College Savings Nation 2016:

Investment Options Moderate as Market Matures

An Update on Direct and Advisor 529 Plan Options

May 2016

Overview

This AKF Market Report reviews the current state of 529 plans and the investment choices available to American families. From our perspective as the strategic advisor to 529 administrators nationwide, we believe that 529 plans continue to have a strong presence in the college savings marketplace. The broad array of investment options both in direct and advisor plans remains an important factor whether investors choose to work with a financial advisor or invest in a plan directly.

Although there are a smaller number of new investment options than in the past, the breadth of investment choices continues to meet the objectives of all investors. College savers have access to a variety of age-based portfolios, a wide range of static investments, and a significant number of individual mutual fund options. If an investor chooses to design and manage custom asset allocations, an extensive selection of asset classes are now available. From the aggressive to the most conservative investor, there is an assortment of investment options an investor can feel comfortable choosing.

The presence of diversifying asset classes in investment options continues to increase, as the 529 market matures and becomes more competitive. We expect continued market volatility in 2016, with uncertainty regarding both fixed income and global equity markets. Some asset classes may fare better in rising rate environments, but as important, plans may revisit fixed income alternatives such as stable value options to provide higher, more consistent returns. Finally, the emergence of robo-advisor platforms in the 529 space may represent a new distribution channel and enhance the way 529 plans are offered and selected.

Method

Data for this AKF Market Report was aggregated through a review of official offering documents for ninety 529 savings plans as of April 14, 2016.

Findings and Observations

Number of Plans and Investment Options Decrease

Ninety college savings and 12 prepaid plans are available to investors today as compared to 92 savings and 13 prepaid plans when we published our last AKF Market Report in December 2014 (the "2014 Market Report"). The decrease in plans is consistent with the changes reported from February 2012 to October 2014. As shown in the chart on the top of the following page, savings plans offered directly to the public ("direct plans") continue to outnumber plans offered through professional financial advisors ("advisor plans"). Just one savings program continues to offer identical investment options in both direct and advisor plans. The chart on the following page also shows a slight decrease in the number of overall investment options offered across plans, following several years of steady increases in investment choices:

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Data as of	February 2012			October 2014			April 2016		
Plan Type	Direct	Advisor	Direct and Advisor	Direct	Advisor	Direct and Advisor	Direct	Advisor	Direct and Advisor
Number of Savings Plans	59	34	1	60	31	1	59	30	1
Total Investment Options	636	609	8	723[1]	675	8	726	660	8
Open Prepaid Plans	12[2]			13[3]			12[4]		

The changes between October 2014 and April 2016 reflect the following:

- July 2015 closure of the Montana Bank Plan, a direct plan managed by the College Savings Bank and consisting of 3 FDIC-insured options:
  - Investors still have an FDIC-insured option in the Montana Investment Plan, managed by Ascensus, with First National Bank of Omaha providing the FDIC-insured account
- Conversion of the Missouri Advisor to the Missouri Direct Plan:
  - This eliminated at least 16 investment options, including at least seven ETFs
  - This conversion (resulting from the August 2015 program management re-bid) means that Deutsche Asset Management is no longer affiliated with a college savings program
- A net decrease of 15 investment options across all savings plans compared to a net increase of 140 from February 2012 to October 2014:
  - The largest change in investment options stems from 12 new static options being offered across direct plans
  - In the aggregate, however, the net decrease suggests that 529 plans may be reaching a saturation point in terms of offering investment options to meet most college savings investors' objectives
- At the margin, several prepaid plans (notably Illinois and Mississippi) over the years have suspended new enrollments and then reversed course:
  - Washington State suspended enrollments in September 2015 but is expected to re-open in July 2017
  - We also note that Tennessee formally terminated its Prepaid Plan as of November 2015, although enrollment had been suspended long before

As indicated above, we believe the reported decrease in the number of 529 savings plans is consistent with the decrease captured in our 2014 Market Report. As was the case in 2014, it is difficult to launch a new direct or advisor plan without tax or other state-specific benefits. In addition, unless there is an inherent advantage, such as a privately-labeled advisor plan or strong tax benefits, it can be costly to continue to offer an advisor plan that is slow to attract assets. We suspect that termination of the Missouri Advisor may reflect the challenges presented by parity tax treatment for new 529 players (Deutsche assumed its role in the Missouri Advisor in 2011). When state tax benefits are the same regardless of which plan an investor chooses, new program managers may struggle against more established 529 managers that advisors already promote.

