College Savings Nation 2019: Searching for Enhancements

May 2019

Overview

This AKF 529 Market Report provides an update on the 529 college savings market and noteworthy developments in a maturing industry. 529 plans continue to offer extensive investment choice and flexibility for American families that choose to save for education. But, to improve plan appeal and remain competitive, State Administrators and Program Managers are searching for plan enhancements more rigorously than ever before amidst industry competition and regulatory scrutiny. Key take-aways from this 2019 Market Report include:

- Asset-based fees have decreased and the number of investment options has increased over time as State Administrators and Program Managers are compelled to reassess how to remain competitive and transparent.
- Predominantly passively-managed Direct Plans are quickly approaching rock bottom fees while the largely actively-managed Advisor Plans still have room on the downside.
- States have begun to address K-12 expansion at the program level, including in one instance carving out a separate K-12 program.
- K-12 conformity may have accelerated C Share Class suitability concerns, highlighted by FINRA's recent 529 Share Class Initiative.
- We expect more 529 plans to adopt an enrollment-based structure, commonly used in retirement plans, in lieu of the more typical age-based structure. Several states have moved forward with this model in recent years.

Overall, the future of the 529 industry remains bright with opportunities for both refinement and growth.

Methodology

Data for this AKF 529 Market Report was aggregated through a review of the Program Disclosure Statements for 90 Savings Plans as of April 1, 2019.

Findings and Observations

Observation 1: Continued Growth in a Maturing Market

Overall, we are seeing the 529 industry entering maturity but continuing its growth trajectory. Since inception more than two decades ago, the industry has grown to $311 billion in total savings and prepaid assets across 13.8 million accounts as of December 31, 2018.[1] The growth rates of assets and accounts have generally remained positive[2] even while the earliest 529 investors have begun to draw down their funds for college expenses.

[1] Data based upon College Savings Plans Network ("CSPN") as of December 31, 2018
[2] Based upon CSPN data, asset growth rates declined in 2008 (-18.6%) and 2018 (-2.5%) due to negative market performance.

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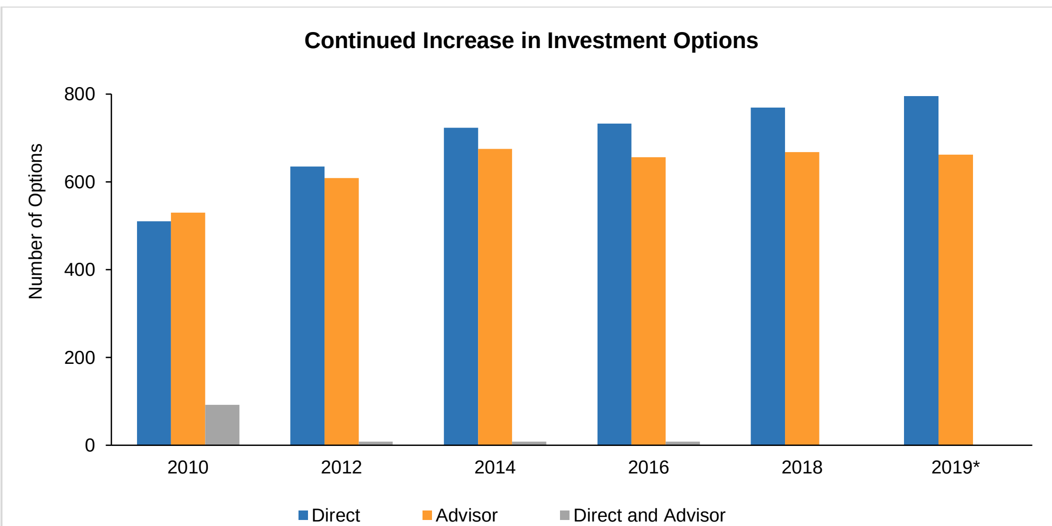
Since our 2018 College Savings Market Report, the number of available savings plans has slightly increased from 89 to 90. The change reflects the April 2018 launch of the Washington Dream Ahead 529 Savings Plan, the first new Plan since the advisor-sold Nevada Wealthfront 529 Plan in October 2016 and the direct-sold Tennessee TNStars College Savings Plan in September 2012.

