs,” says Barry Stokes, CEO of 1Point Solutions, a firm that has been active in the DC arena since 1999 and offers a stellar lineup of 28 funds to HSA participants. “They are very straightforward and easy to process.” One of the reasons for this is that firms such as 1Point Solutions take on the tax reporting required, “freeing the mutual fund company to focus on its core competency—managing great mutual funds,” says Stokes.

If We Build It, Will They Come?

One of the key misconceptions regarding the HSA marketplace is that in order for fund companies to participate in the market, they must struggle with administering accounts with low balances. Though some firms are self-managing accounts, the Treasury guidelines allowing management of the accounts in trust allow for employers to open single accounts for employee groups and TPAs to manage fund sales through omnibus relationships. Given the ready market of HSA participants who are available through employer group plans, and the expected adoption rates of large employers for the upcoming open enrollment period, FRC projects employer group enrollment to provide adequate incentive for fund firms not yet participating on investment platforms to seek placement opportunities.

For fund firms, success in HSA platforms will be achieved through the same venues as for DC platforms. FRC’s 2004 study *IODC Trends: Gathering Assets in the Investment-Only Defined Contribution Market* highlights key strategies that will also drive growth in the HSA arena:

- **Proper pricing structure** — Participating fund companies need to price funds appropriately to allow for investment platform fees.
- **Saleable product** — Competitive investment performance is vital to more DC plan parties than any other product characteristic, a feature that will become increasingly important in the HSA arena.

Key Market Trends

Several market trends support the adoption of HSAs: high healthcare costs, decreased employer funding for healthcare expenses, concerns over Social Security, and

the declining balances available in Medicare. These factors, in combination with an increase in the number of baby boomers, make both the healthcare and retirement benefits of HSAs appealing to plan providers and participants. Cora M. Tellez, CEO of Sterling HSA, says she is “not surprised that early adopters of HSAs are young boomers [early 50s].” Tellez cites statistics for her firm showing that 60% of her client base is over 40, while 40% is over 50.

As in the retirement market, advice services to HSA participants provide opportunities for marketing, branding, and customer acquisition. One firm already providing limited advice on asset allocation is Alliance Benefit Group. The ABG HSA offers 11 mutual funds and a MetLife Guaranteed Fund, and suggests a percentage of investment in each of the funds to meet Conservative, Moderate, Moderately Aggressive and Aggressive allocations. In a similar strategy, Farmers and Mechanics Bank provides HSA investors with a choice of six pre-selected asset allocation portfolios from Accessor Funds, ranging from Income to Aggressive Growth.

While such basic advice and asset allocation services will be offered for free in the near term, HSA-held investments are part of a participant’s total portfolio, and rising account balances will lead to increased managed account opportunities and demand for fee-based advice.

Outlook and Recommendations

HSAs hold \$1.1 billion in 1.2 million accounts, and are expected to reach \$2 billion in assets by year-end. At present, 39% of the 87 HSA providers nationwide offer access to long-term funds, either through direct investment or brokerage accounts, with an additional 10 providers rolling out long-term investment options in the near future. Mutual funds from seven of the largest 10 fund companies are now available in HSAs, making up 21% of the 200 unique portfolios that are available to participants. Of the top fund firms, Vanguard leads with 23 funds available through HSAs, followed by Fidelity with eight funds.

FRC projects that total HSA assets will grow to \$48 billion by 2010, with a minimum of 50-70% of assets held in long-term funds. This represents between \$24 billion and \$33 billion flowing in and remaining until retirement, based on FRC’s moderate projections. While this may not seem like a compelling figure for some firms, it does represent new dollars, new customers, and an increase in share-of-wallet for existing customers.

FRC recommends that mutual fund firms entering the HSA marketplace find placement on the new HSA-specific investment platforms. Investment firms that supplement their retirement product line with HSAs, either by offering their funds or providing access to funds through brokerage accounts, will benefit from both the incremental sales volume and branding opportunity.