[1] Certain clarifications have been made, resulting in a slight increase over numbers reported in 2014 Market Report
[2] Includes AK, FL, MD, MA, MI, MS, NV, PA, TX, VA, WA and Private 529. Excludes IL, which had suspended enrollment
[3] Includes IL
[4] Excludes WA, which has suspended enrollment

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While we think it is unlikely that we will see many new 529 savings plans launched in the near-term, we note several important recent developments:

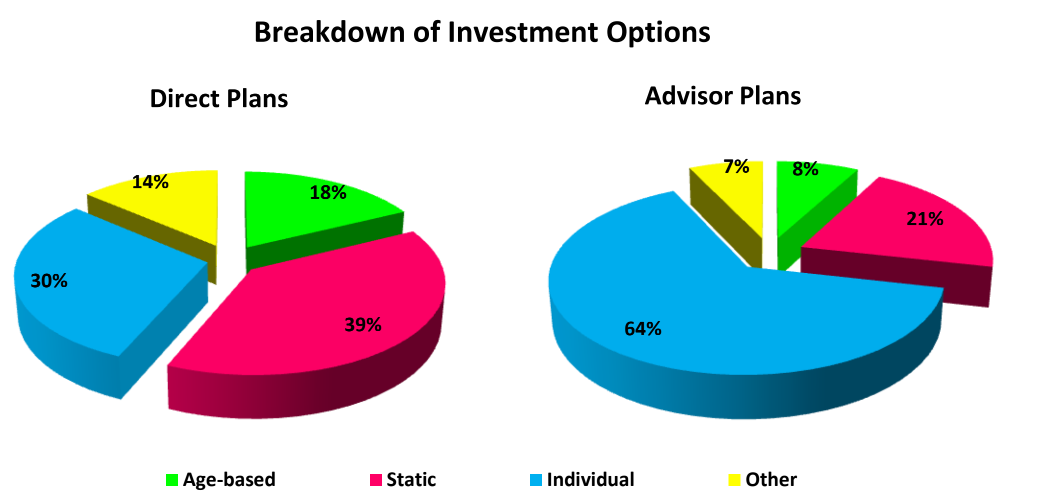
- First, in November 2015, Rhode Island announced the selection of Ascensus to replace Alliance Bernstein as Program Manager, with Invesco serving as investment manager and distributor for the Advisor Plan. This marks the first new entrant to the 529 market since NorthStar assumed management of the Texas 529 Program in September 2014. It also leaves Alliance Bernstein, a long-time leader in 529s, without an anchor in the business.

- Second, Washington State is expected to launch a direct plan in the year ahead to complement its Prepaid Plan. Without committing to convert prepaid assets to a new direct plan, private sector market reaction to a program management solicitation will be interesting.

- And finally, there may be a dedicated robo-advisor 529 platform in the future. See our discussion under "What's Next for the 529 Plan Market?" addressing this important emerging distribution channel.

Direct vs. Advisor Plans: Consistent Differences in Types of Investment Options

In our 2014 Market Report, we noted that fewer states offered identical investment options in both direct and advisor plans. That continues to be the case today, where the District of Columbia 529 Program alone offers identical investment options in its Direct and Advisor Plans.[5] Although the actual number of overall investment options has decreased slightly, the breakdown of types of investment options between direct and advisor plans continues to be a distinguishing factor between the two channels as shown in the following chart:



Source: Plan Offering Documents. "Other" includes short-term, guaranteed, TIPS and federally–insured options
Note: Totals do not add due to rounding

