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College Savings Nation:

Thrift and Caution Spur Greater Investment Choice, Lower Fees

A Nationwide Analysis of Advisor and Direct 529 Plan Options

March 2012

Overview

In December 2011, the personal savings rate increased to 4.7% after steadily declining throughout the course of the year and hitting a low of 4.3% in November, according to the Federal Reserve. The change may reflect optimism about the broader market, as the S&P 500 Index rallied at year-end 2011 and continued to its highest point since mid-2008.

Despite the recent uptick, the personal savings rate is still lower than the 5.4% level of our last Market Report in September 2010. The decrease in the savings rate is no doubt a reflection of increased stock market volatility during the period, caused by debt crises in the U.S. and Europe, and stubbornly high unemployment. Interestingly, the average new account size dropped, with the Financial Research Corporation (FRC) reporting an average new funding amount in the fourth quarter 2011 of $4,920 compared to $5,993 in the fourth quarter 2010.[1]

Still, the most recent year-end market numbers confirm that the uptick brings some improvement to the college savings market. 529 savings plans collected $2.3 billion in new contributions during the fourth quarter 2011 vs. $2.1 billion in fourth quarter 2010, according to FRC.[2] As of December 31, 2011, 529 plans held more than $72.4 billion across 4.8 million accounts in the "direct-sold" market and more than $72 billion across approximately 5.1 million accounts in the "advisor-sold" market.[3]

To court investors and broaden their investment menus, many state administrators and plan managers continued to add more index funds from low-cost providers, as well as more guaranteed-return products, a trend that accelerated since the publication of our September 2010 Market Report.

The following AKF Market Report surveys the state 529 plan marketplace to assess the various options in advisor and direct-sold programs.

Method

Data for this AKF Market Report were aggregated through a review of offering documents for ninety-four 529 savings plans as of February 15, 2012.

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[1] Based upon information collected by FRC from members of the College Savings Foundation (CSF)

[2] Fourth quarter 529 college savings data released by CSF using data provided by CSF members and analyzed by FRC

[3] FRC analysis based upon industry data

Findings and Observations

Total Number of Plans and Options Increases

There are a total of 94 different 529 college savings plans currently available to investors. Among those, 59 are available directly to individual investors ("direct-sold") and 34 are available through financial professionals ("advisor-sold"). Since September 2010, this represents a 5.6% increase in the number of 529 plans investors can choose from, and a 10.6% increase in the number of investment options offered across those 94 plans, as shown by the following chart.

	September 2010			February 2012		
Plan Type	**Direct**	**Advisor**	**Advisor and Direct**	**Direct**	**Advisor**	**Advisor and Direct**
Number of Plans	53	30	6	59	34	1
Total Investment Options	510	530	92	635	609	8
Open Prepaid Plans	12			11		

An interesting point to note is that at the time of our last Market Report, six states offered identical savings plans in both the direct-sold and advisor-sold channels. In those cases, investors acting on their own or investors working with professional financial advisors could choose from the same exact investment options. The only differences were the fees that an investor would pay, with the overall fees being higher in the advisor-sold plan. Today, only one 529 program continues to offer investors the same exact investment options in its advisor- and direct-sold plans. We believe that the change in the five other programs reflects the States' and Program Managers' efforts to differentiate the value proposition for investors in each channel. In each case, the "new" direct-sold plan resulted in additional low-cost investment options being offered. We see this in particular in Montana, Rhode Island and Wisconsin.

