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Saving for College: Thoughts on 529 College Savings Plans

A 529 plan is a state-sponsored program that allows people to invest exclusively for college or post-graduate education. Named for the Internal Revenue Code which governs them, 529 plans were initially established in 1986 as a tax-advantaged vehicle to help people save for the rising costs of a college education. Investments in 529 plans grow tax-free as long as the money is used to pay for qualified higher-education expenses (tuition, fees, books, supplies, room and board). Most states make 529 plans available to residents of any state: A parent in Portland can enroll in Oregon's plan or that of any other state, such as Alaska or Wyoming.

Here's how a 529 plan works: An account owner (usually a parent) enrolls in a 529 plan on behalf of a beneficiary (can be a child, niece or other family member) and invests the contribution in a portfolio of mutual funds. When the beneficiary enters college, funds can be withdrawn tax-free to pay for college expenses. The account owner retains control over the plan assets and can even change the beneficiary, if necessary. If a child decides not to go to college or receives a full scholarship, no problem: the beneficiary can be changed to another college-bound relative.

529 plans are typically managed by a third-party asset manager, such as Fidelity or Vanguard, and are generally one of two investment portfolio types: Age-based or Lifestyle. Age-Based portfolios' underlying investment allocations become more conservative as the beneficiary approaches college age. For example, an age-based portfolio invested on behalf of a four-year old child beneficiary might begin with 90% invested in stocks and 10% in bonds. As that child nears college, the portfolio allocation automatically becomes more conservative, adding to bonds and cash while reducing the allocation to stocks. In contrast, Lifestyle portfolios have a static investment mix that does not change. The allocation of Iowa's Moderate Growth portfolio (60% stocks, 40% bonds), for example, remains constant regardless of beneficiary's age. We favor Age-Based portfolios because they provide a disciplined and easy way for account owners to manage their savings.

Since 529 plans will vary from state to state, it is important to analyze them much like one would pick a mutual fund: very carefully. New York's age-based portfolios, for example, do not include an international allocation. Oregon's "aggressive" portfolio invests only 80% in stocks, while Iowa's invests 100% in equities. Contribution limits vary, too: New York accepts contributions as long as the account value does not exceed \$235,000; those enrolling in Utah's plan can stash away up to \$280,000.

Costs are perhaps the single largest factor differentiating the best plans from the worst. Consider, for example, Sally Investor who wants to establish a 529 plan for her newborn son. If she puts \$10,000 into Iowa's 529 plan and earns a 7% annual return over the next 18 years, she'll end up with \$30,288 by the time the first college tuition bill arrives. If she instead puts that money into Wyoming's plan and earns the same 7% return, she would end up with only \$22,352. Why the nearly \$8,000 difference in return? High fees and expenses. The Iowa 529 plan, run by Vanguard, charges a paltry 0.65% of assets on an annual basis. Wyoming's plan, run by Merrill Lynch and MFS, charges annual fees as high as 2.43%.