At the same time, we have seen an increase in the number of investment options offered across Direct Plans. We believe this reflects an appeal to more do-it-yourself investors, who we believe are increasingly drawn to the low costs and ease of the Direct Plans. Finally, as shown in the following chart, the number of open Prepaid Plans has not changed:

		April 2018		April 2019	
Plan Type		Direct	Advisor	Direct	Advisor
Savings	Available Plans	59	30	60	30
	Investment Options	769	668	795	662
Open Prepaid Plans[3]		12		12	

Noting the increase in the number of investment options offered in Direct Plans, this trend is more clearly visible over the long term. The following chart shows the number of investment options since 2010 in two-year increments, including the first quarter data from 2019. As the chart also shows, the gap between Direct and Advisor investment offerings has incrementally widened since 2010.[4]



*Reflects Q1 data only

[3] Includes: Alaska, Florida, Maryland, Massachusetts, Michigan, Mississippi, Nevada, Pennsylvania, Texas, Virginia, Washington and Private College 529. Enrollment in the Illinois Plan has been suspended since 2018. While not reflected in the chart, the Virginia Prepaid529 Plan is closed to new enrollment as of May 1, 2019; a new Virginia Prepaid 529 Plan will be offered in 2020.
[4] During the past nine-year period, the number of investment options offered in Direct Plans grew on average 5.1% while the number in Advisor Plans grew on average 2.5%. Note, as of 2018, the 529 industry no longer had Direct and Advisor Plans with identical investment offerings. In April 2017, the North Dakota Direct Plan added an Advisor Class Unit to target the broker-dealer channel. The same investment line-up is utilized, but we categorized this change as Share Class differentiation rather than the launch of a separate Plan.

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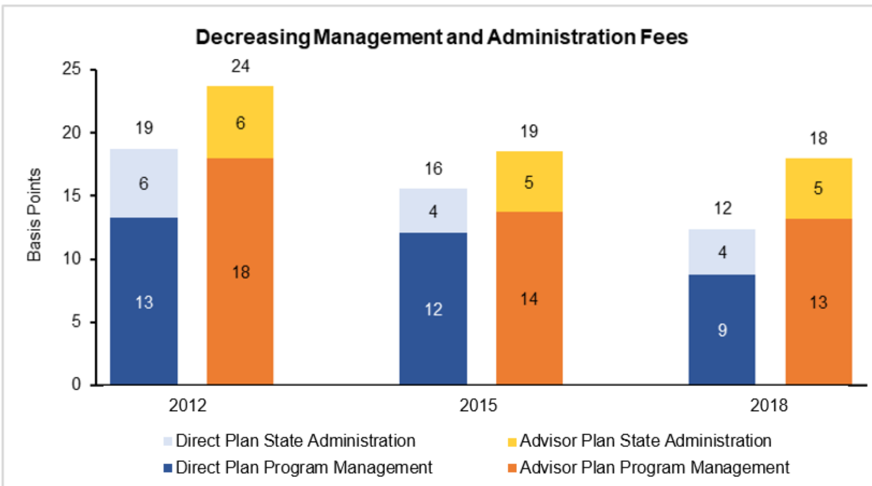
As the 529 industry continues its growth trend and more Plans reach economies of scale, State Administrators and Program Managers are under pressure to stay competitive and reassess the value proposition for investors, including participant fees and investment offerings.

Observation 2: Fees Continue Race to the Bottom

We have monitored program management and state administration fees for the ten largest Direct and Advisor Plans since 2012.[5] These asset-based fees are established by Program Managers and State Administrators and are charged to investors. The following chart shows that Advisor Plan program management fees have consistently remained higher than Direct Plans, while state administration fees have closely tracked one another.



As shown above, since 2012, management and administration fees have trended downward. Direct Plan fees decreased by 7 basis points while fees in Advisor Plans decreased by a similar amount (6 basis points). In each case, decreases in program management fees drove the reduction. State administration fees for Direct and Advisor Plans have also decreased between 2012 and 2015 but hardly budged after 2015.

We have also analyzed total fees, including the impact of underlying fund expenses and distribution fees. Total fees in Advisor Plans are notably higher than Direct Plans, largely due to the cost of underlying investments and the service charges associated with professional financial advice, as shown in the following chart:[6]

[5] Top ten by asset size based upon December 31, 2018 CSPN data. The charts in this section show average management fees across Direct Plans in California, Illinois, Iowa, Maryland, Michigan, Nevada, New Hampshire, New York, Ohio and Utah, and Advisor Plans in Alaska, Colorado, Illinois, Maine, New Hampshire, New Jersey, New York, Ohio, Rhode Island and Virginia.
[6] "Underlying Fund and Distribution" charge includes an annual 0.25% for A Shares but does not include loads associated with A Shares; "Management" includes fees for both State Administrators and Program Managers.

