YOUR FINANCIAL FUTURE

Your Guide to Life Planning

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In This Issue

Bond Market Perspectives | Week of February 20, 2018

Key Takeaways

- Yield curve positioning and proper diversification remain prudent strategies to manage interest rate risk.
- Small allocations to lower-quality fixed income can also be additive for suitable investors.
- Long-term investing allows total return to potentially work in the investor's favor: focus less on short-term price volatility and more on long-term total return.

Managing Interest Rate Risk

As 2017 ended, fixed income investors were searching for income, after several years of 10-year Treasuries yielding less than 2.5%. When 2018 began, this changed quickly as tax reform and signs of inflationary pressures pushed market interest rates higher. The 10-year Treasury yield rose 0.87%, from a starting yield of 2.04% on September 7, 2017 to 2.91% on February 15, 2018. Investors have grown concerned that improving economic data and rising inflationary pressures may cause the Federal Reserve (Fed) to raise interest rates in 2018 at a more aggressive pace than originally anticipated. Given this backdrop, investors are naturally reassessing their interest rate risk.

WHAT WORKS WELL WHEN RATES ARE RISING

As outlined in our Outlook 2018: Return of the Business Cycle, we expect yields to grind gradually higher during the year, but not in a straight line. As such, we continue to recommend portfolio positioning with a duration (a measure of interest rate sensitivity) lower than the Bloomberg Barclays U.S. Aggregate Index, along with additional diversification across sectors, maturities, and credit ratings (for suitable investors), which may potentially help mitigate the impact of rising interest rates on investors' portfolios.

An efficient way to determine proper positioning is to examine prior periods of rising rates to identify what has worked well (and what has not). Figure 1 reviews periods of rising interest rates over the past 25 years. As shown, the Bloomberg Barclays Aggregate, a proxy for the broad high-quality bond market, posted a negative total return in rising interest rate periods, confirming the principle that as rates move higher, high-quality bond prices move lower. The sectors can be compared with the broad bond market returns to determine relative outperformance or underperformance against the benchmark, in this case, the Bloomberg Barclays Aggregate. The performance review in Figure 1 results in several takeaways for bond investors.

1 PERFORMANCE OF ASSET CLASSES DURING PERIODS OF RISING INTEREST RATES

Rising Rates Start Date	Rising Rates End Date	Length (Months)	10-Year Treasury Yield Change	Broad Bond Market Return (Bloomberg Barclays Agg)	Sector: Treasury	Sector: MBS	Sector: Corporate	Sector: High Yield	Sector: Municipal
9/30/1993	11/30/1994	14	2.5%	-3.5%	-4.3%	-1.5%	-4.9%	2.0%	-5.9%
1/31/1996	8/30/1996	7	1.4%	-1.8%	-2.4%	0.0%	-2.9%	3.2%	-0.3%
11/29/1996	3/31/1997	4	0.9%	-1.5%	-1.9%	-0.4%	-2.4%	1.8%	-0.7%
10/5/1998	1/21/2000	16	2.6%	-2.3%	-4.5%	1.5%	-3.8%	3.7%	-2.6%
11/7/2001	4/1/2002	5	1.2%	-2.4%	-4.8%	-0.5%	-2.8%	4.7%	-1.5%
6/13/2003	9/3/2003	3	1.5%	-4.5%	-6.5%	-1.7%	-6.0%	1.1%	-4.5%
3/16/2004	6/14/2004	3	1.2%	-4.3%	-5.2%	-3.0%	-5.4%	-1.9%	-4.6%
6/1/2005	6/28/2006	13	1.4%	-1.3%	-2.2%	-0.1%	-2.7%	5.5%	1.0%
3/5/2007	6/12/2007	3	0.8%	-1.8%	-2.0%	-1.4%	-2.9%	1.6%	-1.8%
3/17/2008	6/16/2008	3	1.0%	-2.2%	-4.5%	-2.3%	-1.1%	6.2%	1.0%
12/30/2008	6/10/2009	5	1.9%	-0.5%	-7.0%	1.5%	4.7%	32.2%	6.2%
11/30/2009	4/5/2010	4	0.8%	-0.5%	-2.3%	-0.6%	0.8%	8.3%	1.6%
10/8/2010	2/8/2011	4	1.3%	-3.1%	-4.7%	-1.7%	-3.4%	5.0%	-5.5%
9/22/2011	10/27/2011	1	0.7%	-1.7%	-2.8%	-1.1%	-1.1%	3.7%	-1.2%
1/31/2012	3/19/2012	2	0.6%	-1.2%	-2.5%	-0.2%	-0.9%	2.3%	-1.0%
7/24/2012	9/14/2012	2	0.5%	-0.7%	-1.8%	0.2%	-0.5%	4.0%	-0.4%
12/6/2012	3/11/2013	3	0.5%	-1.0%	-1.5%	-0.3%	-1.2%	3.2%	-1.1%
5/2/2013	9/5/2013	4	1.4%	-4.9%	-4.5%	-4.0%	-6.4%	-2.4%	-6.8%
4/17/2015	6/26/2015	2	0.6%	-2.8%	-2.6%	-1.6%	-4.2%	-0.7%	-1.2%
7/8/2016	11/25/2016	5	1.0%	-3.6%	-4.7%	-1.8%	-3.9%	3.7%	-4.5%
9/7/2017	2/15/2018	5	0.9%	-2.6%	-3.4%	-2.3%	-1.9%	0.3%	-1.6%