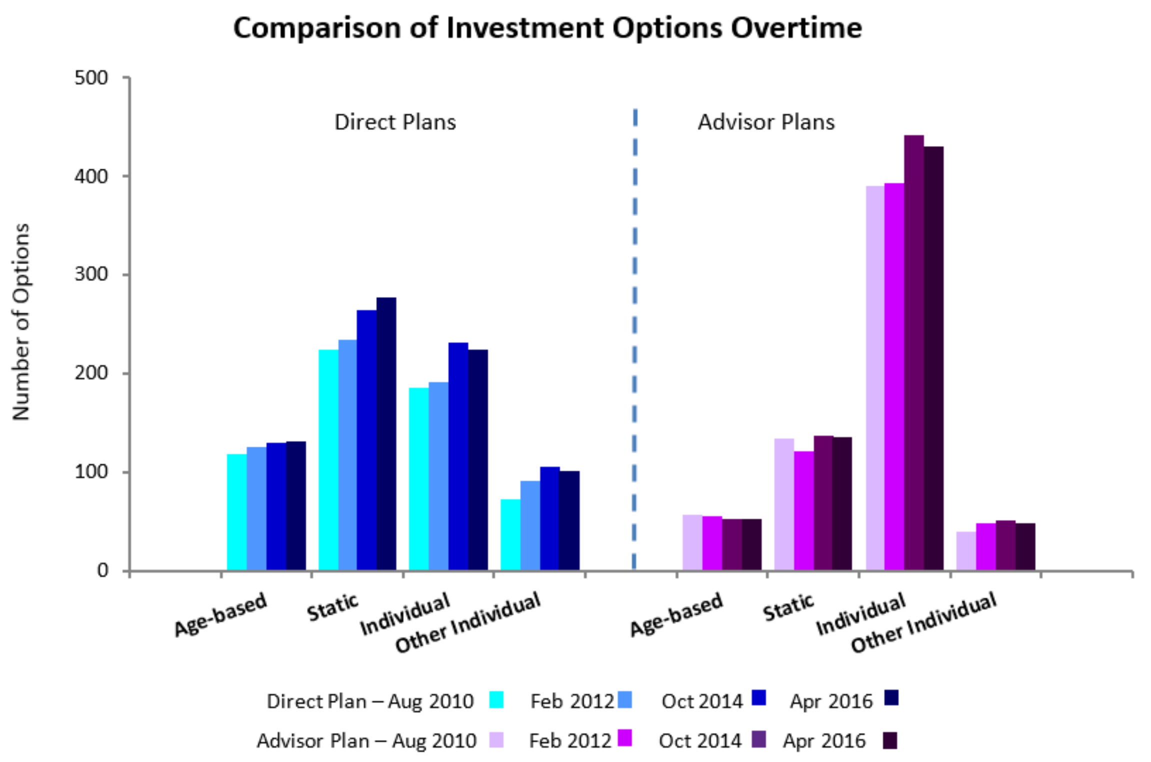
[5] We note that this could change depending upon the results of the December 2015 program management rebid by the District

Since our 2014 Market Report, the percentage for static options in direct plans increased from 37% to 39%. We believe this reflects consumer demand for additional choices in static asset allocation strategies. As shown in the chart above as well, advisor plans continue to facilitate a more creative portfolio strategy through the use of individual options with the guidance of a financial advisor. As a result, individual options continue to represent 64% of all options offered by advisor plans, which is unchanged from our 2014 Market Report.

The continued difference in the choices between the direct and the advisor plans is predicated upon the role of the financial advisor. More age-based and static asset allocation strategies in direct plans empower the investor to make investment choices. In contrast, a wide range of individual options in an advisor plan enables a financial advisor to create a customized asset allocation for each individual investor. Although direct plans offer individual options, we believe these are most often used by experienced investors who develop their own asset allocation ideas or by registered investment advisors who may be recommending low-cost direct plans to their clients.

Static Options in Direct Plans Rise as Individual Options Decline

Digging deeper into the information above, the following chart shows investment option trends over time, confirming the notion that the 529 market has likely reached a saturation point in terms of investment option choices. On a net basis, the total number of investment options actually declined by since October 2014, representing a slowdown in new options offered.



Source: Plan Offering Documents. "Other Individual" includes short-term, guaranteed, TIPS and federally-insured options

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The most recent changes shown in the table above reflect the following:

- Montana Direct launched an age-based option for the first time.
- Direct plans added 12 new static, target risk options with varying degrees of aggressiveness. Some examples include:
    - Virginia Direct added three actively-managed static options ranging from Aggressive to Conservative to complement the passively-managed static options already offered
    - New York Direct added a passively-managed Aggressive Growth option
    - Oregon Direct added a blended Diversified Inflation Protection option
- Direct plans removed 9 individual options while advisor plans removed 11:
    - Notably, New Jersey and Vermont Direct introduced two new short term options while seven other direct plans eliminated 12 individual options, representing a wide range of asset classes
- Closure of Missouri Advisor was the biggest driver in net reduction of total investment options:
    - Missouri Advisor conversion effectively eliminates 13 individual options, but this is offset slightly by the introduction of 6 new individual options in New Mexico, 5 of which are Oppenheimer actively-managed funds