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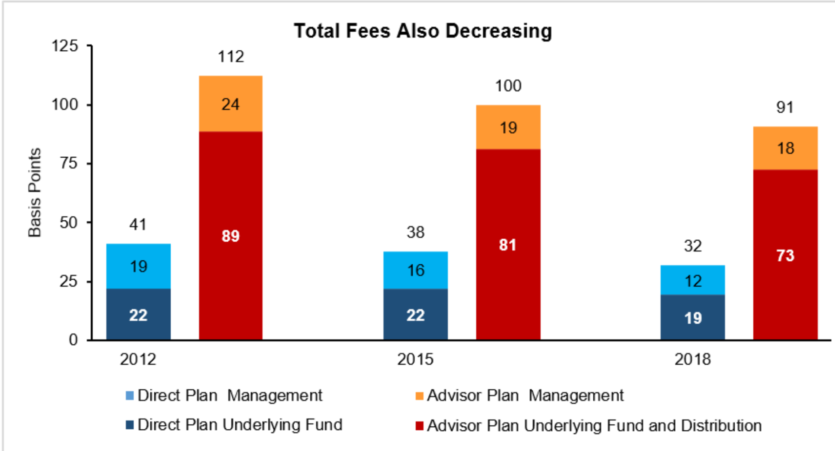

On a total fee basis, Advisor Plan fees have decreased more than Direct Plans over time. Since 2012, underlying fund expenses and annual service fees for Advisor Plans decreased by 16 basis points while Direct Plan underlying fund expenses decreased by just three basis points. This overall downward trend reflects awareness of investors' preference for lower-cost investments. Predominantly passively-managed Direct Plans are quickly approaching rock bottom fees while the largely actively-managed Advisor Plans still have room on the downside.

Observation 3: Convertible C Shares as Industry Best Practice

At the core of FINRA's share class suitability focus is the lack of full disclosure or proper assessment of the appropriateness of A Shares versus C Shares with respect to an investor's investment time horizon and stated goals. FINRA contends that many investors were unnecessarily charged higher annual servicing fees associated with C Shares when A Shares would have been less costly. Broker-dealers had until April 1, 2019 to self-report to FINRA any violations involving the sales, or supervision thereof, of 529 Advisor Plans based upon inappropriate share class recommendations.

That said, even prior to the FINRA inquiry, many 529 Advisor Plans had recognized and addressed share class suitability concerns via the launch of Convertible C Shares. Convertible C Shares retain the trail structure of a traditional C Share and generally convert to an A Share trail at a mathematically determined pivot point. The conversion point should occur more or less when the overall cost of a C Share equals that of an A Share. Convertible C Shares offer flexibility for users with uncertain withdrawal timelines.

Today, Convertible C Shares are present across 23 of 30 Advisor Plans, as shown in the chart on the top of the next page. Generally, the years-to-conversion will depend upon the relationship between the A Share load and the differential between the trails on the A and C Shares.

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A Shares Load[7]	A Shares Trail[8]	C Shares Trail[9]	Years to Conversion to A Shares	Advisor Plan
2.50%	0.25%	1.00%	After 4 Years	Connecticut
2.50%	0.25%	0.99%		West Virginia
3.25%	0.25%	1.00%	After 5 Years	Maine
3.50%	0.25%	1.00%		Nebraska (NEST)
3.50%	0.25%	1.00%		New Hampshire
3.50%	0.25%	1.00%		New Mexico
3.75%	0.25%	1.00%		South Carolina
4.00%	0.25%	1.00%		Rhode Island
3.50%	0.25%	0.75%	After 6 Years	Colorado
4.25%	0.25%	1.00%		Michigan
4.75%	0.25%	1.00%		Iowa
4.75%	0.25%	1.00%		Wisconsin
4.25%	0.25%	1.00%	After 7 Years	Oklahoma
5.00%	0.25%	0.50%		Alaska
5.25%	0.25%	1.00%		Indiana
5.25%	0.25%	1.00%		New York
5.25%	0.25%	1.00%		Ohio
5.50%	0.35%	1.10%		South Dakota
5.75%	0.25%	1.00%		Kansas
5.75%	0.25%	1.00%		Nevada (Putnam)
5.50%	0.25%	1.00%	After 10 Years	New Jersey
5.75%	0.25%	1.00%		Oregon
5.75%	0.30%	1.00%		Virginia

Source: Program Disclosure Statements and State contacts as of March 29, 2019

Share class suitability concerns increased with the passage of the Tax Cuts and Jobs Act of 2017 (the "2017 Tax Act"), which expanded the use of 529 funds to pay for K-12 tuition expenses. As a result, share class suitability has become a priority consideration since K-12 beneficiaries generally have a shorter investment horizon than college savers. For 529 Advisor Plan investors saving for dual purposes, most advisors would agree that electing the Convertible C Share Class would be a reasonable choice.