Source: LPL Research, Bloomberg 02/16/18

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

Green indicates outperformance relative to Aggregates, red underperformance, and yellow equal performance

Indexes: Treasuries - Bloomberg Barclays US Agg Govt; MBS - Bloomberg Barclays US Agg Securitized; Corporate - Bloomberg Barclays US Agg Corporate; High Yield - Bloomberg Barclays US High Yield; Municipals - Bloomberg Barclays Municipal

The difference between credit risk and interest rate risk is a meaningful one of which investors should be keenly aware. Of the sectors shown, U.S. Treasuries have the least credit risk, as they are backed by the full faith and credit of the U.S. government. They carry elevated interest rate risk, however, as their price sensitivity to interest rate changes (duration) is higher than the broad Bloomberg Barclays Aggregate. This explains Treasuries' underperformance in most of the rising rate periods in Figure 1. High-yield bonds, conversely, possess higher credit risk and lower interest rate risk. Generally, interest rates rise when economic growth and inflation pick up, a scenario that's usually a good backdrop for economically sensitive portions of fixed income, like high yield. The additional yield cushion is also a buffer against higher interest rates that could push prices lower. This explains why high yield has outperformed the broad Bloomberg Barclays Aggregate during rising rate periods over the last 25 years. Despite this outperformance, we still believe lower-quality fixed income should be used at the margins of higher quality, for suitable investors.

Sector diversification and yield curve positioning can help investors during rising rate periods. Investment-grade corporate bonds possess greater interest rate sensitivity than the broad high-quality market, because of their longer maturities. We favor the intermediate portion of the yield curve, which boasts diversification benefits without the significant interest rate risk of long-term bonds. By either targeting intermediate-maturity corporate bonds directly, or using an active investment manager to position the portfolio opportunistically, investors can manage the headwinds of rising rates on investment-grade corporates.

High-quality mortgage-backed securities (MBS) have performed well in most rising interest rate environments. This can be attributed mostly to the sector's shorter duration. Importantly, MBS are not without their own unique risks. If rates move significantly higher, fewer homeowners refinance their mortgages at the higher rates. As a result, investors can be left with investments that have a longer maturity than expected, essentially locking in lower interest rates.