The chart on the following page provides a detailed breakdown of the broad options available in the current market versus what was available at the time of our September 2010 Market Report:

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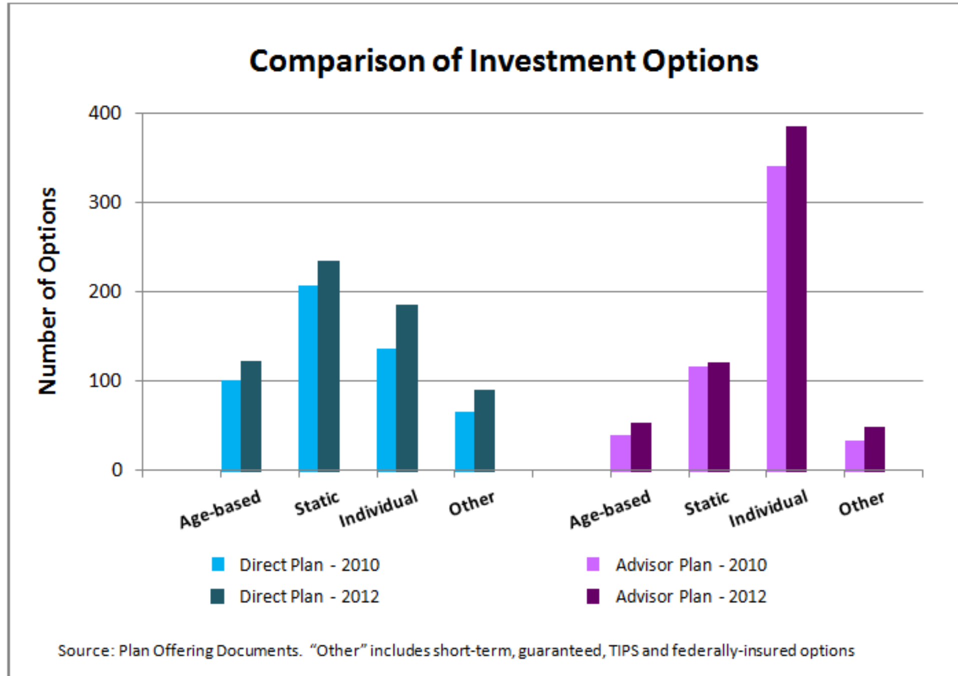

Not surprisingly, individual investment options continue to dominate the choices in advisor-sold plans (386 different individual fund choices in advisor-sold plans versus 186 choices in direct-sold plans). We also note an increased number of age-based options offered in advisor-sold plans since September 2010. Today there are 54 age-based options to choose from in advisor-sold plans; in September 2010, there were just 39 such options offered across advisor-sold plans. This is consistent with our understanding that approximately 60% of all 529 investors choose age-based options over individual mutual funds or other static choices.

The charts on the next page compare the relative breakdown of investment options in each of the direct-sold and advisor-sold channels. While we would have expected the percentages for age-based options to be higher in the direct-sold channel than the advisor channel, the increase in age-based options among advisor-sold plans suggests that their simplicity appeals to advisors as much as to individual investors operating without the benefit of professional financial advice. This may indicate that advisors find it easier to promote age-based "set-it-and-forget-it" choices, rather than creating an asset allocation and choosing individual funds accordingly.

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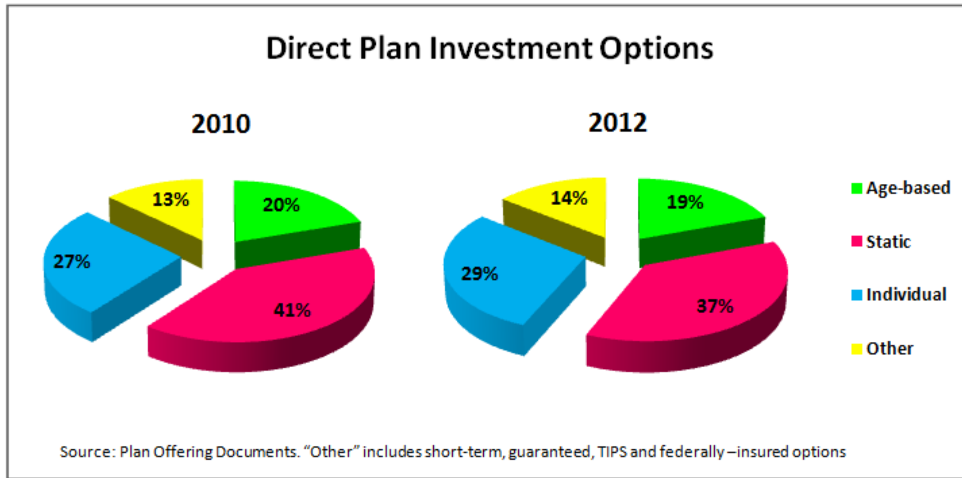

