Reserve Investment & Inflation

by Robert M. Nordlund, PE, RS
& Dave Lynn

www.ReserveStudy.com
www.LynnWM.com

May 24, 2023

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? How do recent bank failures affect your decisions? 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 years of 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: Safety, Liquidity, and Return/Yield. He talks about the tradeoffs, the priorities, and what that means for month-to-month account management. Keep your Reserves safe! You can't pay for Reserve projects if you've lost the money!

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 expectation 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 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 part-time 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 (AZ 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

Investment Questions

Q: How do we find an HOA investment advisor in our state?

A: For CA, AZ, and TX associations, please contact my office here. For others states, I recommend contacting your local Community Associations Institute (CAI) chapter for recommendations of potential vendors.

Q: David, our Association is in Florida. Do you work with Associations nation wide?

A: No, only in CA, TX, and AZ. For FL, I recommend contacting your local Community Associations Institute (CAI) chapter for recommendations of potential vendors.

Q: What if your HOA doesn't have an investment counselor? We don't, that task has fallen on the shoulders of whomever is Treasurer!

A: Get one!

Q: Could you please repeat what would be an average charge/fee for an investment counselor? or different ways to know what we would be required, is it a % of the account/investments?

A: You should not pay a fee for an investment counselor. We are compensated by the banks which participate in our nationwide CD inventory.

Q: What would be an average charge/fee for an investment counselor? or %?

A: You should not pay a fee for an investment counselor. We are compensated by the banks which participate in our nationwide CD inventory.

Q: Is it risky to have the HOA Financial Management company manage Reserve CDs?

A: Not risky perhaps, but there is a potential for conflict of interest.

Q: Are HOAs in CA allowed to invest $10,000 in I-bonds/ They are currently offering a return of nearly 7%. Last fall, they were earning 9%. They are backed by the government.

A: Yes, however, if not held for at least 5 years, you are subject to a 3 month interest penalty.

Q: Should an underfunded HOA invest?

A: Absolutely! Every dollar from investment returns means one dollar less required from the homeowners. But of course, the primary response of underfunded associations should be to increase their Reserve funding.

Q: **Can you provide some insight of CDs versus T-Bills. T-bills are liquid and easily purchased through Treasury Direct.**

A: Both are considered 100% safe and "brokered" CDs are liquid in the same way Treasury securities are.

Q: **Under what circumstances are Reserve Fund investment accounts not appropriate?**

A: We can't really think of one… other than perhaps where the association has no common areas, has a small budget, and therefore no need for a "savings" account.

Q: **What are your thoughts about the US gov't failing along with banks? Can HOAs invest in gold under those circumstances?**

A: If that were to ever happen, you would have a lot more problems than worrying about Reserve funds. The US Government would not allow itself to fail. It would simply print more money.

Q: **What danger is there to treasuries if the country defaults?**

A: None, the US cannot default. If they did, CDs would also be worthless. They would simply print more money.

Q: **We spent most of our reserves the last few years on projects, so our balance is now low (approx. $20,000). Since this is so low (we bring in $27k a year), would a Sallie Mae Bank account giving 4.5% interest be best? It is FDIC insured. Right now we have a regular savings account at a bank and it pays less than 1%.**

A: The 4.5% Sallie Mae account sounds like a good option – as long as it is FDIC insured.

Q: **We use a Bank that purchases "brokerage CDs" with unique CUSIPs (with some bps retained by the bank) - - how does this compare to a service provided by an investment advisor?**

A: What you are describing is IntraFi[R] Network Deposits (Formerly CDARS). CDARS was created to compete with brokerage firms and their brokered CD programs. The biggest difference is that the Intrafi program usually does not include professional help (proactive recommendations, analysis, continuing monitoring, etc. Another difference is the Investment Advisor typically has access to a much greater inventory of CDs.

Q: **Are there tax advantages for investing in Treasuries vs CDs?**

A: Yes, Treasury securities are free from state tax.

Q: **Are invested funds taxable?**

A: In the webinar, we did not have a tax professional to answer such a question with authority, but our understanding is that investment returns are taxable income for associations.