RISING RATE STRATEGIES

Although interest rate risk is present in almost all bonds, it can be managed by buying shorter maturity bonds with higher coupons. Generally, the longer the maturity and the higher the bond's duration, the more sensitive the bond's price is to changes in interest rates. For example, a bond with a duration of five years will decline in price by 5% if all Treasury yields rise by 1%, all else being equal. The higher the duration of the bond, the higher the yield should be, as investors need to be compensated for the time it takes to regain their principal investment. Historically, despite greater sensitivity to changes in short-term interest rates, short-term bonds perform relatively well in rising rate environments because they don't require investors to tie up their money for long, making reinvestment at higher rates possible.

Another factor is the bond coupon. For example, a Treasury bond paying a 2% coupon when interest rates increase to 3% will decline in price. If not, the bond will not compete with the higher-yielding bonds entering the market at the new prevailing interest rate. If the coupon was well above the 3% rate, then the bond is said to have coupon protection. This demonstrates that the higher the coupon is on the bond, the more defensive the bond is against rising rates. In other words, rates need to rise substantially before the market would require a significant discount in price to make the bond attractive.

KEEPING PERSPECTIVE

Even though bond prices fall as interest rates rise, and interest rates have risen notably since the beginning of the year, investors should remain focused on their long-term objectives. By focusing on total return rather than on short-term market price fluctuations, investors can avoid selling at inopportune moments due to emotion. Total return is the rate of return over time that is derived from interest income, plus gains or losses on the price of the bond. As interest rates rise, the cash flows of the bond will eventually be reinvested at higher prevailing interest rates. Over a longer horizon, the investor may chip away, or even overcome, price declines that occurred due to rising interest rates [Figure 2]. The takeaway is critical: it pays to remain patient.

CONCLUSION

Fixed income performance thus far in 2018 has delivered a painful reminder of the impact of rising interest rates on bonds. Rate increases of this magnitude are relatively infrequent, and much of the pain may be over already. Nonetheless, it is important for investors to remain diligent in their asset allocation choices. Well-diversified portfolios that maintain a shorter duration profile with allocations across various sectors and asset classes may help to manage the risk associated with additional interest rate volatility.

Please see our Outlook 2018: Return of the Business Cycle *publication for additional descriptions and disclosures.*

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Mortgage-backed securities are subject to credit, default risk, prepayment risk (that acts much like call risk when you get your principal back sooner than the stated maturity), extension risk, the opposite of prepayment risk, and interest rate risk.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Active management may involve more frequent buying and selling of assets and will tend to generate higher transaction cost. Investors should consider the tax consequences of moving positions more frequently.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a nondiversified portfolio. Diversification does not protect against market risk.

DEFINITIONS

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

INDEX DESCRIPTIONS

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

The Bloomberg Barclays U.S. Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include T-bills (due to the maturity constraint), zero coupon bonds (strips), or Treasury Inflation-Protected Securities (TIPS).

The Bloomberg Barclay's High Yield Municipal Bond Index tracks consists of below-investment grade municipal bonds.

The Bloomberg Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year.

The Bloomberg Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

The Bloomberg Barclays U.S. MBS Index measures the performance of investment-grade mortgage-backed securities of FNMA, GNMA, and FHLMC.

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Weekly Market Commentary | Week of February 20, 2018

KEY TAKEAWAYS

- Stocks have made a significant comeback, rallying nearly 6% off the recent lows.
- Solid fundamentals and technical indicators suggest that recent lows may hold.
- Historical relationships suggest stocks and yields can move higher together and stock valuations are justified based on current inflation levels.

OUT OF THE WOODS?

Are we out of the woods yet? After the fastest correction from a record high in the history of the S&P 500 Index, stocks staged an impressive comeback last week. The S&P 500 put together its best week since 2013, rallying more than 5% off the lows to bring its session win streak to six. This week we consider what this means moving forward, including what higher interest rates and rising inflation might mean for stocks.

STRONG FUNDAMENTALS

Whether we are out of the woods yet is a tough question to answer with any confidence, but when we weigh the evidence, it appears the odds are good that the worst is behind us.