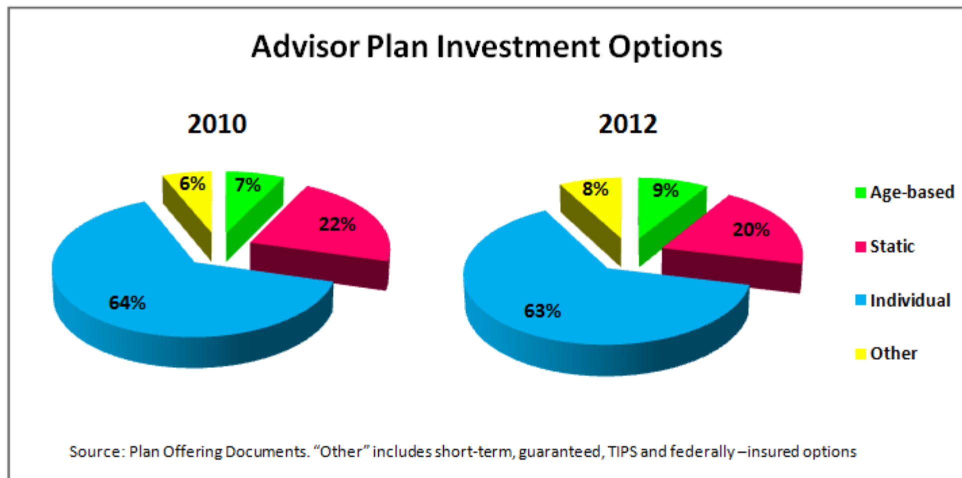

Cash is King

With the sting of losses from the 2008 financial crisis still a recent memory, States continued to offer more conservative investments in 529 plans, despite strong equity performance (a 22.5% three-year average return for the S&P 500 Index through 2011), as shown by the chart on the following page:

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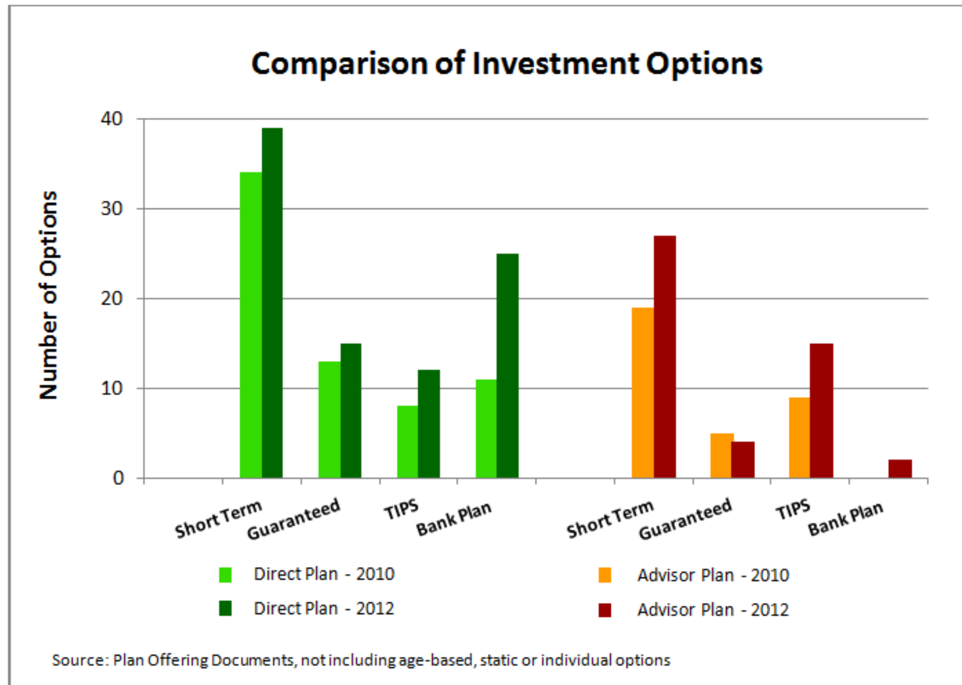