Q: **Our Property Manager Accountant apparently didn't like our investments earning market rate interest. She said that we would be paying 30% in taxes on those investments, seemingly preferring to "earn" the low big-bank rates, e.g. 0.50%. I've read that there 2 methods of taxation, true (and briefly explain)? How do you know which one your association is following? (if not answered in the webinar) When is it better to invest in non-taxable instruments?**

A: We did not have a tax professional to answer such a question with authority, but our understanding is that income is good, and more of it from sources outside of the homeowners is even better! So even if you pay a portion of the investment returns to the government in tax, the association is still ahead. And yes, there are two federal tax forms, the 1120 and the 1120-H. The latter is the more common and simpler one, designed specifically for "H"omeowner associations. Check with your tax professional which one is best for your association.

Q: **What is the tax rate of yield from CDs?**

A: Consult with your CPA. Generally speaking, the interest income is taxed at the Federal level (~30%) and, if your state has an income tax, the interest is also taxed and that marginal rate.

Q: **Is investing in secondary market CDs advisable, especially related to liquidity?**

A: No, primary brokered CDs are as liquid as secondary CDs but secondary CDs will come with accrued interest and likely either a discount or premium to their maturity value.

Q: **At my HOA, nobody volunteers to be a signer on an account. What can be done in this situation?**

A: Board members have a fiduciary responsibility to protect and maintain the value of the community. If they are not willing to accept that responsibility, I am curious as to why they would want to be a board member in the first place.

Q: **Investment income on reserve funds creates income taxes. Can these income taxes be paid with reserve funds?**

A: Yes, but more typical taxes are paid from the Operating account. Per National Reserve Study Standards, taxes do not qualify as a Reserve expense.

Q: **There's been some chatter on the association boards about HOAs that invest in I-bonds. What's your opinion?**

A: You are limited to $10k per year in purchases and must keep the bond for at least 5 years to avoid an interest penalty. There, they are not optimal for most associations.

Q: **Please comment on the feasibility of these kinds of investments:**

1. **Fixed annuities from insurance companies with an AM Best rating of A- or higher**
   a. Absolutely not, they are not government backed, must list an individual as the "annuitant", and lack liquidity.
2. **Indexed Annuities**
   a. Absolutely not, they are not government backed, must list an individual as the "annuitant", and lack liquidity.
3. **No-load mutual funds investing exclusively in the authorized investments (of the HOA)**
   a. Absolutely not, they are not government backed.
4. **Corporate and municipal bonds held to maturity with an AAA rating or equivalent.**
   a. Absolutely not, they are not government backed, must list an individual as the "annuitant", and lack liquidity.
5. **Brokered CDs (please explain what these are for the benefit of the audience)**
   a. Yes. These are CDs that are purchased from hundreds of banks around the county by a brokerage firm and held in inventory for investors. The CDs are placed into the tax ID #and name of the individual client (Association) and are then owned by the client and are merely custodied at the brokerage firm.

Q: **How safe are bond funds?**

A: U.S. Treasury bills, notes, and bonds are considered the safest and most liquid investments in the world. Corporate bonds, however, are only as safe as the corporation which issues them and are therefore not appropriate for associations.

Q: **A Fidelity Gov Money Market, which is NOT FDIC insured, but is backed by US Treasuries and other Gov securities, would you consider this a safe investment for an HOA?**

A: Not as safe as induvial CDs and treasury securities. It can lose money, especially in a rapidly rising interest rate environment.

Q: **What drives CD rates?**

A: Many factors, including the Federal Reserve's actions. CD rates correlate strongly with the federal funds rate. When the Federal Reserve increases its benchmark rate, interest rates across the economy, including CD rates, increase. Similarly, decreases in the federal funds rate cause CD rates to fall.

Q: **What is your opinion on using short term treasuries?**

A: U.S. Treasury securities with maturities from 3 months to 36 months are appropriate for most associations.

Q: Since we're at peak interest rates now, what do you think of putting a certain amount of Reserve funds (which we don't want to touch) into a max duration CD, i.e. 5-yrs

A: As long as your current reserves is sufficient to cover the cost of repairs and replacements of common items out to 5 years, looking in "some" money into 5 year CDs may be appropriate for some associations.

