Reserve Investment & Inflation

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Miss the webinar? Watch it here

In this webinar, Reserve investment expert Dave Lynn provides the wise counsel you've been waiting for – to hear how you can be a better steward of the precious Reserve funds you've set aside for your association. Everything deteriorates, and every association should have at least some Reserves set aside for future repair or replacement projects. But what should you do with that money? What are best practices? Do your choices change if you have $50,000, $500,000, or $5,000,000 in Reserves? When is a good time to hire a Reserve investment counselor, and how would you know a good one? It was hard work to collect and set aside Reserves. Don't put them at risk.

In this webinar Dave tells us what the benchmarks are for properly caring for your Reserve fund, and some guidelines for proper expectations about safety, interest, inflation, and account management. You can't pay for Reserve projects if you don't have the money ready and available!

Some general principles you'll find addressed in the webinar:

- As a trustee (fiduciary) of the physical and financial assets of others, it is totally inappropriate for boards or managers to take financial risks.
- Investment types trade off risk with reward.
- Caring for (managing) large sums of money can be complicated and time-consuming.
- An association loses FDIC protection for funds "on deposit" in an institution when the total of those funds in that institution exceed $250,000. For safety purposes, that's when the association should responsibly begin using multiple financial institutions or different investment vehicles.
- Investment professionals are available to help associations manage their Reserve funds, keeping those funds safe and insured while maximizing interest earnings.
- Associations with Reserve Funds under $250,000 can significantly increase their interest earnings by following the techniques used by Investment professionals.

- Inflation is expected to exceed interest earnings. Boards need to let go of any aspiration that interest earned will, or should, offset inflation.
- The best way to plan for higher costs in the future due to inflation is to:
  - Create a multi-yr Reserve Funding Plan (one of the three results of every Reserve Study) that provides for the anticipated needs of the association, including the very real effects of interest and inflation.
  - Regularly update that Reserve Study.
- There is no expectation that boards or managers should be well-informed and capable money managers of potentially hundreds of thousands or millions of dollars of Reserve funds.
- Reserve investment counselors serve as agents of the association, expertly managing and placing the higher returns of commercially available investment vehicles, serving the needs of smaller investors. (associations) that are too small for the "big institutions" to handle themselves.
- In return, those large financial institutions provide an underwriting fee to those investment agents for placing their commercial investment vehicles in the hands of smaller clients the large financial institutions are not equipped to serve. This allows these "niche" investment agents to serve the needs of their client associations at no charge to the association. For the association, it is clearly a "win-win" (expert counsel and management plus higher returns, at no cost).
- At Lynn Wealth Management, this begins to become cost-effective when the association has $500,000 in Reserves (CA) or $1,000,000 in Reserves (FL and TX).

Association Reserves and Lynn Wealth Management stand ready to guide your association safely and successfully to the future.

For additional information, please visit:
www.ReserveStudy.com and www.LynnWM.com

Webinar Attendee Questions

Reserve Questions

Q: How should we calculate the cost of a new roof replacement in 20 years?

A: You don't! You estimate the current replacement cost, set an inflation factor, and then you approach that 20-yr point in the future with regular updates to your Reserve Study. So, at most, you are making a three-yr projection forward (CAI "Best Practices" for Reserve Study updating frequency).

Q: How often should a reserve study be updated?

A: Best practice is to have your Reserve Study updated on the basis of a diligent visual site inspection at least every third year.

Q: What is the minimum percent funding by law?

A: No law dictates a minimum Reserves Percent Funded. Reserve Funding is guided by the board's responsibility (per Governing Documents) to set budgets and collect assessments appropriate to responsibly provide for the needs of the association.

Q: What is the % required for the reserved account?

A: No required amount (measured by cash or Percent Funded) is dictated, but Reserve Fund strength is generally divided into three categories: weak, fair, and strong. See more here.