Static options in direct plans offer more pre-set choices for 529 investors who appear to want more control of asset reallocation but may not be interested in an all-individual fund line up. An age-based option automatically reallocates assets based upon the beneficiary's age leaving no opportunity for investor participation, whereas with static options, the timing of reallocation and ultimate equity exposure is completely left to the investor. Additionally, we believe that offering more static options offsets the lack of choice in risk tolerance (i.e., equity exposures) in age-based options. It is interesting that five of the seven direct plans that recently increased the number of static options also offer just one age-based option. Perhaps the addition of new static options is viewed as a way to supplement single risk posture, age-based options.

Mixed Bag on Short Term, Secure and Other Options

As in our previous Market Reports, we continue to track investment options geared to investor preferences for secure alternatives. The chart on the following page showing investment option trends indicates fairly steady increases in the number of "safe" options offered in direct or advisor plans through October 2014 but a slight slowdown to April 2016:

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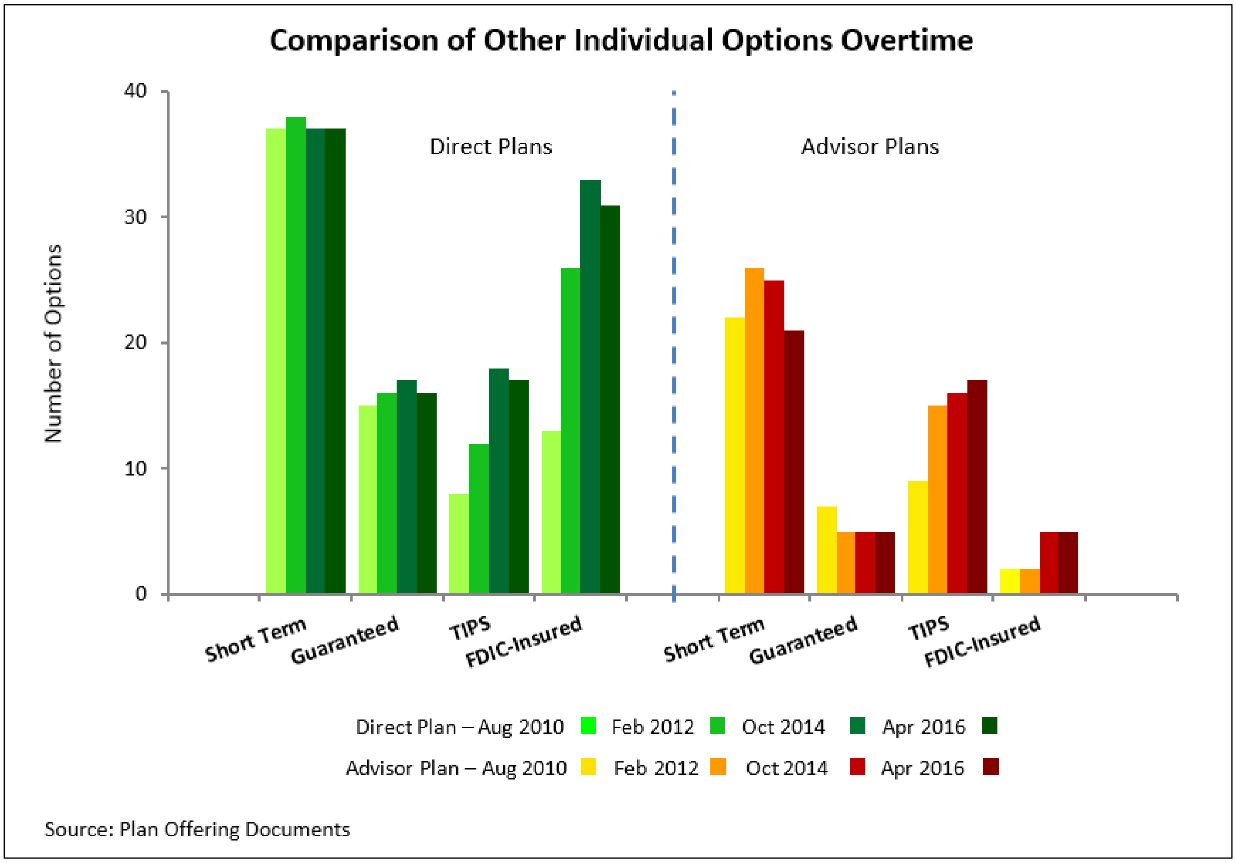

