College Savings Nation 2014:

Safety and Risk Coexist as Investment Options Multiply

An Update on Advisor and Direct 529 Plan Options

December 2014

Overview

In our 2014 Market Report, a review of the current 529 college savings plan industry shows that investors have ample investment choices across the plans currently available, whether they choose to work with a professional financial advisor or invest in a plan directly.

Investors have access to varied age-based portfolios, a wide range of static investments, and more individual mutual fund options than ever before. Those who choose to design and manage custom asset allocations have a broad range of asset classes represented, with plenty of choices for aggressive and even the most conservative investors.

In looking ahead, many plan administrators and program managers are already considering the impact of future rate increases as well as equity performance uncertainties around the world. These will be the next challenges for 529 investors, particularly those with beneficiaries in the near-college years.

Method

Data for this AKF Market Report were aggregated through a review of official offering documents for ninety-two 529 savings plans as of October 15, 2014.

Findings and observations

Number of Plans Declines Slightly While Investment Options Expand

A total of 92 different 529 college savings plans were available to investors as of October 2014, compared to 94 plans available in March 2012, the publication of our last Market Report. Currently, 60 plans are offered directly to the public ("direct plans"), 31 plans are available through professional financial advisors ("advisor plans") and one plan – the District of Columbia's – offers identical investment options in both advisor and direct channels. Since our last Market Report, the total number of investment offerings increased, with 529 plans adding 140 new options over the 32-month period, all as summarized in the chart on the top of the following page:

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Data as of	August 2010			February 2012			October 2014		
Savings Plan Type	Direct	Advisor	Advisor & Direct	Direct	Advisor	Advisor & Direct	Direct	Advisor	Advisor & Direct
Number of Plans	53	30	6	59	34	1	**60**	**31**	**1**
Investment Options	510	530	92	636	609	8	**722**	**663**	**8**
Open Prepaid Plans	13[1]			12[2]			13[3]		

The changes summarized in the table above reflect the following:

- California's ScholarShare Advisor Plan closed in March 2012, with assets and accounts converted to the ScholarShare Direct Plan.
- In May 2012, the New York Advisor Plan converted from Columbia Management as Investment Advisor to J.P. Morgan. This did not change the number of advisor plans, but it increased the number of investment options available across plans.
- Tennessee launched its TNStars College Savings Plan in September 2012, marking the first launch of a completely new, entirely "state-managed" 529 plan since the 2002 launch of the Florida College Investment Plan.
- Wisconsin converted the EdVest Advisor to the advisor-sold Tomorrow's Scholar 529 Plan in conjunction with a Program Manager change in October 2012. This resulted in TIAA-CREF Tuition Financing Inc. taking over the direct-sold EdVest College Savings Plan, and Voya Investment Management (formerly ING Investment Management) assuming responsibility for Tomorrow's Scholar.
- Voya replaced Ascensus College Savings (formerly Upromise Investments) as Program Manager of the Iowa Advisor Plan as of March 2013.
- The Mississippi Affordable College Savings ("MACS") Advisor Plan closed as of May 2013, and all accounts were transferred to the MACS Direct Plan.

We believe the reduced number of advisor plans offered nationwide is the result of two factors. First, it is difficult to offer a relatively new advisor plan in states without tax or other state-specific benefits, particularly when advisors can choose from a well-established array of advisor plans nationwide. And second, unless there is a distribution play or some other inherent advantage (e.g., a privately-labeled advisor plan), we believe that offering more than one advisor plan in a single state will dilute the state's primary 529 brand (note the October 2012 consolidation of Advisor Plans in Wisconsin).

As for Section 529 prepaid plans, their numbers have changed slightly since February 2012. As shown in the chart above, thirteen prepaid plans (including prepaid-like options in Alaska and Massachusetts, as well as the Private College 529 Plan) are currently available for new enrollment. The players have shifted a bit, however, since 2012:

[1] Includes Alaska, Massachusetts and the Private College 529
[2] Excludes Illinois as enrollment was suspended at the time
[3] Includes Illinois and Mississippi

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- The Illinois prepaid plan, CollegeIllinois!, was suspended to new enrollments as of December 2011 but re-opened in September 2012.
- Colorado's Prepaid Tuition Fund, which was closed to new investors as of December 2002, permanently closed as of November 2013 and liquidated all assets.
- The Mississippi Prepaid Affordable College Tuition Plan, suspended to new enrollments as of September 2012, reopened as of October 2014.