The stock market's strong fundamentals are supportive. U.S. economic growth is solid despite last week's retail sales shortfall, which we attribute to temporary factors. Consumer and business confidence remain high, as personal spending and capital investment are both likely to get a boost from the new tax law. Inflation is rising, but remains relatively low when compared to historical averages. It also may not be as strong as the January Consumer Price Index (CPI) data initially suggested due to weather and other seasonal factors.

Earnings season has been excellent, with a 15% increase in S&P 500 earnings in the fourth quarter and an 8% revenue increase, both nicely above prior expectations. The new tax law hasn't even kicked in yet, but analysts have increased their 2018 estimates for S&P 500 profits by $10 per share (nearly 7%) since January 1. Companies are just starting to announce how much in overseas cash they are repatriating back to the United States due to the new tax law. A good portion of that cash is expected to be directed to share repurchases, boosting earnings per share.

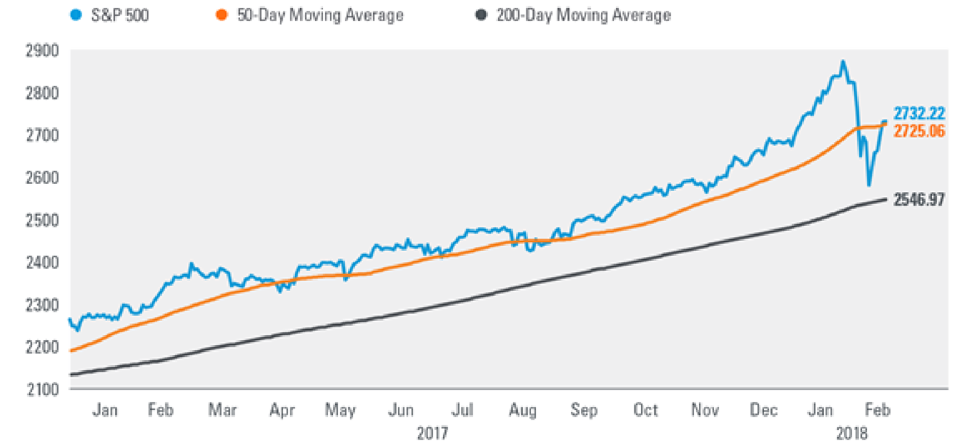
POSITIVE TECHNICAL EVIDENCE

From a technical perspective, here are some indicators supporting the view that the worst may be over:

- **Bullish trend intact.** The S&P 500 broke back above its 50-day moving average (MA) on Thursday, February 15 (at 2721) and managed to close above the 200-day MA (2547 as of February 16) throughout its latest correction. The 200-day MA remains upward sloping, indicating a continued bullish technical trend **[Figure 1]**.
- **Evidence of capitulation selling.** On February 5, when the Dow Jones Industrial Average dropped 1175 points, or 4.6%, the number of S&P 500 stocks declining relative to those advancing was greater than 40:1, indicative of extreme panic selling. The low percentage of stocks above their 50-day MA, below 20% on February 8, is another indicator of extreme selling pressure.
- **Reversal from oversold levels.** After entering oversold territory on February 8, based on the 14-day Relative Strength Index, the S&P 500 subsequently reversed and moved strongly higher while maintaining its bullish trend, a pattern that has historically proven to be a bullish technical signal.
- **Strong rebound.** Historically, when the weekly S&P 500 price closes 3% or more above its intra-week low, it has been a bullish short-term signal. This happened on February 9.

The combination of solid fundamentals and the technical evidence suggests to us the recent lows may hold. However, that does not rule out the likelihood that the return to normal volatility brings more daily moves of 1% (or more) and 5-10% pullbacks over the course of the year.