In the past we attributed the increased number of secure or short term options to a strong desire for stability and security, particularly as investors in both advisor and direct plans move assets to short term investments as college enrollment approaches. We now suspect that the decrease in short term options reflects the impending effects of money market reform, which could result in even lower-yielding money market instruments than in the past with the shift from prime money market funds to government-only funds. We also suspect that the increased presence of TIPS-based options in advisor plans reflects a defensive strategy in anticipation of an uncertain inflationary environment. The addition of TIPS may also accommodate yield-seeking behavior as advisors recommend a shift from low yielding short term bonds to TIPS (and other longer-term bonds) with slightly more attractive yields. On a final note, in light of continued low fixed income rates, we predict a resurgence of sorts for guaranteed products such as stable value or other guaranteed principal options.

Presence of Diversifying Asset Classes Solidifies

A variety of different factors continue to impact the divergence between direct and advisor plans. In 2015, we saw deterioration in the US equity markets as compared to strong returns in the previous four years. China concerns, a strong dollar and the collapse of oil prices exacerbated this decline. The elevated volatility experienced recently in the equity and fixed income markets has manifested itself in higher risk aversion and yield seeking behavior among investors in a low yield environment. These factors have led to increased use of diversifying investments across both direct and advisor 529 plans since October 2014. Direct savers and advisors alike have expanded their portfolios to include asset classes like emerging market equity, non-US small cap, global bonds, high yield bonds, and senior secured loans in an effort to diversify risk and potentially improve risk-adjusted returns.

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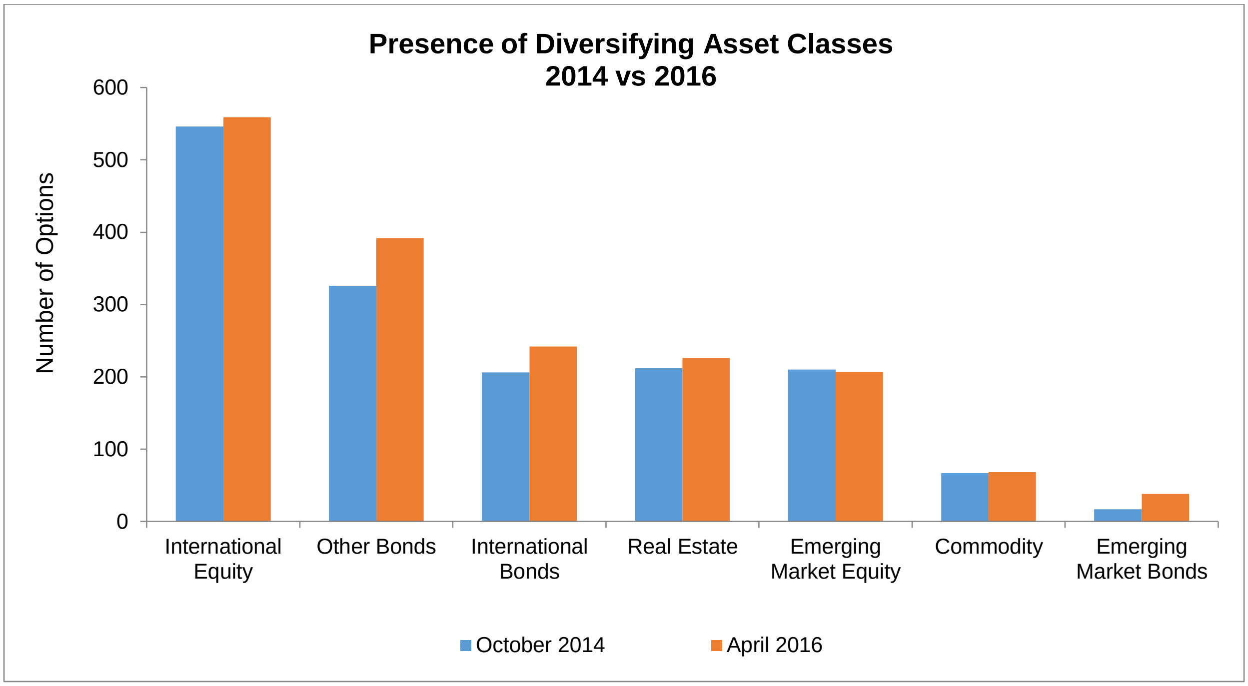
As shown in the chart below, the presence of diversifying asset classes has generally grown since October 2014. Consistent with our 2014 Market Report, we have continued to review exposure to international equity, emerging markets, real estate, commodities and other bond asset classes to track the prevalence of these options and pinpoint diversification trends. New asset classes we have begun to track include emerging market bonds and international bonds. Our research shows that savvy investors can find exposure to these asset classes in direct plans or investors may seek professional financial advice to apply asset allocation strategies that include these options where applicable.