Q: Compare using CDs vs Treas Bills & Notes

A: Both are considered 100% safe and "brokered" CDs are liquid in the same way Treasury securities are. Treasury securities are also exempt for applicable state tax.

Q: Many banks, especially those who cater to HOAs, have access to INTRAFI which enables HOAs to access CDs from numerous banks without an intermediate entity. Is this not a good option for HOAs?

A: Yes, IntraFi^{R} Network Deposits (Formerly CDARS) was created to compete with brokerage firms and their brokered CD programs. The biggest difference is that the Intrafi program usually does not include professional help (proactive recommendations, analysis, continuing monitoring, etc. Another difference is the Investment Advisor typically has access to a much greater inventory of CDs.

Q: Does the California Civil Code require that a bank used by a California HOA be a California bank?

A: No, not for Reserve funds. But yes, for Operating funds.

Q: Can an association create an account at treasury direct and invest in T-bills?

A: Yes, although I am told it is quite a "clumsy" process, that is, the site is not very "user friendly".

Q: Can you comment on INTRAFI?

A: IntraFi^{R} Network Deposits (Formerly CDARS) was created to compete with brokerage firms and their brokered CD programs. The biggest difference is that the Intrafi program usually does not include professional help (proactive recommendations, analysis, continuing monitoring, etc. Another difference is the Investment Advisor typically has access to a much greater inventory of CDs.

Q: My association has over $350,000 in monthly expenses and collects homeowner assessments quarterly - how do we protect our operating account which must exceed $250,000?

A: Ensure your operating bank has a surety bond in place.

Q: **With CDs used as a tool, with the option of liquidation without penalty, is it sound to invest a large portion of the reserve fund?**

A: Generally, we recommend investing 90% of the Reserve funds in a 6 to 36-month CD ladder and keeping 10% in FDIC insured money markets. Of course, your individual situation will vary depending on anticipated upcoming expenses as outlined in your reserve study.

Q: **When you have T-bills and perhaps need to cash one in before maturity will we get the accrued interest to the date it's cashed in or do we lose it?**

A: For U.S. Treasury notes and bonds, you will get the accrued interest. However, T-bills are purchased at a discount to Face value and mature at Face value. If interest rates are static, the price of a T-bill will generally increase to reach face value at maturity.

Q: **What is your opinion regarding "secure sweep accounts" as an alternative to managing individual bank accounts to protect the association's funds?**

A: All of our associations place approximately 10% of their Reserve funds in FDIC insured sweep accounts. So, any interest paid by a CD or any deposits made into the account are automatically "swept" into the insured money market. Our sweep accounts consist of 5 banks, electronically linked together to provide ($250k x 5) $1.25 million in FDIC coverage. The sweep accounts are an integral part of the associations' Reserve funds, but CDs are where the bulk of the finds will earn interest.

Q: **Can you discuss sweep accounts in general?**

A: See above.

Q: **What about a cash sweep account over $250K?**

A: See above.

Q: **Are money market funds considered to be "safe" investments for HOAs?**

A: Not all money funds, only those which are FDIC insured.

Q: **What about using a letter of credit to ensure that funds are available when needed? 1. Good idea? 2. Cost? 3. Other options?**

A: I do not know of any association which does this nor do I know what kind of liquidity (easy/quick access to funds) a letter of credit would provide. I do know that if the funds are not FDIC insured, they it would not be appropriate for associations. But first check with your attorney, as your governing documents may require you to "budget adequately" for upcoming expenses. That means setting aside Reserves.

Q: **I've been told that short-term T-bills have a higher interest rate than long-term. They can also be dissolved without penalty. Is this true?**

A: From time to time, the yield curve is flat or inverted. When this temporary situation occurs, shorter term securities can pay the same (flat) or more (inverted) than longer term securities. Please note, this is a temporary phenomenon and often times signals a peak in the interest rate cycle.

Q: **Is liquidity defined as 2-2.5 X expected expense?**

A: Generally yes. It is considered good practice that an association retain 2 to 3 months of Operating expenses in its Operating account. Check with your Reserve Study provider with respect to

Q: **What are the current bond rates?**

A: From 3 months to 3 years, most CDs and treasury securities yield between 4 ½% and 5%.