1 BREAK ABOVE 50-DAY MOVING AVERAGE AND RISING 200-DAY MOVING AVERAGE ARE BOTH BULLISH INDICATORS



LPL Research, Bloomberg 02/16/18

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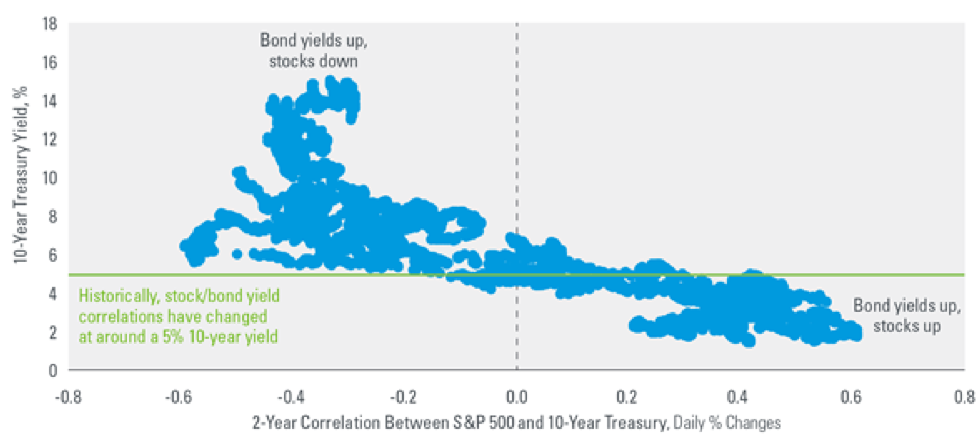
HOW WORRIED SHOULD WE BE ABOUT RISING RATES?

The latest downdraft was triggered primarily by accelerating wage growth that sparked fears of rising inflation and a more aggressive Federal Reserve (Fed). As such, we think it is helpful to examine the historical relationships between stocks, inflation, and interest rates.
With regard to interest rates, **Figure 2** illustrates that historically, when the 10-year yield has been below 5%, the stock market and interest rates have tended to move together (positive correlations), meaning stocks can go up despite rising rates. When rates are relatively low, rising rates usually indicate improving growth, as is evident today.

At higher interest rate levels, rising interest rates have tended to spook stock investors as the Fed gets more aggressive and borrowing costs rise (negative correlation in Figure 2). With the 10-year yield not having eclipsed 3% during this latest bond market sell-off, we think we may have a ways to go before the level of interest rates impairs economic activity and/or the stock market, even if the relationship reverses at lower interest levels than what we've seen historically.

The exception would be if rates potentially spike again, because the speed at which rates move can be as important as the level. This is something to watch, but we continue to expect only a gradual increase in the benchmark 10-year Treasury yield; our year-end forecast remains 2.75-3.25%.

2 STOCK AND BOND YIELDS TEND TO GO UP TOGETHER AT LOW INTEREST RATE LEVELS



Source: LPL Research, Bloomberg, FactSet 02/16/18

Correlations are based on 2-year periods, daily data. Data back to 1968.

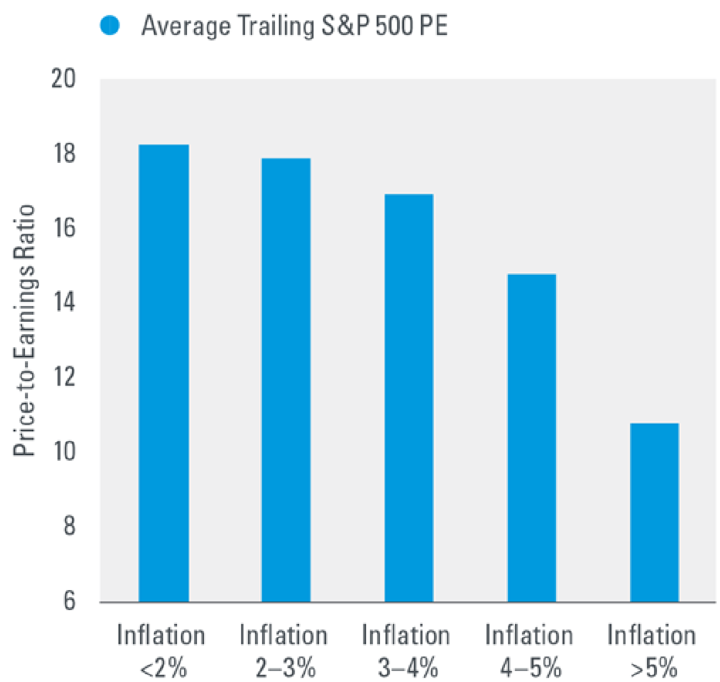
Correlation ranges between -1 and +1. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random.