The information in the chart above reflects the following:

- International equity continues to be an important asset class in 529 investments:
  - Almost every savings plan now includes dedicated international equity funds (dedicated bank plans and stable value plans are the principal exceptions)
  - Five plans added international equity (predominantly advisor plans) while only advisor plan reduced the number of international equity individual options
- Bond strategies that could help reduce interest rate risk or succeed in a rising rate environment ("Other Bonds" in the chart above) are an increasingly significant asset class for 529 plans:
  - Approximately 80% of all savings plans include either a short term, high yield, low duration or floating rate (i.e., bank loans) fixed income fund.
  - Since October 2014, a range of direct plan investment and program managers added these strategies for the first time, generally in asset allocation strategies
- Almost half of all plans include exposure to international bonds through an asset allocation strategy:
  - Twelve plans offer this asset class as an individual option, including five direct and seven advisor plans with distinct investment managers
  - And yet, seven direct plans included a similar underlying international bond fund as part of aged-based and static asset allocations

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- Half of all 529 plans include some form of real estate:
  - Four direct plans with largely distinct investment and program managers either expanded the exposure to real estate or now include real estate for the first time in asset allocation
- While half of all savings plans include exposure to emerging market equity, the number has fallen:
  - Five plans removed dedicated emerging market equity funds (predominantly advisor plans with Allianz as an investment manager)
  - Just two direct plans with very different investment managers added this asset class to their menus
- Only a handful of plans offer exposure to commodities today:
  - Only one plan recently introduced commodities for the first time in an asset allocation strategy
- The presence of emerging market bonds in asset allocation strategies has also increased:
  - As of the date of this Report, at least eight direct and advisor plans offer exposure to emerging market bonds
  - Fidelity-managed direct plans and one advisor plan added emerging market bonds in asset allocation for the first time

On a separate note, we see several less traditional fixed income options being offered, which we believe is in response to demand from advisors seeking additional yield. Examples of these alternate strategic investment selections include:

- Each of Connecticut and West Virginia Advisor Plans (managed by Hartford Life) offer an unconstrained bond fund in its asset allocation. The fund invests at least 80% in fixed income and fixed income derivatives.
- The South Carolina Advisor offers a convertible securities fund in its asset allocation. The fund invests at least 80% in convertible securities.
- The Oregon Advisor offers absolute total return strategies in its asset allocation, while the Nevada Putnam Advisor Plan offers these as individual options.
- The South Dakota Advisor offers an equity strategy that aims to beat the S&P 500 benchmark by pairing an active fixed income portfolio with a passive stock index overlay.

What's Next for the 529 Plan Market?

We expect that market volatility will continue through 2016 as a bumpy road lies ahead for the global economy. Concern surrounding divergent or even ineffective central bank policy, negative interest rates, depressed energy prices, and slower worldwide economic growth has strained investor confidence and amplified uncertainty, leading to more volatile price swings in global equity and fixed income markets. With this in mind, investors at least annually should consider their time horizon and reassess the appropriate level of equity exposure in 529 plans, particularly right before and during college enrollment. Given the uncertainty in the capital markets, many investors may seek guidance on asset allocation and investment selection from their financial advisors. With the addition of more static investment options, direct investors may choose to invest in those portfolios thereby more closely matching their asset allocation to their particular objectives, without having to sort through many individual options to do so. Regardless of whether an investor chooses an advisor or a direct plan, all portfolios require regular assessment, especially where there is exposure to volatile capital markets.