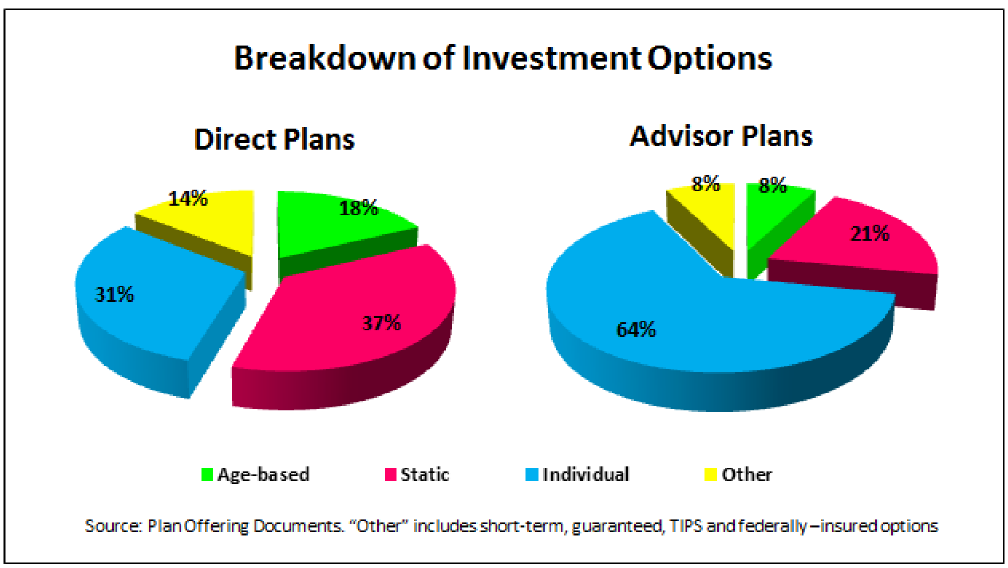
As a general matter, prepaid plans continue to be scrutinized by the press due to ongoing unfunded liabilities stemming from tuition inflation in the face of unpredictable investment returns. The "noise," however, has quieted down as the plans generally seem to have stabilized with recent equity market improvements.

Direct vs. Advisor Plans: Growing Divergence in Investment Options

In August 2010, six states offered the exact same investment options in their advisor and direct versions. By February 2012, only the District of Columbia College Savings Plan was identical in both its advisor and direct plans. Investment differentiation continues across plans today for two main reasons.

First, pressure remains on states to offer low-cost, often indexed investment options in their direct plans. If indexed options were prevalent in advisor plans, it would be difficult to justify the expense of professional advisors for value-added investment advice. And second, offering identical investment options would make it difficult for advisors to sell against a state's less expensive direct plan. In this case, we believe most advisors, particularly fee-based, registered investment advisors ("RIAs"), would simply point their clients to the relevant state plan, forgoing the additional compensation they might have earned in advisor shares.

While both direct and advisor plans have increased the overall number of investment offerings since 2012 (direct plans by 13.5% and advisor plans by 8.9%), the differences in the type of offerings are key, as shown by the following:



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- Direct plans continue to offer more than twice as many age-based options as advisor plans (129 vs. 51). Interestingly, since September 2010, direct plans have increased the number of age-based options offered – from 101 to 129. This change reflects an increasing demand for different approaches to asset allocation within the age-based format, e.g., from aggressive age-based to moderate to conservative.

- Currently, 426 individual fund options account for almost two-thirds (64%) of all advisor plan investment options.[4] This represents a 10.1% increase in individual fund options offered since February 2012.

- In contrast, 225 individual mutual fund options account for less than a third (31%) of all options in direct plans. As an aside, we note that this is a 24.9% increase over the last two years, which we believe is largely the result of Exchange Traded Funds ("ETFs") being offered as underlying investments in five direct plans (21 of 39 new individual options are ETFs).

In our view, the breadth of different choices across direct and advisor plans reflects the intrinsic role played by the professional financial advisor. More individual mutual fund choices provide greater opportunities for a professional to help with asset allocation and fund selection, while pre-set age-based portfolios give individual investors a "set-it-and-forget-it" option. We also believe that the increase in the number of individual options offered in direct plans may be an effort to attract the growing numbers of RIAs directing their clients to low-cost direct plans.