Q: **I'm a fan of I-bonds that are built in a ladder. I have a client that has 12 years of I-bonds - so their base layer of their reserve fund is now set to inflation with some of those I-bonds actually beating inflation due to the fixed rate on some bonds. After 5 years those bonds are completely liquid with no interest penalty. And after 1 year those I-bonds only have the most recent 3-month interest penalty. The net after tax return (even losing that 3-months of interest) almost always beats the after-tax effect of equivalent length CD investment. So what am I missing as to why an I-bond ladder of $10,000 per year for the absolute minimum threshhold of reesrve funds that we should never be touching?**

A: That strategy may be fine for your association but would not be very practical for an association which has $5 million + in reserves to be managed.

Q: **Some BOD members think large amounts over $250,000 is safe in a large bank like BOA, JPM or WFC. Comments?**

A: Janet Yellen advised differently just a few weeks ago when testifying before congress. I do not see the advantage of taking that risk.

Q: **Typically, CC&Rs limit the time you can hold the money in an investment. Ours is 1 year. Is there anything you can you do with that?**

A: Consider investing in updating your Governing Documents. But check with your association's legal counsel - you may be misinterpreting your documents. The 1-year clause typically refers to entering into "contracts" for more than 1 year. An investment (CD) owned by the association is not considered a contract and is therefore exempt from that clause.

Q: Your thoughts on ICS or CDARS accounts.

A: IntraFi[R] Network Deposits (Formerly CDARS) was created to compete with brokerage firms and their brokered CD programs. The biggest difference is that the Intrafi program usually does not include professional help (proactive recommendations, analysis, continuing monitoring, etc. Another difference is the Investment Advisor typically has access to a much greater inventory of CDs.

Q: Do you have a recommendation for treasury funds or Treasury ETF's?

A: No, only individual treasury securities. Funds or ETFs may lose money.

Q: So for our Mobile Home Park the board should only invest in FDIC accounts & each under $250K? The board should not invest like for example Morgan Stanley like companies? These type of companies are not safe & against the boards fiduciary responsibility? Are government secure accounts like bonds & treasury okay?

A: I spent almost 30 years at those large brokerage firms and if you work with someone who specializes in community Associations, then your money is perfectly safe. But the advisor would need to keep 100% of the association's funds in FDIC insured investments.

Q: Is First Clearing Corp similar or the same as buying a brokered CD at Fidelity or some other brokerage account?

A: Yes. The difference would be the advisor with whom you would work. Make sure they have several years of Community Association experience.

Q: How long has it been since the FDIC insurance protection limit of $250,000 was set? How likely is it that the FDIC will increase this limit? I think increasing the limit is way overdue.

A: The Emergency Economic Stabilization Act of 2008 Temporarily Increased Basic FDIC Insurance Coverage from $100,000 to $250,000 Per Depositor. Basic FDIC Insurance Coverage Permanently Increased to $250,000 Per Depositor on *07/21/2010. I do not deem it very likely the FDIC limit will increase above $250k any time soon.*

Q: Do CDs count toward the $250,000.00 insured limit?

A: Yes

Interest Questions

Q: Can you move interest earned from reserve funds investments to the operating fund?

A: Theoretically, yes. However, most Reserve studies will consider the interest earned on Reserves towards supporting the reserves. With the rising and falling Reserve Fund balance it yields a rising and falling (very inconsistent) income stream to the Operating Fund from year to year.

Q: I happened to find two banks so far that pay close attention to market interest rates for business accounts (which HOAs are considered), but is there a list of such banks?

A: Brokerage firms with a brokered CD program have their own inventory of banks with whom they work. Also - spend time with your local industry trade organization (CAI, etc.) to learn which banks most effectively serve the community association market, and start with that list.

Inflation Questions

Q: What is your inflation outlook (a) for the next five years 2024 to 2028 and (b) for the next five years 2029 to 2033?

A: Dave: Anyone who tries to predict inflation past 2 to 3 years is only fooling themselves – including you. It is largely dependent on how much money the government prints. I personally believe inflation will remain elevated for the next 2 + years.

