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AKF Market Report

College Savings Nation:

As American's Embrace Thrift, College Savings Market Strives to Create New Investment Options

A Nationwide Analysis of Advisor and Direct 529 Plan Options

September 2010

Overview

According to the U.S. Department of Commerce, the personal savings rate in America increased during the economic recovery, hitting a high of 6.4 percent in June 2010, compared with 2.1 percent in 2007. The college savings market has been a beneficiary of this trend. While 529 college savings plan assets plummeted approximately 23 percent from January 1, 2008 to the market low-point in the quarter ending March 31, 2009, just five quarters later, in June 2010, 529 savings assets were up almost 36.7 percent to $117.8 billion, according to the College Savings Plans Network. By this measure, the growth rate of college savings plan investments was consistent with the S&P 500 and exceeded the Barclays Capital Aggregate Bond Index through the first half of 2010.

According to a recent study by Fidelity Investments[1], the good news is that today 67% of parents have begun to save for college, up from 63% in 2009, and 58% in 2007. Despite this trend toward increased savings, however, the same Fidelity study found that American families saving for college are only expected to meet 16 percent of projected college costs for their children, down from 18 percent last year.

This combination of national thrift and consumer expectations about seemingly insurmountable college expenses is creating a perfect storm in the college savings market, with more investment options being created, new plans opening their doors and fees dropping nationwide.

As we enter the "back-to-school" and holiday season prime marketing periods for college savings plans, we will see a renewed focus by state administrators and plan managers to differentiate their products amidst an increasingly crowded field of competitors. How does the current crop of 529 options stack up to previous years, and what should investors look out for in the year ahead?

The following AKF Market Report surveys the state 529 plan marketplace to assess the various options in advisor and direct-sold programs. It finds a wide range of investment options that state administrators and plan managers have been developing to tap into the nation's newfound sense of fiscal responsibility.

Method

Data for this AKF Market Report were aggregated through a review of offering documents for over ninety 529 savings plans as of August 24, 2010.

[1] Fidelity Investments' 4th Annual College Savings Indicator Study

Findings and Observations

Total Number of Plans and Options

There are a total of 95 different 529 college savings plans currently available to investors. Among those, 59 are available directly to individual investors and 36 are available through financial advisors. Of these, 5 plans are the same whether offered directly to individual investors or through advisors (including plans in the District of Columbia, Montana, Nebraska, Rhode Island and Wisconsin).

While the bulk of the available investment options are actually static blend options or individual mutual fund portfolios, the biggest change has been the make-up of short-term investment options including money market funds and short term cash funds, guaranteed investments (including, for example, GICs and funding agreements from insurance companies) and Treasury inflation-protected options. More recently three 529 plans have launched bank-type products that offer FDIC or NCUA insurance to 529 investors, bringing the total number of plans offering federally-insured products to nine and the number of choices for investors to 16.

The following table offers a detailed breakdown of the broad options available in the current market versus what was available in May of 2009:

	May 2009			August 2010		
Plan Type	**Direct**	**Advisor**	**Advisor and Direct**	**Direct**	**Advisor**	**Advisor and Direct**
Number of Plans	52	29	6	54	31	5
Total Investment Options	512	490	93	544	559	74
Age-Based Options	101	36	18	104	42	15
Static Options	209	100	17	213	123	14
Individual Mutual Fund Options	139	326	51	153	358	38
Short Term Options	31	16	3	36	21	3
Guaranteed Options	16	6	2	14	4	2
TIPS Options	7	6	0	10	11	0
Federally-Insured Products	9	0	2	14	0	2
Open Prepaid Plans	13			12		

We note that the increase in number of direct-sold plans over the last year reflects a new stand-alone bank plan in Colorado as well as a new savings plan in Alabama. And, the change in advisor-sold plans reflects new mandates in Alabama, Michigan, Ohio and Oklahoma along with advisor plan closures in Nebraska and Oregon. We anticipate additional overall changes in the near-term as the plans in Montana and Nebraska shift to new program managers before year-end.

Short Term and Conservative Focus

The biggest trend evident in the comparison between 2009 and 2010 529 investment options has been the growth in short-term, Treasury-protected and federally-insured choices. This increased interest among investors in lower-risk investment options has been a trend we've been watching for several years. Over the past year, new federally-insured options were launched in Colorado, Indiana, North Carolina and a second federally-insured option was introduced in Virginia. We anticipate at least another five FDIC-insured options will be launched within the next two quarters.

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Though the trend toward federally-insured choices has been consistent across the industry, the paths to implementing those plans have varied widely. Colorado offers a distinct plan that partners with a local banking institution – First Bank – whereas Indiana's bank option includes online banking products offered by the Sallie Mae Bank and North Carolina introduces the State Employees Credit Union as an insured partner. It remains to be seen whether there will be an advantage to any one approach over the other, but each option is fulfilling a vital customer need in the current market: a relatively risk-free haven for precious college savings dollars. Future AKF Market Reports will take a closer look at the challenges of offering federally-insured options within 529 plans.

Consistent with the overall trend toward lower-risk options, new money market options were created this year in Kansas, Maryland and Texas while new bond fund options were launched in Colorado, Illinois, Indiana and Texas. We note, too, that four different plans shuttered stable value or GIC options, no doubt a reflection of the weak market performance of these wrapped or otherwise insured products.