Observation 4: K-12 State Program-Level Changes

Tax exemption of withdrawals for K-12 tuition expenses is well established at the federal level, but not all States have chosen to allow qualified K-12 withdrawals for state tax purposes. Since our April 2018 529 Market Report, twelve additional states and the District of Columbia have conformed their treatment of K-12 withdrawals to the federal tax code. As shown by the following chart, K-12 withdrawals are qualified today in 36 states and the District of Columbia, while 14 states are still determining the treatment or deem such withdrawals to be nonqualified for state tax purposes.

[7] Represents the maximum A Shares Load
[8] Represents the maximum A Shares Trail
[9] Represents the maximum C Shares Trail

State Allows K-12 Withdrawals		State Treatment Unclear or Not Qualified
Alabama	**Missouri**	California
Alaska	New Hampshire	**Colorado**
Arizona	New Jersey	Hawaii
Arkansas	Nevada	**Illinois**
Connecticut	North Carolina	**Michigan**
Delaware	**North Dakota**	**Minnesota**
District of Columbia	**Ohio**	**Montana**
Florida	**Oklahoma**	**Nebraska**
Georgia	**Pennsylvania**	**New Mexico**
Idaho	**Rhode Island**	**New York**
Indiana	**South Carolina**	**Oregon**
Iowa	South Dakota	Texas[11]
Kansas	Tennessee	**Vermont**
Kentucky	**Utah**	Wyoming[11]
Louisiana	**Virginia**	
Maine	Washington	
Maryland	**West Virginia**	
Massachusetts[10]	**Wisconsin**	
Mississippi		

Source: Program Description Statements as of April 16, 2019
States in **BLUE** offer state tax deductions or credits for 529 contributions

States have begun to address K-12 at the program level. In December 2018, Louisiana carved out a dedicated START K12 Program[12] only available to K-12 savers. The Program offers five Vanguard-based individual investment options and no age-based or static option. Two of the five options are fixed income, an asset class not offered as an individual choice in the State's 529 Plan. Account owners are subject to a maximum contribution limit of $180,000, based upon the annual $10,000 withdrawal limit over an 18-year period. Unused funds can be rolled over to a standard 529 plan but not vice versa.

With the exception of Louisiana, other States accommodate K-12 users within their existing 529 Programs. Most States generally provide disclosure that age-based options, which are specifically designed for higher education, may not be suitable for K-12 purposes. A typical 529 beneficiary can have an investment horizon of 18 or more years while a K-12 beneficiary would likely have a much shorter investment horizon. Depending on the situation, a K-12 beneficiary could be overweight equity and subject to unnecessary market timing risk if invested in an age-based option. A potential modification would be a shift to an enrollment-date structure.

An enrollment-based option would align all beneficiaries with varying investment horizons according to their year of matriculation. We have seen more 529 Plans adopt this structure in recent years, albeit for reasons unrelated to K-12. For example, in February 2019, Kentucky transitioned to an enrollment-based option in connection with the conversion to a new Program, and in early April, California approved the proposal of its Program Manager to replace its age-based options with enrollment-based options.

[10] Earnings will be free from tax but treatment of previously taken deductions is unclear.
[11] Neither Texas nor Wyoming has a state income tax.
[12] Program Disclosure Statement can be found here: https://www.startsaving.la.gov/Common/Docs/START_K12_Disclosure_11-30-18.pdf

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Enhancements for the Future: Moving to an Enrollment-based Portfolio Structure

Since the inception of college savings plans, almost every 529 plan has offered an age-based investment option, designed with a particular matriculation date based on the account beneficiary's age when the account was opened. The age-based concept very clearly reflects the target-date structure prevalent in retirement plans but in execution it has a stepped glidepath as compared to an evolving glidepath implemented by a handful of managers from the start (e.g., Fidelity and T. Rowe Price, among others). More recently, interest in this structure (including a progressive glidepath) has increased, propelled by Morningstar's consistent support for evolving glidepaths as well as the K-12 funding provisions introduced by the 2017 Tax Act.