The charts on the top of the next page compare the growth of different investment options across direct and advisor plans since August 2010.

[4] AKF Market Reports do not include short term, TIPS, guaranteed or federally-insured options in the “individual mutual fund option” category. These are separately accounted for in our database.

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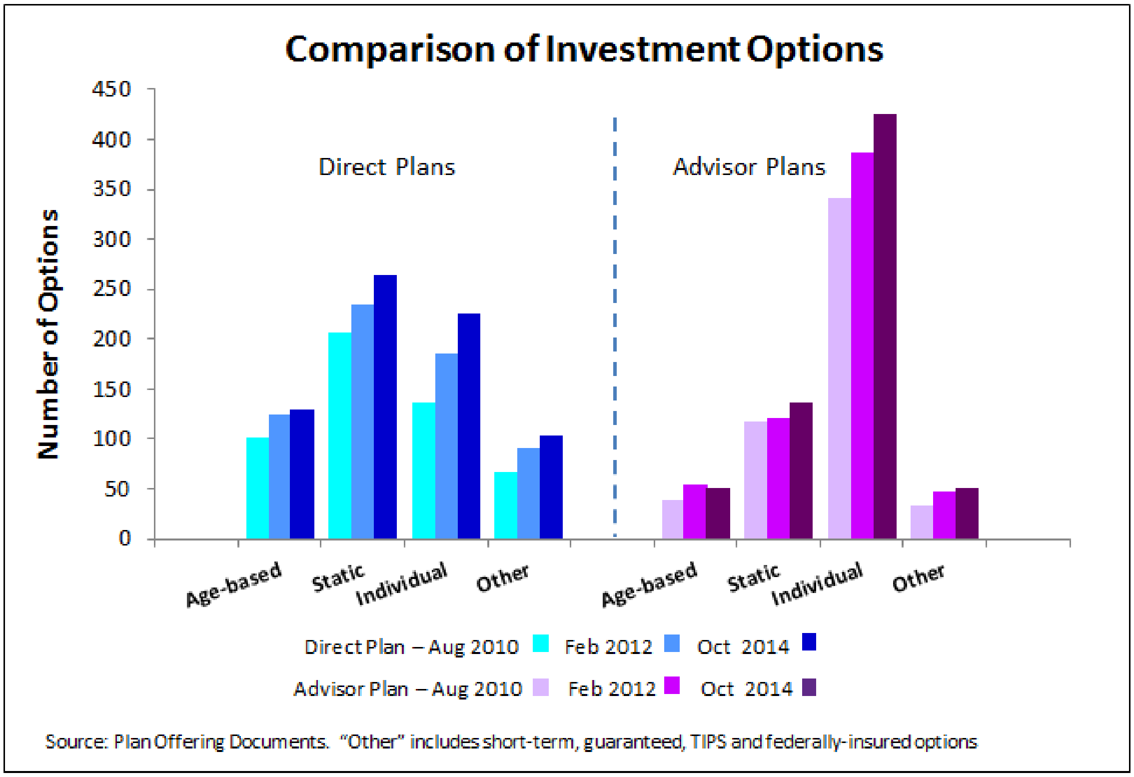

ETF Growth Plateaus

As indicated above, we find more ETFs in 529 plans than ever before. In addition to the 21 new ETF-based options in five direct plans mentioned above, 42 new ETF individual options were introduced by eight advisor plans. As a result, ETFs are now offered in six direct plans and ten advisor plans, across 27 age-based options, 46 static asset allocation options and 80 individual fund options.

The major growth in ETFs occurred in 2012, with plan sponsors adding at least 65 ETFs in that year alone. In fact, the largest ETF infusion in direct plans resulted from the April 2012 launch of the Nevada SSgA Upromise 529 Plan. This Plan completely replaced an all-Vanguard indexed fund line-up with an SSgA Spider line-up, including 19 ETF investment options. Fifteen are offered as individual options with exposure to International Real Estate, International Small Cap, Emerging Market Small Cap, International Government Inflation-Protected Bond and Short-Term Corporate Bonds, among others.

