The Morningstar College Savings Guide

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The Best and Worst 529 College-Savings Plans

By Morningstar Analysts

It's a dismal scenario: As college tuition continues to shoot up at an alarming rate, investors brave enough to open their 529 college savings account statements have likely seen a precipitous drop in assets.

In the past, we've been able to laud the 529 industry for lowering fees, improving investment options, and closing down poorly structured plans. Unfortunately, the past year hasn't been so rosy in the college savings universe. Several plans had maintained too-aggressive asset allocations for students nearing or in college, while other plans were hamstrung by their allegiances to floundering investment options.

A Major Player Stumbles

OppenheimerFunds is the poster child for how badly some 529 players went awry in 2008. Over the past few years, the company had firmly established itself in the 529 college savings universe. The firm currently manages nine separate college savings plans, both advisor- and direct-sold, in five states. Unfortunately, all of those plans had exposure to one of the worst bond-fund blowups in 2008. Oppenheimer Core Bond (OPIGX) (or separate accounts managed in the same style), a fixture in those Oppenheimer-managed 529s, lost more than 35% in 2008 due to management's bets on nonagency mortgages. In particular, management gained exposure to the battered commercial mortgage-backed securities market through derivatives that had a leveraging effect on the fund, amplifying losses. But it didn't stop with just Core Bond. Many of the Oppenheimer plans also had exposure to Oppenheimer Limited-Term Government (OPGVX) and U.S. Government (OUSGX), two other troubled fixed-income funds that were run by the same management team as Core Bond. Government bonds were the only pocket of strength in 2008, but these funds managed to finish last year in the red despite their focus on that asset class. The reason? The funds owned mortgage-related securities and derivatives that weren't backed by the U.S. government, including commercial mortgage bonds that dropped precipitously last year. (Like most government funds, these two have the ability to invest up to 20% of their assets in nongovernment securities.)

In fact, one of those nine Oppenheimer-managed plans, Illinois' direct-sold Bright Start College Savings Plan, made our best list last year. The previously named "Active Portfolios" were caught up in Oppenheimer's fixed-income fiasco. The losses were so unprecedented that in mid-January 2009 Illinois' State Treasurer Alexi Giannoulias indicated that he was preparing to file a lawsuit against OppenheimerFunds. At the same time, the state also reacted by no longer offering the three troubled Oppenheimer fixed-income products, but existing shareholder money is still tied up in them. All told, the plan still holds plenty of appeal; its untainted "Index Portfolios" are still the cheapest nationally available Vanguard options.

The worst part for investors in these plans is that the Oppenheimer portfolios positioned closest to college were the ones holding the largest positions in these bond funds. Thus, even though fixed-income investments are typically considered more conservative than equities, the plans' bond options didn't provide the ballast that one might have expected--far from it. For example, Texas' direct-sold College Savings Plan's "Blended Age-Based 15 - 17 Years Portfolio," which had half its assets in Core Bond, fell nearly 30% in 2008, compared with less than half that amount at many peers in a similar age-band. A similar pattern of losses can be found in the same age band at nearly every Oppenheimer-managed 529 plan.

Risky Age-Based Options

Unfortunately, the Oppenheimer-managed plans weren't the only ones with problematic age-based options. Age-based options are designed to transition from mostly equities in a younger child's account to more conservative investments--bonds and cash--as the beneficiary approaches college. There's not a strong consensus on the exact amount of stocks, bonds, and cash to hold for a particular time horizon, but it's clear to us that some plans didn't move out of equities fast enough and were courting far too much risk given that they were geared toward students getting close to matriculation. After all, most students deplete their 529 assets in the space of four years, leaving little time to recover from a serious market downturn like 2008's.

The most striking example of an overly aggressive asset allocation comes from one of Utah's five age-based options. That plan's "S&P and Bonds" age-based option stashes 65% of assets in equities for a college-enrolled beneficiary. This is dangerously bold, in our opinion. It's important to note, however, that this best-in-class plan features four other age-based options with much more sensible structures.

An overly aggressive asset-allocation framework becomes a more serious issue when investors are offered only a single age-based choice. For example, Oregon's OppenheimerFunds 529 Plan has just one age-based option, and until March 30, 2009, the plan's "1-3 Years to College" portfolio had 40% devoted to equities, with more than 5% in foreign stocks. Additionally, New Jersey's direct-sold plan has just one age-based option that can have as much as 35% in equities--including up to 12% in international and 6% in smaller-cap fare--for a beneficiary already enrolled in college. The critical lesson for investors is to pay particular attention to the latter stages of a plan's age-based option, and be sure you are comfortable with the risk your plan is taking.

Our Methodology

The terrible performance of some 529 plans in 2008 clearly illustrates that, now more than ever, investors can't afford to invest in anything but best-of-breed college savings plans.

To arrive at our annual list of the best and worst 529 plans, we've combed piles of 100-plus page plan documents, talked with several plan sponsors and used our own tools to evaluate these plans. There's an enormous amount of data to review, but the critical features we focus on are asset-allocation schemes, fees, flexibility, and the overall quality of the underlying investments.