…AND HIGHER INFLATION?

We can also look at the relationship between inflation and the stock market. **Figure 3** shows that at low inflation levels, the price-to-earnings ratio (PE) for the S&P 500 tends to be higher, and vice versa. With the CPI right around 2%, we think stock valuations at current levels of about 17 times the next 12-month earnings estimates are reasonable.

If the S&P 500 delivers the consensus earnings number for 2018 ($157 per share), then it would only take a trailing PE slightly over 18 to get to our fair value S&P 500 target range of 2850-2900 at year-end. From Friday's close at 2732, that level of the S&P 500 would represent 4-6% upside. Keep in mind that the average PE when inflation is below 3% historically has been over 18 times. At current inflation levels, we see stock valuations as quite reasonable, especially when considering the solid economic and profit backdrop.

3 INFLATION IS NOT HIGH ENOUGH TO IMPAIR STOCK VALUATIONS



Source: LPL Research, FactSet 02/16/18

Inflation represented by consumer price index (CPI); data series back to 1962.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

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CONCLUSION

We maintain our positive outlook for stocks despite the recent bout of volatility as fundamentals remain solid in our view. As we wrote in our *Outlook 2018: Return of the Business Cycle* publication, the combination of improved business fundamentals and fiscal legislation may sustain momentum in the economy and equity markets in the coming year and potentially beyond. After years of depending on the largess of monetary policymakers, investors can now focus on fiscal levers that we believe will support consumption and spur new business investment over the next few years.

In terms of investor positioning, consistent with a "return to the business cycle," we favor cyclical equity exposure. Small caps may benefit from the new tax law due to their relatively higher tax burden. We believe the value style of investing may get a boost from fiscal legislation, with many value names poised to benefit from tax cuts and reduced regulation, notably financials. Meanwhile, the industrial sector may benefit from a combination of lower taxes, 100% expensing, higher U.S. government defense spending, and accelerating global growth. The technology sector is also poised to benefit from solid global growth, in addition to the large trove of profits held overseas that now have the opportunity to be repatriated at attractive rates.

Thanks to David Tonaszuck for his contributions to this report.

IMPORTANT DISCLOSURES

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.
Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments.

DEFINITIONS

The 200-day moving average (MA) is a popular technical indicator which investors use to analyze price trends. It is the security or index's average closing price over the last 200 days.

Relative Strength Index (RSI) is a technical momentum indicator that compares the magnitude of recent gains with recent losses in an attempt to determine overbought and oversold conditions of an asset.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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Forward price-to-earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated PE analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Dow Jones Industrial Average (DJIA) Index is comprised of U.S.-listed stocks of companies that produce other (nontransportation and nonutility) goods and services. The Dow Jones Industrial Averages are maintained by editors of The Wall Street Journal. While the stock selection process is somewhat subjective, a stock typically is added only if the company has an excellent reputation, demonstrates sustained growth, is of interest to a large number of investors, and accurately represents the market sectors covered by the average. The Dow Jones averages are unique in that they are price weighted; therefore, their component weightings are affected only by changes in the stocks' prices.

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Advance Directives: Planning Ahead for Your Own Care

In most states, a health care proxy does not take effect until you can no longer make medical decisions for yourself; until then, only you can legally consent to any treatment.

Although the thought may not be pleasant, you may someday face a sudden health crisis that leaves you unable to make your own medical decisions. Fortunately, there is a legal means, known as an advance directive, to address this potential concern.

An advance directive is a written statement that you complete prior to a serious illness. Generally speaking, this document names someone to act on your behalf or outlines how you want medical decisions to be made when you are no longer able to make decisions for yourself. Some types of advance directives may do more for you than others, so it is important to know the differences.