Robert: Although I'm a Reserve Study provider and not a fortune-teller (I only look at what I see and report back), I expect inflation will be "higher than average" for the next two or three years, then "back to long term average" after that point for a while. Sharp minds at the Federal Reserve and US Treasury are working hard to bring inflation down to more "normal/average" levels.

Q: Do you think the Fed will get inflation down to 2 percent, over time?

A: I think 3% is a much more realistic goal, but that may not occur for another 3 to 5 years

Reserve Questions

Q: Your comment about reserve provisions usually being at least 15% of the budget. Would that apply differently to HOAs vs. condos/ townhomes?

A: That "15-40% of total budget to Reserves" is amazingly consistent across all property types, of all ages, and all areas of the country.

Q: This last slide... what do you mean by 15-40% reserves? Do you mean we should be collecting annually this amount?

A: Yes. Whether monthly or annually, the majority of associations with a healthy/balance budget need to set aside 15-40% of their total budgeted income to Reserves… to offset the cost of ongoing deterioration.

Q: When would I want 15% in reserves? When would I want 40% in reserves? Why such a wide potential variation?

A: What was recommended is <u>ongoing transfers</u> to the Reserve Fund, not Reserve balance. That 15-40% varies based on the type of association, the strength of its Reserve Fund, and the timing of its Reserve projects, all things which are captured in an updated Reserve Study.

Q: Did I understand that you should always keep 10% of your reserves in cash?

A: I don't believe I said that. A minimum threshold of "10% of budget going to Reserves" is a market standard (driven by Fannie Mae, Freddie Mac, and the FHA) for condo associations. As far as what you do with that cash, it is always good to leave some in cash (or readily accessible), because life is full of surprises. Discuss that % with your investment counselor.

Q: Please define replacement or new asset.

A: That definition turns on the question "does it currently exist or not". Installation of something that previously did not exist (a new tennis court, a new entryway fountain/monument) is a capital improvement, and an inappropriate use of Reserve funds. Replacement does not have to be "like for like" (you can replace the furniture in the rec room with a different assortment of sofas, card tables, chairs, and barstools than were originally there), but the asset must currently "exist".

Q: Can you pay income taxes due on the reserve funds income out of reserve funds?

A: You can, but taxes are usually paid from the Operating Fund, as taxes are not a qualified Reserve expense.

Q: Will Association Reserve conduct SIRS?

A: Short answer: the original 2022 definition of a "SIRS" was close to unworkable. The 2023 revised definition (awaiting the FL Governor's signature as of this date) now falls into the definition of a Reserve Study, so the answer is "yes".

Q: How often should the reserve study be done?

A: Our recommendation is that a Reserve Study be updated annually, as it is regularly one of the association's largest budget line item (if not the largest). National Best Practices now recommend an **update with-site-visit** at least every third year. Note that special assessments <u>measurably decrease in frequency</u> the more frequently an association updates its Reserve Study.

Q: **In CA, the balcony bill calls us to obtain a costly (& possibly invasive) engineering or architectural study report prior to 1/1/2025. What reserve amount should HOAs estimate for such a report?**

A: Check with your Reserve Study provider. The cost will vary based on type and size of property. But indeed, that inspection (and likely the "fixes" arising from that inspection) are appropriate to be funded through Reserves.

Q: **How accurate have future cost projections proven to be?**

A: Accurate enough for planning purposes. It is reckless to think that if it is not perfect, it can be ignored.

Q: **We do not have much in the fund yet, as it is our first year taking Reserve preparation seriously. We need lots of repairs due to deferred maintenance. Should we concentrate on saving or could we use some of the reserve for repairs identified in our study?**

A: Check with your Reserve Study. Reserves are to repair and replace assets at the property. The objective is not to amass a large Reserve fund balance. It may be that for a while, all your Reserve funding goes right into the property, not into your Reserve fund.

Q: **What percentage of the reserve fund do I need to add to account for inflation?**

A: We recommend, for long term planning purposes, to count on what the historical inflation rate has been here in the USA, and that's something in the range of 3%. Since inflation always exceeds interest earnings, the difference is made up with slightly higher Reserve funding.