The types of ETFs offered are also less conventional, as shown by the following examples:

- In June 2012 the Nebraska Educational Savings Trust ("NEST") Advisor College Savings Plan added eight ETFs including, among others, Short-Term Bond and Emerging Market ETFs.
- Since October 2012, South Carolina's Future Scholar Advisor Plan added seven ETFs, including a TIPS Bond ETF.

- In late October 2012, the Arkansas iShares 529 Plan added seven new ETFs including an Emerging Markets Minimum Volatility Index and a High Yield Corporate Bond ETF.
- In late November 2012, Illinois' Bright Directions added 15 new ETF individual options including, among others, Short Term Bond, International Real Estate and Emerging Markets ETFs.
- In October 2013, Maine's NextGen Select College Investment Plan added 12 new ETFs, which included the creation of a new iShares age-based option, two iShares static asset allocation options and three iShares individual options.

As a general matter, we believe plan sponsors increased the number of ETF-based investment options to appeal to RIAs and other fee-based advisors, many of whom are accustomed to using ETFs in fee-based investment advisory accounts for access to less liquid asset classes. However, since 2012, fewer ETFs have been included in underlying investments (we believe only six have been added since Maine's addition in October 2013).

In our view, the more recent decreased appetite for ETFs reflects two points. First, one of the major benefits of ETFs, intraday trading, offers no real advantage in 529 plans, where a 529 investment option is traded like a traditional mutual fund, with a post-closing Net Asset Value. And second, the ETF benefit of daily transparency of holdings is diminished by federal restrictions on 529 investment option changes. With fee pressures continuing to build, particularly in direct plans, sponsors may have decided that investors are just as well — or better — served by less costly index funds.

Safety First

Despite a five-year bull market in equities, the desire for liquidity and safety continues, manifested by the proliferation of short-term, guaranteed, federally-insured and inflation-protected securities in 529 plans. This may reflect residual investor caution after the crisis of 2008, as well as shorter timelines for many investors in 529 plans. The chart on the top of the following page depicts the growth of these investments since 2010:

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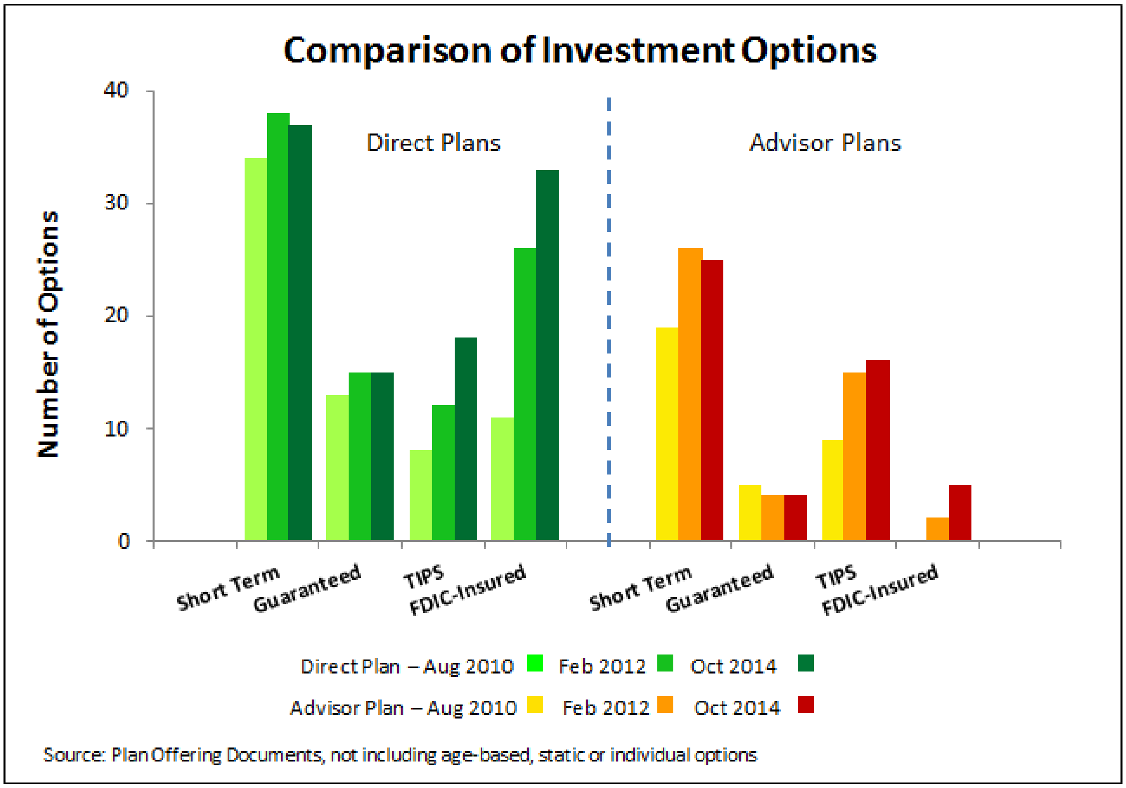