Q: I understand there are no statutes in CA for percent funded for reserves. What is your recommendation for percent funded of the HOA's portfolio?

A: Reserve Fund strength, where the association has minimal risk of special assessments, occurs when the Reserves are 70% Funded or higher. So, we recommend aiming for the 100% target, but tolerating drops down to the 70% level as very acceptable.

Q: Our latest reserve suggested a Fully Funded reserve balance of $850,745. We have less than $150,000 in our Reserve Fund. Is feasible or even possible to fund this over time (next ten years) or should we plan on communicating an assessment to cover all of our deferred maintenance within the next 2?

A: Generally special assessments are a "last resort" method of funding Reserves. Work with your Reserve Study professional to craft a plan to gradually spread out the strengthening of your Reserve Fund over as many years as possible.

Q: **Can the Board purchase a new asset from Reserves and add it later to the Reserves and adjust going forward?**

A: No – Reserves are for repairs and replacements to existing assets. So, purchase the new asset with non-Reserve funds (special assessment, excess Operating, etc.). Once it exists, then add it to your Reserve Study so the association can begin preparing for the next repair or replacement of that asset.

Q: **How do we figure what reserves can or cannot be spent on? Example - water well. Reserve Study lists the components of the well i.e. pumps, controllers, etc. but not the well itself. If the well goes dry can reserves be used to drill a new well?**

A: Please contact your Reserve Study professional. They will guide you through the decision process. If well replacement is "reasonably predictable in scope and schedule" then drilling a new well qualifies as a Reserve expense.

Q: **We have a guideline of having 3 years in reserves. This year and the next 2 years. Do you have any other guidelines?**

A: The amount appropriate to have in Reserves is determined by a calculation comparing your Reserve Fund to the Reserve needs of the association (the fractional deterioration of all your Reserve components). See more here. The simple "three yrs of contributions" target will not serve your association well.

Q: **I expect a reserve study to show that we are underfunded. We have a bank credit line for hurricane deductible. Can we draw on the credit line to stock up the reserve by 12/24 and then pay off the loan over 5 years?**

A: The credit line is for unscheduled, "surprise" events such as a possible hurricane. Raise your homeowner assessments and build up the Reserve Fund at a rate recommended by your Reserve Study professional, avoiding all loan payback interest payments!

Q: **Approximately how many HOAs have very low reserves?**

A: Approximately 30% of all associations in the country have a Reserve Fund in the 0-30% Funded range, which is considered "weak" (between 35 and 60% chance of a special assessment in the next 3 years).

Q: **Reserve studies in FL are now in flux with the new Surfside bill (SB 4-D) requirements, and no reserve study companies are ready to provide the structural integrity reserve study. Should we wait for revisions to the laws?**

A: No. You need a (normal) Reserve Study for budget planning purposes. Get it. Florida SB 4-D requires anywhere from minor to significant "cleanups" before it becomes a product that can be prepared for associations. Getting a Reserve Study done now and finding someone who can perform your "milestone inspection" will both be steps in the right direction.

Q: **If an engineering company was the company who recently completed structural work on our Florida association, can that same company be one performing our newly required FL "Phase 1 Milestone Inspection", or is that a conflict of interest?**

A: We of course recommend you check with your association's legal counsel on this matter, but it would seem that a staff member from that company who is a licensed engineer or architect, familiar with your FL property, would be a good candidate to perform your Phase One Milestone Inspection.

Inflation Questions

Q: **We are told that Florida does not allow for inflation in the reserve study line component. Is that correct?**

A: Silly but true.

Q: **Where can we show inflation on capital reserve projects in our capital account?**

A: For all non-FL associations, simply inflate future expected costs of your Reserve projects into future years when planning to handle those expenses.

Q: **All information I find suggests that the long term inflation (10+ years) is about 2.4%. Can you differentiate that value with the 2021 to 2023 inflation increases (values please) that may be applied before performing the long-range requirements?**

A: Set current costs at the high costs that they presently are. We are also "hedging our bets" by giving short term (under 3 year) Remaining Useful Life projects an extra cost boost. Otherwise, we expect inflation will stabilize back to something in the range of 2.5% to 3.5% for longer term planning purposes.