Why a Health Care Proxy?

Two common forms of advance directives are a living will and a durable power of attorney for health care, the latter commonly referred to as a health care proxy. A living will explains in writing the care you wish to receive or avoid in the event you are incapacitated. For instance, it can express your wishes for controlling pain, receiving nutrition, or making life-support decisions.

But unlike a living will, a health care proxy allows you to legally designate someone, a proxy, to make medical decisions for you. In some states you may even be able to combine a health care proxy and living will into a single document.

Hospitals and nursing homes are required to ask about the existence of an advance directive when you are admitted. In most states, a health care proxy does not take effect until you can no longer make medical decisions for yourself; until then, only you can legally consent to any treatment. In addition, you can always change or cancel the document as long as you are mentally alert. If you decide to make changes to these documents, be sure to do so in writing.

Know the Potential Drawbacks

Though it is a legal document, a health care proxy cannot handle every medical situation. For instance, the advance directive might not be followed by emergency medical services (EMS). If EMS is summoned to treat you, they are usually required to resuscitate and stabilize you until you reach the hospital, regardless of an existing advance directive.

An attorney can provide you with additional information about advance directives. Though you cannot anticipate an unexpected health care crisis, you can prepare ahead of time to ensure that you are cared for in a manner that coincides with your intentions.

Compliance Tracking #513338
This article was prepared by Standard & Poor's Financial Communications Tracking # 684645 Exp. 11/17/2011

You can fund an HSA with pretax dollars. You can also carry any unused funds from year to year and build a reserve against future health care costs.

HSAs Are Gaining Traction With Consumers

The health savings account (HSA) market, which has been in existence since 2004, has seen rapid growth in recent years. As of the end of 2016 there were an estimated 20 million HSA accounts -- 77% of which have been opened in the past few years.[1]

The reason that HSAs are catching on with consumers is not clear. It could be partly due the growth of HSA-eligible, high-deductible health plans, which now cover nearly a third of employees. It could be due to the uncertain future of health insurance costs in America -- and the ability to create a buffer against that uncertainty by setting aside money to pay for uncovered medical expenses in a tax-friendly manner.

HSA Surplus

Whatever the reason, account holders are contributing to their HSAs and carrying over balances at the end of the year to cover future health expenses. By comparison, flexible spending accounts (FSAs), which generally operate under a "use it or lose it rule," may, but are not required to, give participating individuals the option of carrying over a portion of their account balance into the next plan year.

According to data compiled by Employee Benefit Research Institute (EBRI), as of year-end 2016, the average HSA balance among account holders with individual or employer contributions was $2,532, up from $1,604 at the beginning of the year. Fully 90% of these HSAs ended 2016 with funds to roll over for future expenses. As 2016 drew to a close, two-thirds of HSA owners had positive net contributions -- but just 13% had contributed the full amount allowed.

Is an HSA Right for You?

HSAs are typically offered in conjunction with high-deductible health plans to help offset out-of-pocket medical expenses that must be incurred before the deductible is met and the insurance policy coverage kicks in.

They do this by offering tax savings three ways:

- Contributions made to the account are tax deductible up to certain limits or, if they are made through an employer program, they are made with pretax dollars.
- Any interest or investment earnings accrued on the money in the account is tax deferred while it remains in the account.
- Withdrawals used for qualifying medical expenses of the account holder, his or her spouse or dependents are tax free. Qualifying medical expenses include doctor's visits, prescription drugs, and dental and vision care.

There are no income-level phaseouts restricting contributions to HSAs. For 2017, singles can contribute up to $3,400 and families can sock away up to $6,750.