We note that direct plans steadily increased the presence of TIPS and other inflation-protected securities in asset allocation and individual investment options over the last two years. To this end, direct plans today offer approximately 34 individual inflation-protected investment options, while inflation-protected securities are also included in approximately 256 age-based or static allocation options. This makes sense in anticipation of possible inflationary pressures in the future, but low inflation in the last several years has caused TIPS to be among the lowest performing fixed-income sectors. In 2013, for example, TIPS lost 9%, as measured by the Barclays US Treasury Inflation Linked Bond Index. Still, with the U.S. economy appearing to grow and unemployment seemingly decreasing, inflation worries are not far from anyone's consideration.

In addition to the increase in inflation-protected options, the number of investment options comprised of federally-insured deposit accounts has more than doubled since August 2010 in both direct and advisor plans. Direct plans have consistently rolled out FDIC- or other federally-insured options (or stand-alone plans) over the years; advisor plans have been slower to embrace these low-yield, risk-free investment options. Based on our research, FDIC-insured investments are offered in just five advisor plans, including Arkansas iShares, Indiana's College Choice Advisor, Maine's NextGen Client Select, the Nebraska NEST Advisor, and South Carolina's Future Scholar Advisor. Clearly, however, doing so is in response to a perceived desire by investors to find a principal-preserving investment.

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Unique Options Add Diversification

Even as plans filled their menus with low-risk options, many continued to increase the number of investments with historically higher volatility. We reviewed exposure to international equity, emerging markets, real estate, commodities and other select asset classes to track the prevalence of these options and identify asset class diversification trends.

- International equity is increasingly becoming an important asset class in 529 plans. International equity exposure is included in 165 age-based options and 77 individual options as of October 15, 2014, compared to approximately 138 age-based options and 71 individual options in July 2013.
- Approximately half of all 529 plans have some level of exposure to emerging markets. Most often, we find this exposure as part of an asset allocation strategy, where emerging markets are included for diversification purposes. Few plans offer emerging markets as stand-alone investment options.
- Real estate is offered in 203 investment options across 42 plans, including 72 age-based options, 111 static options and 20 individual options.
- Commodities as an asset class are present in 15 plans, including six direct plans (Arizona's Fidelity College Savings Plan, the Delaware College Investing Plan, Massachusetts' U.Fund College Investing Plan, Nevada's USAA College Savings Plan, the New Hampshire Unique College Investing Plan, and the South Dakota College Access 529 Plan), and nine advisor plans (Alabama's CollegeCounts 529, Arizona's InvestEd 529 Plan, the Maine NextGen Client Select, the Michigan 529 Advisor Plan, New Hampshire's Fidelity 529 Advisor Plan, the New Mexico Scholar's Edge 529 Plan, Oklahoma's Dream 529 Plan, the Oregon MFS 529 Savings Plan, and the South Dakota CollegeAccess Advisor).

We also discovered some unique investments offered by 529 plans, including social choice equity, multi-asset classes, volatility management, absolute return strategies, derivatives and sector-specific funds, among others. These tend to be prevalent in advisor plans, which are designed to provide active management and greater opportunities for professional financial advisors to add value. Below are some examples:

- Socially responsible funds offered by Calvert, TIAA-CREF or Vanguard are offered as individual options in seven direct plans, including California's ScholarShare, Connecticut's Higher Education Trust, the District of Columbia College Savings Plan, the Oregon College Savings Plan, Pennsylvania's 529 Investment Plan, the Texas College Savings Plan and Wisconsin EdVest.
- Volatility management and international managed volatility funds are present in six advisor plans, including Arkansas' iShares, Maine's NextGen Client Select, the Michigan 529 Advisor, Oklahoma Dream, the Rhode Island CollegeBound*fund* Advisor and South Dakota's CollegeAccess Advisor.
- Sector-specific funds, such as technology and health sciences, are offered as part of an asset allocation strategy or individual option in the Alaska John Hancock Freedom 529, Arizona's InvestEd 529 and Ohio's BlackRock College Advantage Advisor Plans.
- South Carolina's Future Scholar Advisor Plan includes a convertible securities fund in its age-based and static options.
- Missouri's 529 Advisor Plan offers a "terror-free" multi-cap individual option that does not invest in companies involved with countries associated with terrorist activities.

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- Four advisor plans (Maine's NextGen Client Select, the Michigan 529 Advisor, Oklahoma Dream and South Dakota's CollegeAccess Advisor) and one direct plan (South Dakota's CollegeAccess) offer the PIMCO Foreign Bond Fund. This US dollar-hedged fund invests in derivatives such as mortgage-backed securities, options, futures and swaps.
- Finally, we note that as of March 2014 each of the direct and advisor plans offered by Rhode Island's CollegeBound*fund* include an age-based option that tracks a Morningstar index. Underlying funds in the options in both plans are passively-managed AllianceBernstein funds. Our only observation on this development is that Morningstar will not provide 529 plan ratings for plans that incorporate a Morningstar index.

The following chart summarizes our research for this section of the AKF Market Report:

	Number of Plans			Included in Number of Options		
Funds in Savings Plans	**Direct**	**Advisor**	**Direct and Advisor**	**Age-based**	**Static**	**Individual**
International Equity	52	31	1	165	311	77
Emerging Market	25	23	0	67	134	12
Real Estate	24	18	0	72	111	20
Commodities	6	9	0	23	39	5
Unique Investments (Select Direct and Advisor Plans)	9	15	1	23	33	24

What's Next for the 529 Plan Market?

We believe certain challenges loom for 529 investors in the months and year ahead. With the Federal Reserve tightening the money supply, less-than-robust productivity, and the possibility of another European recession, investing for college may become as fraught as investing for retirement, particularly when considering the finite time horizon associated with college saving.

Prepping for a rate rise

We continue to see uncertainty about fixed-income markets, with many market forecasters predicting an interest rate hike sometime in 2015. Investors with children close to college tend to have higher allocations to bonds and are thus most vulnerable to rising interest rates, which will push the prices of their bond holdings down. Even a balanced 60/40 portfolio would suffer a material decline if rates rose.

Certain sectors of the bond market, particularly high-yield corporate bonds and floating-rate bonds, are likely to weather a rate increase better than others. In recent months, several asset managers have debuted more short-duration bond options and other products built for a rising rate environment. Specifically, we have counted at least 486 options across 61 plans that include high yield, bank loan, and short-term or short duration bond funds, all of which can potentially

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reduce interest rate risk (five plans offer exposure to these asset classes through seven individual ETFs). And years after the market for collateralized mortgages and other debt collapsed, we are seeing a resurgence of these products in an effort to add fixed-income diversification. We expect 529 sponsors to monitor this trend and at least consider adding some of these options in the months ahead.

Equity exposure

With stock indexes closing at record high levels, many investors are wondering how much longer equities can outperform. Sell-offs have already occurred, with increased volatility in the S&P 500 Index, and the Russell 2000 Index dipping into correction territory. We believe the volatility may cause many investors to reassess the appropriate level of equity exposure in 529 plans, particularly in the years right before and during college enrollment.

In light of uncertainty in the equity markets, investors working with professionals will need to lean on their advisors more than ever for guidance on asset allocation and investment selection. Many direct investors could avoid over-exposure to individual options in favor of age-based or static options designed to take the guesswork out of asset allocation. Even these solutions, however, require regular assessment, particularly with exposure to international and emerging market equities. As we've shown in this Market Report, these asset classes are currently included in many asset allocation solutions and are expected to be highly volatile at least in the short term.

In our view, at a time when buy-and-hold has been replaced with vigilance as a result of the 2008 financial crisis, we may see more plan sponsors increase their efforts to remind investors of what they actually own and to reassess their investments in light of evolving goals and objectives.

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 33 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.