Q: **How does AR determine rate of return and inflation numbers to use in their studies?**

A: We believe the best predictor of future results is past experience, so we look backward to learn what stable inflation trends have been and use those in our forward projections.

Q: **What inflation number source should boards consider when proposing new budgets? (ie, CPI-w, Social Security COLA, etc.)**

A: We actually use a blend. Contact your Reserve Study provider for counsel specific to your association, but feel free to gain some insights into our thinking here.

Q: Why does the Association Reserves online Reserve calculator (uPlanIt) not allow for the inflation rate to vary by year?

A: Because they are not known that well, and because we thought adding that level of complexity would confuse more uPlanIt users than it would help.

Q: What rate of inflation are you using in your current reserve studies?

A: Depending on the region of the country, 2.5% - 3.5%

Q: If the HOA has been using an inflation rate of 3% for the last 10-15 years, how has the 3% number affected the reserve calculations? What has been the consequence of using a 3% rate when inflation ran at about 2%/yr over the period?

A: Everything is re-adjusted at the time a Reserve Study is updated. We find that reasonable inflation rate, along with regular Reserve Study updates (inexpensive No-Site-Visit updates annually, and With-Site-Visit updates every third year) keep our clients well informed and well prepared for their own expenses.

Investment Questions

Q: I thought FDIC insured was for each account not a total of all accounts?

A: The $250k FDIC limit for corporate (HOA) accounts is "per financial institution". It is not "per account".

Q: So if you have $250K CD for the reserve account in one financial institution and $250K for the operating account in the same bank this bank will only cover $250K? Is your recommendation to move $250K to a different financial institution to get the other $250K insured too?

A: Correct.

Q: If there are two entities sharing the money in the accounts, is their FDIC limit increased to $500,000?

A: Not necessarily, if the two entities have the same tax ID #, they are considered as one entity, insured up to $250k.

Q: Just to double check - FDIC insured money market or CDs or Treasury Bills or Notes for our reserves?

A: The laws vary, state-by-state, but that is our strong recommendation.

Q: What do you do when the board has more money in accounts than the FDIC limit? The property management company says nothing (they never even pointed out that this is an issue). I've brought this up, and board members say no banks fail. When I was on the board, I attempted to move the money, but the property management company couldn't follow directions. Ultimately, it was moved but then it just increases over the limit again. The year-end financial review points out this issue. But no one does anything. What can I do?

A: Lynn Wealth Management is specifically designed with this problem in mind. In order to keep within FDIC limits, an association would need to open more and more bank accounts – or use a financial advisor who specializes in managing Reserve funds. By the way - in 2010, 157 U.S banks failed, 92 banks failed in 2011, 51 banks in 2012, etc. You don't want them to take your Reserves with them.

Q: What is your opinion on using Market Linked CDs?

A: While your principal is FDIC insured, the association is at risk of receiving absolutely no return (interest) if the underlying index does not perform as expected. Furthermore, market linked CDs are very illiquid (difficult, and potentially costly to sell them early) and the terms are typically 5 or more years in duration. Bottom line, we are not supportive of this vehicle for HOAs.

Q: The webinar slide said Bonds but I think the speaker does not agree to bonds per se. Only CD's?

A: Good eyesight! "Bonds" was used as a generic term for investments which will pay periodic interest and principal upon maturity. We felt that specific graphic nicely illustrated the concept of laddering. We only recommend CDs and U.S. Treasury bills & notes.

Q: Can you use the money put in escrow to buy these bonds?

A: I recommend first checking with the association's attorney, but it is our opinion that if the maturity of the CD occurs prior to the end of escrow, you should be okay to do this.

Q: If the yield curve is very flat shouldn't you invest in shorter vehicles?