Fed Interest Rate Hike and Impact on 529 Investors

In December 2015, the Fed raised the federal funds rates for the first time since 2006. This rate hike was long expected and additional hikes are possible at some point in mid- to late-2016. Although expectations have quieted somewhat as certain economic indicators have come in below expectations, the Fed has insisted that future rate increases are still on the table for 2016. Generally, a rate hike can be an immediate blow to portfolios invested in bonds. Thus, while the timing of another rate hike is not clear, investors should be prepared for its ramifications and consider ways to offset potential risk. To that end, we note that bond strategies that help reduce interest rate risk or succeed in rising rate environments have increased in the past year from 62 to 70 plans (see our description under “Presence of Diversifying Asset Classes Solidifies” above).

More conservative portfolios or later stage age-bands usually have an increased allocation to bonds. College savings investors should assess the risk of their bond holdings as higher interest rates cause the value of bonds to decline. Maturing age-based portfolios will often require liquidation to pay for college expenses and are therefore at the greatest risk because of the need to preserve capital. College savings plan investors can lower their interest rate risk allowing for greater capital preservation during a rising interest rate environment by lowering the duration of their bond holdings. Conversely, investors should be mindful of the fact that they can still potentially realize capital appreciation during the college years by maintaining some equity exposure.

The Robo-Advisor: A New Channel for 529 Financial Advice

The robo-advisor, which may be a misnomer altogether, has begun to figure prominently in the world of financial advice. Although this means of delivering investment advice has emerged only recently in the college savings marketplace, we believe it is just a matter of time before more robo-advisor providers directly address the needs of college savings investors.

When working with a robo-advisor, an individual completes an online questionnaire that focuses on specific goals and objectives. The robo-advisor then constructs and delivers a portfolio using a unique algorithm that selects appropriate investments, which typically include ETFs, to create diversified portfolios. To date, robo-advisor platforms have been primarily active in the IRA and 401(k) plan marketplace, with their services available to individuals and small businesses.

That being said, we note that BlackRock’s FutureAdvisor currently offers a variety of college savings investment vehicles, including Coverdell Savings Accounts, UTMA / UGMAs and a handful of 529 plans. According to the FutureAdvisor College Savings Service, the Service will create a customized college savings plan (that could include a variety of investment vehicles) that will be monitored and adjusted on an ongoing basis presumably based upon age of the beneficiary and the individual’s changing financial position. We also note that FutureAdvisor provides the opportunity to communicate with a human being at no additional cost.

We believe that many savvy or do-it-yourself 529 investors choose direct plans because they are comfortable managing investment options, the minimum required balances are often low, and the fees for these investments are often quite attractive. Other investors use advisor plans because they value professional financial advice and understand the higher fees associated with that individualized service. For these investors, the personal touch provides assurance about an investment that is critical to a loved one’s future. In many respects, robo-advisors bridge the gap between these investor alternatives, offering financial advisory services for lower minimum account balances and at significantly lower fees. As such, a 529 robo-advisor platform could attract direct plan investors who want the benefit of low-cost quantitatively-driven investment advice, as well as advisors who want to rely on a lower-cost quantitative solution.

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More importantly, a robo-advisor 529 platform could attract a new investor altogether, one that is younger and perhaps less affluent, but who is willing to rely on technology for the most important financial decisions. The millennial investors, who appear to be using robo-advisor platforms for fundamental investment advice, will embrace robo-advisor 529 plans once they are offered. To that end, we believe the robo-advisor will emerge as a new distribution channel complementing the professional financial advisor in the college savings marketplace, and attracting otherwise direct plan advisors.

Find Out More

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About the AKF Consulting Group

The AKF Consulting Group is the leading strategic advisor in the 529 and 529A markets, counting 34 state governmental entities across 32 states as current or past clients. Specifically, AKF Consulting assists in structuring and advising upon all aspects of Section 529 and Section 529A programs, including investments, administration and marketing. AKF Consulting also advises on program enhancements such as scholarships and matching grant programs, affinity programs and other loyalty builders. For more information, please visit www.akfconsulting.com.

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