Dan Perrin, president of the HSA Coalition and publisher of the *HSA Insider*, predicts “The HSA line on last year’s tax form was a wake-up call to the investment community. Every major company that has a stake in long-term investing is either in the HSA market now in some fashion, or will be within a year.” If this is the case, asset managers that develop HSA-directed strategic initiatives early will be rewarded.

Exhibit 2

Mutual Funds Available on HSA Investment Platforms (As of August 2005)

Fund firm	Funds offered
Platform: 1Point Solutions	
AIM	Leisure Inv, Mid Cap Core Equity A
Allianz	NFJ Sm Cap Val A, OCC Renaissance A
American Funds	Amcap A
Ariel	Appreciation, Ariel
Baron	Growth
BlackRock	Aurora Inv A
Calvert	Income A, Soc Inv Bond A
Citizens	Value
Davis	NY Venture A
Eaton Vance	Utilities A, Wld Health A
Federated	Kaufmann A
Fidelity	Adv Mid Cap A
GMO	Foreign Small Co. IV
Lord Abbett	Mid-Cap ValA, Sm-Cap Val A
Neuberger	Ber Part Adv
OppenheimerFunds	Glob A
Seligman	Commun&Info A
Sentinel	Small Company A
Touchstone	Emerging Gr A
Van Kampen	Comstock A
Wells	S&P REIT Index A

Fund firm	Funds offered
Platform: Assurant HSA	
AIM	Fund list not available
Federated	Fund list not available
Fidelity	Fund list not available
Franklin Templeton	Fund list not available
OppenheimerFunds	Fund list not available
UMB Scout	Fund list not available
Platform: CIGNA Choice Fund	
JP Morgan	Equity Index, Investor Balanced, Prime Money Market, Ultra Short Term Bond,
Royce Funds	Premier
T. Rowe Price	International Growth & Income
Platform: Discovery Benefits	
Vanguard	500 Index, GNMA, Mid-Cap Index, Short Term Federal, Total Bond Market Index, Value Index, Wellington
Platform: Farmers and Mechanics Bank	
Accessor Funds	9 funds in asset allocated portfolios
Platform: Health Savings Administrators	
Vanguard	500 Index, Explorer, Extended Market Index, International Growth, LifeStrategy Conservative Growth, LifeStrategy Growth, LifeStrategy Income, LifeStrategy Moderate Growth, Mid-Cap Growth, Mid-Cap Index, Morgan Growth, Prime Money Market, Selected Value, Small-Cap Index, Strategic Equity, Total Bond Market Index, Total Stock Market Index, Wellington, Windsor II

Continued on following page...

Exhibit 2 (continued)

Fund firm	Funds offered
Platform: Home Federal HSA	
Delaware	30 Funds
Platform: Mellon HSA Solution	
Dreyfus	Appreciation, Intermediate Term Income, Premier Balanced Opty.
Platform: MSAver HSA	
UMB Scout	Bond, Growth, Kansas Tax-Exempt Bond, Money Market, Small Cap, Stock, Tax-Free Money Market, WorldWide
Platform: MyHSA - Alliance Benefit Group	
ABN AMRO	Mid Cap N
Allianz	OCC Value D
American Century	Inflation Adjusted Bond Inv
American Funds	Bond Fund F, Growth Fund of America
Davis	NY Venture A
Munder	Small Cap Value A
Phx Duff & Phelps	Real Estate A
Schwab	S&P 500 Index Inv
Thornburg	International Value A
Platform: Options Blue - BlueCross BlueShield, MN	
American Funds	Growth Fund of America, Income Fund of America
Calamos	Growth, Growth and Income
Dreyfus	S&P 500 Index
First Eagle	Overseas
Hotchkis & Wiley	Large Cap Value
Jensen	Jensen
Neuberger	Berman Fasciano
PIMCO	Low Duration, Total Return
Schwab	Money Market