Consistent with the overall trend toward lower-risk options, 13 plans across eight states have implemented new money market options since our September 2010 Market Report, including Alabama, Connecticut, Illinois, Nebraska, Nevada, Oregon, South Carolina and South Dakota. In September 2010, more than half the Program Managers were subsidizing the costs of these investments in order to provide at least a 0% rate of return. A quick sampling of current disclosure documents confirms that this trend continues in today's extremely low interest rate environment.

We have also seen eight states launch investment options consisting of Treasury Inflation Protected Securities (TIPS) funds in eleven different plans, including Alabama, Arizona, Connecticut, Missouri, Nebraska, Oregon, Rhode Island and Texas. This represents a doubling of TIPS options offered in 529 plans since our initial Market Report in May 2009. As fixed-income assets become more attractive and volatility continues in the market overall, we would not be surprised to see more TIPS options come online in the near term.

Finally, in an effort to attract gun-shy investors, more states offer federally-insured products today than did so in September 2010. Today, 17 states offer 31 different FDIC- or NCUA-insured options, compared to just 8 states offering 15 options in our September 2010 Market Report. FDIC-insured products have now been introduced in Arkansas, Delaware, Idaho, Indiana, Maine, Massachusetts, Nebraska, Nevada and New Hampshire, demonstrating the continuing need to provide conservative investment options despite extremely low rates of return.

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More Choices, More Challenges

Recognizing that many investors want to diversify their exposure to individual fund managers, more state plan administrators have launched multi-manager investment options within their savings plans. Since our September 2010 Market Report, Arizona, California, Delaware, Massachusetts, New Hampshire and Oregon have introduced new investment options managed by investment firms other than the primary Plan Manager. Additionally, Connecticut and Maine have each brought in additional investment managers, and Nebraska offered an entirely new multi-manager line-up as a result of its Plan Manager conversion, affirming its commitment to an open architecture structure.

In reviewing the new multi-manager investment options launched since September 2010, it is interesting to note that the majority of new options were introduced in direct-sold plans: of the ten states introducing new multi-manager options, eight launched them in their direct-sold plans and two launched them through advisor-sold plans. In our view, this suggests that investors in the direct-sold market are perceived as increasingly more sophisticated or at least more discerning when it comes to the investment options offered to them.

We also believe that the move toward multiple investment managers mirrors the format investors are used to seeing in 401(k)s and other employer-sponsored retirement plans, as well as being the preferred approach of many brokers, planners and independent advisors who sell 529 plans. By offering more choices, states seek to enhance the perception of their programs among both investors and distributors of college savings plans.

In this regard, it is also interesting to note that among the newly offered multi-manager options, all nine state plans include multiple-manager choices in their “age-based” investment options, but only three provide multiple-manager choices among their “single-fund” or “individual fund” investment options. Thus, in the age-based investment options, the investor is choosing from a blend of underlying funds pre-set by the Investment Manager, based on criteria ranging from performance to investment style, and possibly even to revenue-sharing agreements. While this format is indeed giving investors greater choice, we believe it differs slightly from the pure open architecture approach of fund supermarkets and many retirement plans.

A final note with respect to multi-manager structures is that, at least at this point in time, program management fees associated with these investment options generally appear to be somewhat higher than those associated with investment options managed by a single fund family. This could become an issue as pressure on program management fees mounts. For the time being, however, we would expect these fees to remain steady to compensate Plan Managers for the asset management revenue lost to other investment managers, and to make up for the additional administrative costs created by including outside managers.