We like to see plans that have sensible allocations among stocks, bonds, and cash that are appropriate for the age of the beneficiary. We like to see plans that are not only well-diversified across the major asset classes, but are also exposed to such areas as foreign bonds, real estate investment trusts, and Treasury Inflation-Protected Securities for added diversification benefits.

Fees are another important item to consider. Morningstar and others have consistently found that costs are the best predictors of a mutual fund's long-term success, and one can safely extrapolate those findings to the 529 universe as well. Expenses are especially important for the growing number of index-centric plans, which have little else besides expenses to distinguish them.

Flexibility is also an essential ingredient to a 529 plan. In addition to multiple age-based options with differing levels of risk, we also like to see a few fixed-allocation offerings (i.e. the level of stocks, bonds, or cash does not change over time) and a good selection of single-fund options for do-it-yourself investors or for advisors looking to tailor-make a portfolio for clients. Finally, the quality of the underlying investments is an important consideration. We look for funds that have experienced managers, a history of good stewardship, and sensible strategies.

Using those criteria, we've ferreted out what we believe to be the five best and five worst college savings plans in the country. It's important to point out that, although we tend to put newcomers at the top, we don't rank plans within each list. This year's Best and Worst lists are a good deal different from last year's lists--with two newcomers on the Best list, and three on the Worst list.

The Best 529 College-Savings Plans

Ohio CollegeAdvantage
Indiana CollegeChoice 529 Direct Savings Plan
Utah Educational Savings Plan Trust
Virginia College America 529 Savings Plan*
*Broker-sold

Ohio CollegeAdvantage 529 Savings Plan
Ohio is in an interesting position. The state has two plans at opposite ends of the quality spectrum, with this direct-sold plan securely in the "best" camp. One of the most important features of this plan is that the Ohio Tuition Trust Authority not only created the plan, but it also manages it directly. (Most 529 plans, by contrast, use mutual fund companies as program managers.) This setup is rare in the 529 universe and it gives the OTTA more freedom to choose from a variety of mutual fund families, such as Vanguard, PIMCO, GE Asset Management, and Fifth Third Bank (for CD options). We like the flexibility here, too. The plan offers four distinct age-based options--all with sensible asset-allocation schemes--with a choice between active and index strategies. Additionally, it offers a bevy of individual fund options--both active and passive. Finally we like the low fees of this plan. Total expenses are 0.23% to 0.47% for the age-based options, 0.24% to 0.46% for the static options, and 0.23% to 0.91% for individual fund options. And the deal is sweetened for in-state residents who can deduct up to $2,000 of contributions. (Excess contributions can even be deducted in later years.)

Indiana CollegeChoice 529 Direct Savings Plan
This direct-sold plan is a newcomer to Morningstar's 529 Best list. Upromise Investments--a subsidiary of the popular Upromise rewards program--took over this plan from J.P. Morgan in the fall of 2008 and upgraded it to a best-in-class choice for investors. This plan keeps it simple, but it gets kudos in a number of areas. First, the plan is built with solid underlying funds from the likes of Vanguard, Dodge & Cox, and Western Asset. The underlying holdings cover all the major asset classes and even include exposure to Treasury Inflation-Protected Securities as a single-fund option. The plan also offers sensibly constructed age-based portfolios and six individual fund options for those who want to customize their portfolios. Fees are very reasonable, ranging from 0.35% for a total stock market index fund to 0.95% for a single-fund international portfolio, while costs for the age based options hover around a modest 0.51% to 0.53%. To top it off, Indiana residents receive a 20% tax credit, up to a maximum of $1,000 per year, on contributions.

The Utah Educational Savings Plan Trust
For those who want a tax-sheltered way to save for college using Vanguard index funds, this is the plan. Utah's 529 plan has long been a favorite of ours and remains a strong choice for its low costs, flexibility, and tried-and-true Vanguard index funds. The plan's fees are a rock-bottom 0.22% to 0.35%, making it one of the cheapest plans in the country. The plan offers plenty of flexibility with five distinct age-based choices, which gives investors a good deal of choice to match the options with a level of risk they are comfortable with. (Even the most risk-tolerant investors should steer clear of the aforementioned "S&P and Bonds" option, however, which has nearly two thirds of assets in equities for college-aged beneficiaries.) Investors also have the option of three individual funds and a few static options to augment the age-based options or

build their own portfolios. We'll admit it's not an exciting option, but as this market has demonstrated, it's tough to argue with the merits of a passive, low-cost approach.

Virginia Education Savings Trust (direct-sold) and Virginia CollegeAmerica 529 Savings Plan (broker-sold)

The final two plans are the only carryovers from last year's Best list. The Education Savings Trust has a lot in common with Ohio's direct-sold plan. Similar to the Buckeye plan, Virginia not only sponsors the plan but it also manages it (instead of using a mutual fund firm). So it's not a big surprise to see plenty of diversification across different mutual fund families. The plan's age-based portfolios offer a compelling mix of solid actively managed and index offerings from such shops as Vanguard, Templeton, and Capital Research (advisor to the American Funds). We also like the plan's sensible mix of static-blend options and a smart selection of single fund options that not only cover the three core asset classes, but give investors access to real estate investment trusts and TIPS. The plan also offers residents generous state income tax breaks up to $4,000 of contributions per year--doubling last year's limit and still retaining the benefit that excess contributions can be deducted in later years. Finally, a nice price tag that ranges from 0.31% to 0.54% rounds out the appealing package here.