A: It depends which way the curve is expected to steepen and over what period. As of this writing, our 3-month CDs yield 1.7% while 3-year CDs yield 3.35%. We believe staggering maturities is the most prudent strategy.

Q: What is the typical penalty for early withdrawal?

A: While it varies, many banks will charge 3 or 6 months of interest as an early redemption penalty. Brokered CDs do not have an interest penalty, although the principal returned may be more or less than the amount invested if sold early.

Q: If our small, self-managed HOA usually holds $80K in reserves, does it still pay to "invest" rather than all money in a MM fund?

A: Yes, if a money market is paying 0.10% and CDs are yielding about 2 ½%, the association would add about $1,920 to reserves in a year's time by investing in CDs.

Q: What happens if you need money tied up in CDs before they mature?

A: Banks will typically redeem the entire CD and charge an interest penalty, broker CDs will allow the CDs to be sold in $1,000 increments so you don't have to sell more than you need. Additionally, brokered CDs will not charge an interest penalty, although there may be a gain or loss on the principal.

Q: We have a stipulation that for our HI association, our Reserve investments must remain in the State of Hawaii. How does an investment advisor organize this?

A: It is our understanding of Hawaii §514B-149 that funds may be invested in CDs, throughout the Country, if the account is held in the state of HI. We recommend checking with your association's attorney prior to making any investment decisions.

Q: Our Association is in Hawaii and it is our understanding that CD's must be placed with Hawaiian Financial Institutions. But we can't get the returns you are talking about. We use laddering. We have explored T- bills but our Management Company will not act as the intermediary for us. We have an ICS account from one Hawaiian FI for one account over 10M but the rates of return are about 0.05% . What would you suggest?

A: Please contact Lynn Wealth Management. We may be able to set up a Reserve account which will only hold U.S. Treasury bills and notes.

Q: You mentioned "brokered CDs". Aren't they traded like bonds or stocks and thus subject to loss of principal?

A: Only if you need to sell a CD (or part of a CD) prior to maturity.

Q: You mentioned treasury bonds at the beginning, but then just talked about CDs. Don't treasury bonds pay more? What about I-bonds? And these don't have the FDIC limit issue.

A: U.S. T-bills and notes do, at times, yield as much or more than CDs. It depends on the maturity timeframe you're looking for. IBonds are not a good fit for associations as there is a $10k max. purchase limit and a long holding period.

Q: Can iBonds currently paying 9% be a part of reserves accts?

A: We do not believe iBonds are appropriate for community associations; There is a $10k annual purchase limit, they cannot be sold in the first year, and if you withdraw the funds within the first 5 years, you will owe 3 months of interest.

Q: **Is it better to use a 3-month CD ladder in an interest rate rising environment, or is 6-month CD ladder better?**

A: It depends on many factors, including at what rate interest is rising. We believe if 6months increments provide the association with enough liquidity, then that is easier to manage than having CDs mature more frequently. Check with your investment specialist to develop a plan that is best for your association.

Q: **What are your thoughts regarding IntraFi Network Deposits?**

A: Formerly CDARS, this program is similar to brokered CDs but it has been our experience the yields provided on CDs offered are not as competitive and the banks provide very little (or no) guidance.

Q: **What about bonds, stocks, and mutual funds? Can any % be invested?**

A: We only recommend FDIC insured CDs and money markets and U.S. Treasury bills and notes. Your state's civil code may provide further guidance on allowed investments

Q: **What kind of terms are offered on T-Bills? Is it similar to CDs so that it can be staggered?**

A: T-bills are offered at Auction in 4, 8, 13, 26, and 52 weeks. You can set up a T-bill ladder, although the maturity of the ladder would be very short (1 year or less).

Q: **You mention that direct investing in US government obligations is a potential path. Would a money market account, such as Vanguard Cash Reserves Federal Money Market Fund, which invests in US government obligations, also work?**

A: Most of these money markets are Not FDIC insured and therefore are not recommended investment vehicles for associations.