Additional benefits:

- Employers can make contributions on behalf of their employees, but the annual limits listed above still apply.
- Savings may be invested in a wide variety of investment vehicles, if offered.
- Unlike flexible savings accounts (FSAs) which may require you to spend accumulated savings year-to-year, HSA account balances may be carried over to the next year.
- Older workers can make "catch-up" contributions. Individuals aged 55 or older can save an additional $1,000 in 2017.
- HSAs are portable. If you leave your job, your HSA goes with you.
- Once you reach Medicare eligibility age (currently age 65), you can take withdrawals from your account for any reason, not just for medical expenses. But be warned: If not used for medical care, withdrawals will be subject to federal (and possibly state) income taxes.
- Upon your death, your HSA can be passed along to your surviving spouse. However, if the account passes to a non-spouse beneficiary or to the owner's estate, the fair market value of the account will be subject to income taxes.

Your tax or financial professional can help you determine if an HSA is right for you.

[1]*Employee Benefit Research Institute, "Health Savings Account Balances, Contributions, Distributions, and Other Vital Statistics, 2016: Statistics from the EBRI HSA Database," September 2017.*

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Sick of Worrying About Health Care Costs?

In terms of demographic groups, millennials (those age 18 to 36) are the most likely to forgo a medical appointment due to cost, while the Silent Generation (those age 72+) are the least likely to miss a medical visit.

With all the news about rising health care premiums, deductibles, and other out-of-pocket costs, a majority of Americans are concerned about what the future may hold for health care expenses.

A new poll conducted by Bankrate.com found that 56% of respondents are worried that they might not have affordable health care in the future.

Fear of the Future

(Percentage of survey respondents who are concerned about future health care costs)

- Very worried = 35%
- Somewhat worried = 21%
- Not too worried = 17%
- Not at all worried = 24%

The same study found that about one-in-four Americans admit that they -- or a member of their family -- have skipped a visit to the doctor due to the expense. In terms of demographic groups, millennials (those age 18 to 36) are the most likely to forgo a medical appointment due to cost, while the Silent Generation (those age 72+) are the least likely to miss a medical visit.

Age Matters

(Percentage of survey respondents who said cost is a barrier to seeking medical care)

- Millennials (age 18 to 36) = 31%
- Generation X (age 37 to 52) = 25%
- Baby Boomers (age 53 to 71) = 23%
- Silent Generation (age 72+) = 8%

Certainly much of the concern expressed by Americans is justified. With the mantra of "repeal and replace the Affordable Care Act" echoing through the White House and the halls of Congress, the nation waits in limbo as the House's version of a replacement health care bill now rests in the hands of the Senate where it faces significant opposition and a very uncertain future.

Start Your "Sick Day" Fund

Instead of waiting, worrying, and compromising your physical health, consider starting a fund to help pay for the uncovered portions of medical expenses. You may already have a rainy day fund for unexpected home or car repairs, so starting a sick day fund may seem like a familiar exercise.

The following tips will help you start saving more right away.

Stick to your budget. Try to maintain financial discipline by avoiding unnecessary "impulse items" that aren't in your budget or on your shopping list.

Buy in bulk. Instead of purchasing just one of anything you use regularly, you may be able to find the same item at a much lower "unit cost" when it is packaged and sold in bulk at a discount retailer or shoppers' club. While you'll spend more up front, the "economies of scale" may help improve your bottom line within a month or two.

Reduce the cost of debt. Every month, millions of Americans spend their hard-earned money on interest and finance charges that arise from carrying personal debt, such as credit card balances. Wherever possible, transfer any high-interest debt to a single, low-rate account. And needless to say, don't use credit to buy things you can't really afford.

Additionally, whenever you're expecting a tax refund, bonus, or other windfall, be sure to put it to good use. Paying off debt and saving for a "sick day" are almost always better strategies than spending without a plan.

[1]*Bankrate.com, "Worried sick about your health care? You're not alone," June 8, 2017.*

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<table>
<tr><td>Not FDIC/NCUA Insured</td><td>Not Bank/Credit Union Guaranteed</td><td>May Lose Value</td></tr>
<tr><td colspan="2">Not Insured by any Federal Government Agency</td><td>Not a Bank Deposit</td></tr>
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