Lower Fees

Fee reductions have been a trend for several years. Since September 2010, at least 31 state plans reduced fees paid by investors, driving the *average direct-sold fee* to today’s low between 0.58% (58 basis points) and 0.64% (64 basis points), depending on whether we include the several no-cost guaranteed or state-run investment options in the average fee calculation. This represents a nearly 10% reduction in fees paid by direct-sold investors – added value for those still grappling with recession, unemployment and the fallout from market losses. Notwithstanding the improvements already made, we expect to see continued pressure on the fees in plans that have not yet reduced them significantly.

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One of the easiest ways to lower 529 investment costs is to replace actively managed funds with index funds, including exchange-traded funds (ETFs). A number of state plans have done just that over the last few years. Since our last Market Report, the direct-sold plans in Montana, Oregon, Rhode Island and Wisconsin have all added low-cost, indexed investments, and Connecticut, Indiana, Maine, Missouri and Nebraska have added ETFs (only Arkansas and Iowa offered ETF investment options as of September 2010). Moreover, Nevada has just announced a new partnership with State Street Global Advisors (SSgA), which will result in an almost all-SPDR ETF lineup in its Upromise College Fund as of mid-April 2012.

Comings and Goings

Market trends and increasing competition have made the 529 business a dynamic one, with new players entering as others exit or are replaced. Since mid-2010:

- Connecticut launched a new advisor plan with Hartford Life
- Ohio closed its Putnam advisor plan and rolled all the Putnam assets into a newly-launched BlackRock plan
- Pacific Life exited the business, leading Montana to convert all the Pacific Life assets into Vanguard options in a new plan managed by the College Savings Bank
- Missouri chose a Upromise-led team that included DWS Investments, the US retail unit of Deutsche Bank's global asset management division, to provide investments and distribution for its advisor plan
- Nebraska replaced Union Bank & Trust with First National Bank of Omaha as Plan Manager
- Nevada launched a new advisor plan with Putnam as Plan Manager
- Nevada later closed its Columbia Management advisor plan and rolled all assets into the Putnam advisor plan
- JP Morgan, which exited the business in 2007 when it relinquished the Indiana plan, is poised to reenter it in New York, where it will replace Columbia Management on the State's advisor plan
- California will close its Fidelity advisor plan by the end of the first quarter of 2012

We also note recent Requests for Proposals (RFPs) for program management services. Since our last Market Report, two of the country's largest 529 plans – approximately $11 billion in New York and approximately $4.3 billion in California – each received only two responses to their RFPs. We believe the tepid response reflects the fact that the fees in the direct-sold California and New York plans were already extremely low when each State released its RFP. We read the response to indicate that other firms in the market were unwilling or unable to sacrifice profits by bidding fees low enough to win the business. In the case of California, the then-current Program Manager made the strategic decision not to rebid at all; more recently, the Wisconsin Program Manager has made the same decision.

This implicitly raises the question of whether firms believe they can generate sufficient revenues (in light of pressure on investor fees) to offset administrative expenses. If not, they may decide to focus on other business opportunities available to them in the 529 marketplace, e.g., serving solely as a distributor for non-proprietary 529 plans or focusing on the profitability of other 529 plans already managed.