Q: **Are Investment fees that come from the banks based on the interest rate of the CD? Could you provide an example of how a fee for a 6 month CD at 2% is calculated?**

A: If a bank wants to provide a $5 million block of 6-month CDs on a national inventory, they must first be vetted to ensure the bank's financial stability, then they must offer a rate that is competitive with the other bank offerings on the inventory, lastly, they must pay an underwriting fee of approximately 0.05% to 0.10%.

Q: **Is it common for FDIC insured institutions to have additional insurance to cover $ amounts over the FDIC insured accounts?**

A: Some banks may offer surety bonds, or independent, third-party insurance. Please keep in mind, this is not government backed insurance (like FDIC) and is only as strong as the insurance company which provide the coverage.

Q: **The bulk of our money, about $1 million, including operating and reserves, is in one bank because that's where our management company puts it. It's covered by a "surety bond." Are surety bonds legitimate and guaranteed to pay off in case of loss? Are they specific to a particular kind of loss?**

A: The surety bond is only as strong as the insurance company backing it. The specific surety contract will explain what losses are covered and which ones may not be covered.

Q: **Is it safer to invest in Treasury Notes especially if there is more than $250,000 to invest?**

A: Treasury securities are considered even safer than FDIC insured CDs as they are backed directly by the US government, whereas FDIC is an agency of the government. However, if you keep your CD purchases within the $250k limit, per financial institution, that is about as safe as you can get.

Q: **Opinion of ICS program with banks vs CDARs or laddering?**

A: ICS would be for the liquid portion of an association's reserves while CDARs (now IntraFi Network Deposits) would be for the CD portion. These are similar to programs offered by financial advisors but typically with much less service and lower yields.

Q: **Where do CDARs fit into the investment decision process?**

A: CDARS is a "do-it-yourself" alternative to working with an advisor. You will not have obtained any professional guidance, and rates may be less attractive. Remember, your job as a board member is to make decisions, not serve as an unpaid investment coordinator.

Q: **What about using a mutual fund of exclusively treasury securities?**

A: We do not think this is a good idea. The fund is not insured or government backed and may lose money as rates increase.

Q: **What about TIPS (inflation protected treasury securities)?**

A: While TIPS may be appropriate for a small portion of your Reserve assets, please keep in mind, the shortest maturity at auction is 5 years.

Q: **Don't account registry CDs (CDAR)s solve the need for multiple banks to avoid the FDIC limit?**

A: Yes, however it has been our experience that CD yields offered by CDARS are not competitive with brokered CDs. Banks offer little to no service, advice, or expert guidance with this program, whereas a financial advisor will review your anticipated cost schedule and craft a CD laddering strategy specifically for your community.

Q: **With Fed Reserve 2022 past and projected interest rate increases, our association has to keep 3 month and 6 month CDs. Would you recommend extending terms beyond that?**

A: Yes, extending maturities to 2 to 3 years may be appropriate, as long as you have "liquid cash" sufficient for upcoming expenses. The expectation of further rate increases by the Federal Reserve has largely been bult into the yield curve. For example, our 2-year CDs currently yield 1.2% more than a 3 month CD.

Q: **What are your thoughts on the use of brokered CDs?**

A: Brokered CDs are what Lynn Wealth Management uses. They are very appropriate for community associations as long as you work with an advisor who properly ladders the maturities of CDs and keeps each CD under the FDIC limit.

Q: **How do you address projected grant income?**

A: Sorry, I do not understand the question.

Financial Advisor/Broker/Lynn Wealth Management Questions

Q: **This seems like a lot of work for the Board to manage! And if it is handled by an investment specialist, would the fees be worth it when interest rates are low?**

A: You're right. It is a lot of work. That's why working with an investment specialist is a good idea. Let us worry about it being "worth it". Lynn Wealth Management is compensated by the banks which participate in the program and not by the association. The banks pay an underwriting fee for the privilege of having their CDs made available on a national level.