Q: **How much cash should we have on hand as a % of yearly expenses? Fund balance? What is the figure of merit?**

A: It varies based on the association, both size and timing of your Reserve projects. Follow what is recommended in your Reserve Funding Plan. Best practice is to always leave at least 10% of any year's Reserve expense total in the Reserve Fund. So, if you anticipate spending $500,000 on a roof in any one year, plan on leaving a balance of at least $55,000 in the Reserve Fund.

Q: **Would it be prudent to use amounts for elements identified in the study early in saving for reserves if it isn't fully or even partially funded yet?**

A: Absolutely. Funding for Reserves is based on the evaluation of common area deterioration, and most of those projects will not actually occur for many years. So plan now, collect now, so the funds are there when needed.

Q: **The CC&Rs specify only 10% of the Operating Budget can go to Reserves. Any suggestions?**

A: Update your Governing Documents. The property needs much more, and your job as a boardmember is to maintain the (financial and physical) assets of the association, setting the budget annually to provide for the needs of the association.

Q: **Will inflation be built into the reserve study in Florida since the new laws passed this year?**

A: Yes, finally. A very restrictive opinion by the FL Department of Building and Professional Services (DBPR) has now been overruled by state law (still awaiting signature by the governor, as-of this writing).

Q: **The most recent reserve study completed for our HOA had an investment return modeled at 1% while costs inflated by 3% annually. What is the current view of long term inflation and return rates on reserves?**

A: We still believe long term inflation will be in the 3% range, so we recommend using that figure. Since boards have control over Reserve transfers, we recommend using the actual investment return figure so they can set their homeowner assessments accurately. So use an investment counselor, and boost that 1% up to the 4% (or more) that Dave was talking about.

Q: **Can you please clarify when to separate accounts - operating expenses & reserve funds? ($100,000/mo operating account, $250,000 current reserves)**

A: Always! Like you heard from Dave, you should be earning interest from Reserves so they are growing while they are waiting to be spent.

Q: **Where can I find reserve study standards? I need this to provide a scope of work for the party developing the reserve study.**

A: National Reserve Study Standards are found here. There you'll find the 2018 version… the 2023 updated version has apparently yet to be posted. But if you're having someone prepare your Reserve Study who isn't aware of Reserve Study Standards, you should select someone else.

Q: **Our community is replacing the roofs but we are finding the funds in reserve are about 20% short of the actual cost. Do we have to assess to pay back those funds that are over the reserve amount?**

A: Your primary responsibility is to maintain the assets of the corporation. Assess the amount you are short and pay it to the roofer. Then get busy setting a budget with higher Reserve funding that realistically offsets ongoing deterioration, so this doesn't happen again!

Miscellaneous Questions

Q: If you file the 1120H tax form, the tax rate is about 30%. What about using an 1120 tax form - what's the rate?

A: Consult your tax professional. The tax rate for filing the 1120 form may be lower than the 1120H, but it will cost you more in tax prep fees to file. So, it is not a clear decision. Our understanding is that most associations find it cost-effective to file the simple 1120H.

Q: What is the name of the weekly podcast?

A: "Common Sense for Common Areas" – available on all major podcast platforms. See more here.

Q: If a professional management company has never talked with the board about investing money in a 30+ year-old community, is that management company in breach of duty?

A: Sorry, that sounds like a question better posed to your community association attorney. Expect your manager to manage, your Reserve Study provider to advise about Reserves, your investment counselor to advise about Reserve fund investing, your attorney to advise about legal matters, etc.

Q: Do these Management professionals have a fiduciary duty to the HOA?

A: That's not as simple a question as it seems. Generally the answer is yes, but please discuss with your community association attorney.

Q: What about meeting insurance deductibles in case of a disaster?

A: Reserves are for projects that deteriorate on an ongoing basis and can fundamentally be anticipated. Special assessments are for unexpected cash needs, like large insurance deductibles. Note that it may be possible to short term borrow from Reserves to help manage the "disaster", but those Reserve funds should be restored with higher ongoing funding or a special assessment. Check with your attorney regarding "borrowing from Reserves" laws in your state. Regarding long term Reserve investments… remember that withdrawing early (borrowing from Reserves) may incur a penalty, making it especially unsavory as an option.

Webinar Attendee Questions - 2022

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 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 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.