Fund firm	Funds offered
Platform: PFPC HSA	
Artisan	Small Cap
Harbor Capital	Bond
Vanguard	Prime Money Market, Short-Term Investment-Grade
Victory	Diversified Stock
Platform: Principal HSA	
Principal Investors	40 Funds
Platform: Saturna Capital	
Saturna Capital	Amana Growth, Amana Income, Idaho Tax-Exempt, Sextant Bond Income, Sextant Growth, Sextant Intl., Sextant Short-Term
Platform: Synovus Securities	
Fidelity	Advisor Balanced, Advisor Bond, Advisor Diversified International, Advisor Dividend Growth, Advisor MidCap II, Advisor Small Cap, Prime Daily Money Market
Platform: Wells Fargo HSA	
Wells Fargo	Advantage Aggressive Allocation, Advantage Conservative Allocation, Advantage Diversified Equity, Advantage Growth Balanced, Advantage Moderate Balanced, Cash Investment Money Mkt

Source: Fund companies & HSA providers offering long-term funds. Excludes mutual fund investment options available through brokerage accounts.

Exhibit 3**Investment Options Available in HSAs through Brokerage Accounts**

HSA provider	Investment firm
Self-directed	
American Health Value	Bancorp/PFIC
Bancorp Bank (The)	PFIC
BASIC (Keystone Community Bank)	Fifth Third Securities (thru 2005)
ChamberSolutions HSA	Bancorp/PFIC
END-IRA, Inc. - Self Directed HSAs ¹	Entrust New Direction IRA
Equity Trust Company ¹	Equity Trust Company
Fifth Third Bank	Fifth Third Securities
First HSA, Inc.	Berkshire Capital
FlexHSA	Millenium Trust
Home Federal Bank	Delaware Charter Guarantee
HSA Bank	Fiserv Investor Services (Update TBA)
My Health Savings Bank	Bancorp/PFIC
Options Blue - BlueCross BlueShield,MN	Charles Schwab Trust Company
Sherman/Howard County Bank	Sunrise Investment Center
Sterling HSA	Partnervest
Trustar HSA	Delaware Charter Guarantee
UMB Bank	UMB Scout
Saturna Capital	Saturna Capital
Full-service	
Merrill Lynch HSA	Merrill Lynch

1. Including real estate

Source: HSA providers. Select providers listed.

Subject Matter Expert

Chris J. Brown

Chris is Vice President, Director of Retirement Services Research & Consulting at FRC. Chris oversees FRC's research and consulting efforts in the defined benefit, defined contribution, and individual retirement account arenas. This includes the analysis of trends in such areas as retirement plan distribution and IRA rollover, as well as retirement products, such as deemed IRAs, individual 401(k) plans, and mutual fund retirement shares.

Previously, Chris served as FRC's director of research, and also worked as an institutional services representative for Funds Distributor, Inc. and as a financial consultant for Salomon Smith Barney. He has 10 years of industry experience. Chris earned a B.S. degree in business administration from New Hampshire College.

J. Lynette DeWitt

Lynette DeWitt is a Research Analyst focusing on mutual fund and emerging market trends. She has developed an in-depth knowledge of the new health savings account (HSA) product and was the author of the FRC white paper, *Outlook for Health Savings Accounts*.

Prior to joining FRC, Lynette worked at Fidelity Investments as a competitive market analyst, researching mutual fund, discount and online brokerage industry trends. Lynette holds a B.S. degree in business administration from Atlantic Union College, and an MBA in marketing from California State University.

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Editorial: Kristin Adamonis, Charlie Bevis and Art MacPherson

Sales: Craig Kilgallen, Beth Wetherbee and Deb Wetherbee

Editorial Offices: Telephone 617-824-1325; Fax 617-557-0708
100 Summer Street, 15th Floor, Boston, MA 02110.

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