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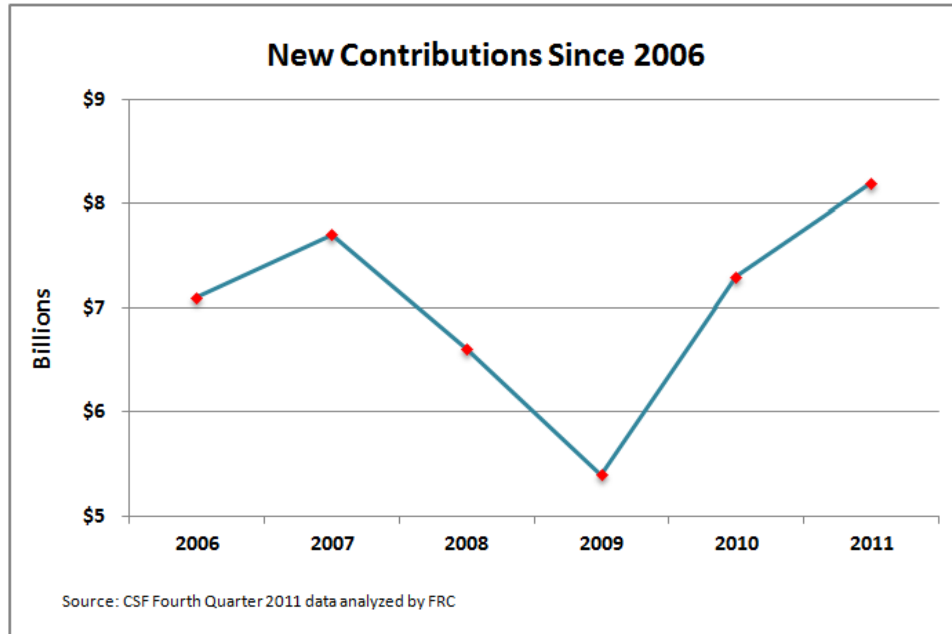
Of course, not all managers are willing to walk away from 529 business. South Carolina just completed its RFP review, and we expect the incumbent to fight hard to retain that mandate. The Wisconsin Program Manager's decision has effectively left the State's $3.2 billion program entirely up for grabs; we fully expect the State to receive several robust bids when responses are submitted in mid-April.

A Look Ahead

Rising Contributions

Recent market performance and the corresponding jump in personal savings bode well for college savings plans, even if the national savings rate is still not back to its 2010 levels. According to FRC, 2011 saw the most new contributions flowing into 529 plans on record, as shown by the chart below. If the financial markets continue to improve, we expect similar or even greater growth in 2012.



A Return to Equities

Despite the increase in conservative investment options, the majority of long-term investors will likely return to equities--particularly low-cost equity options--as they realize they must take on more risk to meet the burgeoning cost of college. FRC reports, for example, that among age-based portfolios, those with a greater concentration in equity investments attracted the most assets and new contributions in fourth quarter 2011. Funds with at least 60% in equities saw 55% of the new contributions for the same time period versus only 20% for conservative portfolios. We would expect to see equity ETFs and index funds benefit substantially from a return to stocks.

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Expansion among RIAs

The exits of some managers notwithstanding, we believe the emergence of new players such as BlackRock, DWS and JP Morgan in an already crowded field is a positive statement about the college savings business. It shows that some investment managers view 529 plans as a viable, even robust, long-term business. It remains to be seen, however, whether these new managers will attract significant assets, particularly since the 529 business is highly concentrated, with the top 10 managers controlling almost 80% of all 529 plan assets. The success of new players and those at the margin will depend on a variety of factors, not least of which would be state tax treatment and the strength of their existing distribution networks within the advisor community.

The registered investment advisor (RIA) channel also presents an opportunity, as Program Managers roll out new investments, tools and packaging aimed at independent advisors. Program developments such as the Nevada/SSgA partnership and recent announcements by fund powerhouses such as Vanguard indicating a new focus on the independent advisor channel will almost certainly appeal to the fee-sensitive RIA market, as will more low-cost full-service direct-sold plans.

Perhaps the emergence of the RIA channel as a meaningful distributor of 529 plans accounts in part for what appears to be a rebalancing of assets between direct-sold and advisor-sold plans. Today, each distribution channel accounts for approximately 50% of college savings assets, compared to more than 70% for the advisor channel in recent years. Look for a deeper analysis of this development in a future Market Report.

Find out more

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About the AKF Consulting Group

The AKF Consulting Group is the leading strategic advisor in the 529 college savings market, counting 32 state governmental entities as current or past clients. Specifically, AKF Consulting assists in structuring and advising upon all aspects of Section 529 savings and prepaid 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.