The greatest potential benefit of an enrollment-based or progressive structure is the ultra-smooth glidepath that minimizes market timing risk, especially for near-college beneficiaries. Additionally, this structure typically uses an enrollment-date naming convention, which better aligns all users – including K-12 – with their expected withdrawal timelines. Importantly, any future adjustments to the glidepath can be easily accommodated.

The following chart compares age-based and enrollment-based or progressive structures in a nutshell:

Key Differentiators	Age-Based Structure	Enrollment-Based / Progressive Structure
Fundamental differentiator	Option with multiple portfolios known as age bands, which include multiple funds that are *exchanged* over time	Option comprises one portfolio for each enrollment cohort. This portfolio *evolves* over time with no exchanges
Portfolio selection determinants	Beneficiary's *current age at account opening* determines the appropriate age-based portfolio	Beneficiary's *expected enrollment year* determines the target-date portfolio selected
Operational complexity	As the beneficiary ages, investments are *transferred* to more conservative age bands at periodic, pre-determined intervals	Assets *remain* in the same target date portfolio throughout investment horizon, with asset allocation changes over time
Potential market risks due to glidepath shape	Stepped asset allocation shifts occur *may increase* market timing risk	Progressive asset allocation changes have historically resulted in a smoother glidepath, thereby *potentially minimizing* market timing risk

Today, 24 Direct and Advisor Plans, represented by 12 investment advisors, offer an enrollment-based or progressive model. This represents 27%, or less than a third, of the ninety different 529 Plans offered today.[13] When it comes to glidepath construction, Morningstar has a stated preference for 529 investment advisors with retirement expertise and that use a continuously smooth glidepath. These factors are reflected in Morningstar's Process Pillar ratings, one of five Pillar ratings for each Plan. The chart on the top of the following page shows Morningstar's October 2018 views on the 24 Direct and Advisor Plans that utilize an enrollment-based or progressive glidepath structure:

[13] Morningstar published a list of 17 Plans using the "progressive" glidepath structure in its May 2016 Industry Survey, using data as of December 2015. Since then, seven Plans have switched to the enrollment-based / progressive structure.

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Investment Advisor[14] (Program Manager)	Sixteen Direct Plans	Eight Advisor Plans
Ascensus	DC IN KY	IN
BlackRock	--	AR OH
Capital Research	--	VA
Fidelity	AZ DE MA NH	NH
Invesco (Ascensus)	RI	RI
Lockwood (BNY)	WA	--
Mercer (Virginia529)	VA	--
Putnam (Ascensus)	--	NV
Sellwood (BNY)	OR	--
SSGA (Ascensus)	NV	--
T. Rowe Price	AK (2)[15] MD	AK[16]
Wilshire (OTTA)	OH	--
12 Investment Advisors	**Medal-rated – 11 Plans** **Positive Process Pillar – 12 Plans** **Non-rated – 5 Plans**	**Medal-rated – 4 Plans** **Positive Process Pillar – 5 Plans** **Non-rated – 1 Plan**

Twelve of the 16 Direct Plans (75%) and five of the eight Advisor Plans (63%) utilizing the enrollment-based or progressive structure receive Positive Process Pillar ratings. In our view, this confirms the value Morningstar places on this asset allocation structure (71% of the 24 Plans). It is also interesting to note that 13 Plans receive both a Positive Process Pillar and a Bronze, Silver or Gold Plan rating.[17]

Conversions of any kind involve potential challenges, especially when significant asset levels are involved. When contemplating an age-based to enrollment-date conversion, State Administrators should be mindful of financial, operational and communication considerations to ensure that the consumer experience remains seamless. Ultimately, it is up to the State Administrator to weigh the pros and cons and determine whether a transition would make sense for its investors.

[14] Includes the party responsible for asset allocation whether it is the investment advisor associated or partnered with the Program Manager or an issuer's independent investment consultant (e.g., Sellwood, Wilshire and Mercer in Oregon, Ohio and Virginia, respectively).
[15] Morningstar rates Alaska's T. Rowe Price College Savings Plan but not the University of Alaska College Savings Plan. Both Plans utilize the enrollment-based structure.
[16] John Hancock provides input on "selection, oversight and changes" to underlying funds and investment managers.
[17] Nevada Putnam is not rated; Advisor Plans in Virginia and Ohio are Silver- and Bronze-rated, respectively, but receive Neutral Process Pillar ratings.

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Find Out More

Despite increased competition and regulatory scrutiny, the future of the 529 market remains bright. We would be delighted to discuss our findings in more detail with you. For more information, please contact:

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