Q: **What does the HOA have to invest to have a financial advisor such as Lynn?**

A: Dave's minimum in TX and FL is $1,000,000, and $500,000 in CA

Q: **Did I understand correctly that Lynn WM only wants to work with associations with more than $250K to invest? Or is there another minimum dollar level?**

A: As it is a lot of work, not only do we have more to offer associations with more Reserves on hand ($1,000,000 in TX and FL, and $500,000 in CA), that threshold is also when those accounts become cost-effective based on current bank underwriting fees.

Q: **Just did our 1st reserve analysis. 2yo 102 townhome HOA here in Pensacola Florida. Reserves were underfunded by the builder so we're putting together our reserves budget for '23 which will increase assessments. We expect to grow our Reserve Fund to $250k by the end of 2024. So… would David Lynn be interested in having a**

conversation given the reserves accounts will grow over $250k within about 18 months?

A: Good for you to be growing the size and strength of your Reserve Fund. Please reach out to me (Lynn WM) when your account reaches our TX and FL account minimum of $1,000,000.

Q: How are investment specialists compensated?

A: We are compensated by the banks which participate in the national CD inventory. These banks pay an underwriting fee for the privilege of having their CDs be made available on a national level to clients smaller than they can handle at a corporate level. Avoid advisors who charge commissions or flat fees.

Q: Are the rates lower when you get products through a broker earning compensation from the bank?

A: Generally speaking, the rates offered with professionally brokered CDs are higher than if you were to go to that same bank yourself. The underwriting fee the banks pay to have their CDs made available on the national inventory is relatively small and because the banks sell the brokered CDs in multi-million dollar increments, they can afford to provide a higher yield than by selling them one-by-one in much smaller amounts. Lynn Wealth Management (and other similar companies) offer these higher commercial yields by administering these investments with clients too small for the large financial institutions to handle.

Q: Are you saying you do this at no charge to the HOA?

A: Yes, agents like those at our firm are compensated by the <u>banks</u> which participate in the program and <u>not</u> by the association. The banks pay an underwriting fee for the privilege of having their CDs made available on a national level to “smaller investors” such as associations.

Q: If an association has closer to $100k, would it still be advised to work with an expert? Our board members are not finance professionals.

A: We recommend finding a bank that specializes in working with HOAs. Check your local CAI chapter for a list. You can still set up a CD ladder at the bank, for example a $20k 6, 12, 18, and 24-month CD ladder may be appropriate.

Q: Do you (Dave) only work in CA, TX & FL? What is a recommendation for an investment advisor in WA state?

A: We recommend checking with your local Community Associations Institute (CAI) chapter and asking if they have any service providers who are Reserve Fund Management specialists.

Q: How to find an investment counselor?

A: I recommend checking with your local Community Associations Institute (CAI) chapter and asking if they have any service providers who are Reserve Fund Management specialists. If your association is in CA, FL, or TX, I would be happy to speak with you (certain minimums apply).

Miscellaneous Questions

Q: Do you recommend splitting Fiduciary Duties between two members? For example, one devoted to intake, the other to spending, or dual signatures on checks.

A: My CA community association clients all have a dual-signature requirement for their checks and the disbursement of Reserve funds. The law varies, state-by-state

Q: Your thoughts on banks that specialize in HOAs and sweep accounts for Reserve Funds?

A: While I think HOA-specific banks are better suited to help associations with their reserve fund investments, I believe an independent investment advisor is much be able to provide the service an association board deserves, especially as the Reserve Fund crosses the $250,000 threshold.

Q: What % of HOA's have Fidelity Bonding for their Treasurer or other Board members?

A: Sorry – we frankly do not know that information.

Q: Please discuss taxes, both Federal and State.

A: Sorry, tax counsel is outside the scope of our expertise.