Returns in money market funds have been negligible over the last year but they continue to offer comfort to parents who remain skittish or who have anticipated funding needs in the short run. From an investment management standpoint, the money market options have presented real costs to the programs – a quick perusal of disclosure documents indicates that program managers are subsidizing the costs of the investments in order to provide at least a 0% rate of return. This should be a temporary situation and not one that should concern investors. We note it, however, because at some point plans may seek conservative alternatives that offer better returns without added costs.

Additionally, several plans introduced new asset classes in their mixes this year, with a real estate-based fund launched in Illinois, a socially-targeted option created in Virginia, a "design your own allocation" option developed in Utah, a small cap option in Missouri, a mid cap option in Illinois, and particular ETF options in Iowa's advisor plan. The ongoing development and performance of these and other potentially "alternative" asset class 529s will continue to be monitored and discussed further in future installments of the AKF Market Report.

Lower Fees

The industry's push to develop new products that meet the needs of today's risk-averse, savings-conscious investors has been accompanied by a number of administrative changes. Over the last year alone, there were nine program manager reviews and rebids, with existing managers re-engaged in Colorado, Connecticut, Kentucky, Massachusetts, Minnesota and Vermont, and new managers selected in Alabama, Nebraska and Oregon. In all cases, the end-result to consumers has been lower fees.

Fee reductions have been a trend we've been observing for several years. Since 2003, more than 78 percent of all direct-sold plans have reduced fees to investors, driving the average direct-sold fee to today's low of between 62 and 68 basis points (depending on whether we include the several no-cost guaranteed or state-run options in the average calculation).

We expect the trend of fee reductions to continue as we head into the next round of program management rebids. Even without a rebid, New York just slashed its direct-sold fees by almost 50 percent. In the year ahead, we estimate that more than $15.56 billion in assets under management will be up for rebid, with at least $9.4 billion in the New York 529 Program alone. We expect that rebids or renegotiations in California, Missouri, New York and South Carolina will continue to exert downward pressure on all direct-sold fees.

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Conclusion

Weighing the Risk/Return Equation

The good news is that investors have come back into the 529 market this year and market performance has helped boost results, reversing a significant decline in total 529 assets under management. The industry has clearly catered to investors' sensitivities by creating more low-risk options and continuing to lower fees. Just as the number of aggressive equity options proliferated during the market's boom times, we find that short-term, low risk options are becoming the must-have product for the recovery and beyond. This enthusiasm for "risk free" investing is a trend to watch in the months and years ahead as consumers continue to voice concern about their ability to meet college cost demands. Without some risk, returns will not reach the levels they have in years past. At some point we expect the appetite for appropriate risk to resurface.

Regardless of how many new options continue to come into the market, an investor still needs to consider the fundamentals in choosing a 529 plan. As always, an investor should look at the plan offered by his home state to determine whether there are specific state tax benefits or other advantages that would only be available by investing in the state's plan. "Other" advantages or benefits can include preferential treatment for state financial aid purposes, and even particular scholarship or matching grant programs for qualifying families. We also note that in five states – Arizona, Kansas, Maine, Missouri and Pennsylvania – an investor can choose any 529 plan and enjoy the same in-state tax benefits offered for the applicable state's plan.

The biggest concern an investor must face is the anticipated need for funds. Depending on when the beneficiary is expected to enter college, an investor might choose options that are more or less aggressive and market sensitive. Almost every plan in the country offers a short-term or conservative option so that if a year-end decision must be made (because of a state tax benefit, for example), then an investor should consider investing in a relatively risk-less option until he feels more comfortable about market direction and his selections. If the investor has a long time horizon, the "safest" investment option may not be the best. It is critical that investors take their own unique needs into account when making a 529 allocation.

Likewise, despite the industry-wide trend toward reduced fees, investors should not lose sight of all the factors that go into choosing an appropriate investment. An investor should understand different asset allocation options (this is particularly true across seemingly similar age-based options offered in the same plan) and different management styles within the same plan (that is, indexed versus actively managed investments within similar asset classes or structures). Investors should also be mindful of different fee levels for more or less the same investment options across college savings plans. This means that an investor should do his homework when considering investments that are available in more than one plan. Likewise, investors must consider whether state tax or other benefits outweigh higher fees, where state benefits are a consideration. Investors can find calculators on the Internet to help sort through some of these issues.

In addition to the individual websites of each 529 plan an investor is considering, some great online resources are:

- www.collegesavings.org
- www.savingforcollege.com
- www.collegesavingsfoundation.org
- www.msrb.org
- www.finra.gov

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Finally, if an investor has funded a Coverdell Education Savings Account ("Coverdell ESAs" or "ESAs") in the past, he should be mindful of Congressional action this fall. The Coverdell ESAs became much more attractive as of January 1, 2002, when the funding limits were increased to $2,000 and the uses of funds expanded to include primary and secondary education as well as religious schools. These changes were part of the "2001 Tax Cuts", which will sunset at the end of 2010 if Congress does not act to extend them. In particular, Coverdell ESAs enhancements would end, causing funding limits to revert from $2,000 to $500 (barely enough for a semester of books) and the qualified uses of funds could be tightened to exclude primary and secondary education. Additionally, it is possible that investors might be penalized once again for contributing to a 529 and a Coverdell ESA in the same year. The bottom line is that investors with 529 accounts and ESAs should consider transferring some of the ESA funds to a 529 should the rules and parameters for ESAs change.

Trends in the college savings market will continue to be monitored and reported in future installments of the AKF 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, currently counting 27 state governments as clients. Specifically, AKF Consulting assists in structuring 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.