The state's other topnotch choice, the advisor-sold CollegeAmerica plan, remains a favorite for its large selection of mostly first-rate American Fund mutual funds that give investors access to a broad array of asset classes, including emerging markets, small-cap foreign stocks, and foreign fixed-income securities. Fees are attractive, too, as most of the plan's A-share options are below 1.00% in total annual fees.

The Worst 529 College-Savings Plans

Nebraska State Farm College Savings Plan*
New Jersey Best 529 College Savings Plan
Montana Pacific Life Funds 529 College Savings Plan
Ohio Putnam CollegeAdvantage*
Nebraska AIM College Savings Plan*
*Broker-sold

Nebraska State Farm College Savings Plan (broker-sold)

In November 2008, this plan overhauled its underlying holdings with Oppenheimer mutual funds, and the timing couldn't have been worse. Just as Oppenheimer Core Bond entered this plan as a prominent fixed-income holding, it imploded, dragging down shareholder assets in both the plan's age-based options and its fixed-allocation options. The plan also had exposure to Oppenheimer Limited-Term Government (run by the same management team), which didn't fall as hard in absolute terms but lagged virtually every peer in Morningstar's short government category. That's troubling, but more worrisome is that Nebraska hasn't done anything about it. In contrast, the eight other states that offered Oppenheimer-managed plans have made varying degrees of changes, mostly involving the replacement of Core Bond. We hope the state does something to address the troubled Oppenheimer fixed-income funds in this plan, but until it does we'd steer clear of it.

New Jersey Best 529 College Savings Plan

Names can be deceiving: Despite this plan's "best" moniker, it lands firmly in our Worst category. The first strike against this plan is its overly aggressive age-based option combined with a lack of flexibility. Even after a recent modification on April 1, 2009, the plan's single age-based option can still have up to 60% of assets in equities in the years just prior to enrollment and has up to 35% in equities when a beneficiary is enrolled in college. Another strike against the plan is its above-average fees. Total annual asset-based fees range from 1.04% to 1.23%, which are considerably higher than a number of other direct-sold plans offered in other states. There's also a lack of flexibility in this plan with just two single-fund options. Finally, New Jersey residents have no incentive to stay at home and invest in this plan because there are no state income tax deductions for contributions.

Montana Pacific Life Funds 529

This is one of the least flexible plans around. Investors are offered only five fixed-allocation portfolios and a money market option. There are no age-based options, which is troubling given how popular these options are. We also take issue with the lack of single-fund options. The plan's prospectus highlights a decent roster of individual-fund offerings, but all these options have been closed to new investors since early 2007. Fees are a problem, too, ranging from a reasonable 0.96% to a pricey 1.47% (excluding the plan's money market option). It's important to note that the plan's five fixed-allocation funds are held down by a fee waiver that is set to expire in June 2009. If removed, the fees on these funds would exceed 2%.

Ohio Putnam CollegeAdvantage (broker-sold)

At the polar opposite end of the spectrum from Ohio's laudable direct-sold plan, on our Best list, is this troubled college savings plan. Similar to last year, we remain concerned about this plan mostly for its heavy exposure to Putnam funds. Putnam has been plagued by stewardship issues since late 2007 due to numerous manager departures and troubling executive turnover. As a result, the firm's funds get F's for the corporate culture section of their Stewardship Grades; no other firm's funds score that poorly for corporate culture. The state deserves credit for attempting to upgrade this plan last year by adding a handful of solid non-Putnam options, lowering fees a bit, and removing what plan administrators believed to be the worst Putnam options. However, the majority of the plan's underlying holdings are still Putnam funds. Until Ohio does more house-cleaning, we'd avoid it.

It's also worth mentioning that Ohio's Putnam plan may soon be overshadowed by a new option: The Ohio Tuition Trust Authority recently announced that BlackRock has been selected to run a new 529 plan in the Buckeye state. Although details remain scant--the state is still in contract negotiations with BlackRock--it's safe to say BlackRock would be a significant step up in quality from Putnam.

Nebraska AIM College Savings Plan (broker-sold)

Next to Ohio's Putnam plan, this is the only other holdover from last year's Worst list. Few changes have occurred here, and the same problems--high fees and a lack of flexibility--still plague this plan. Fees have come down a bit, but they are still high, ranging from a whopping 1.25% for a money market account to 1.61% for an aggressive portfolio, on top of broker charges. We also take issue with this plan's flexibility because it lacks single-fund options (outside of a money market fund), which is especially troubling given that advisors typically mix-and-match individual funds for their clients.

Further reading

Want to dig deeper? We encourage investors to check out the 529 Plans link in our Personal Finance section where we have detailed coverage on more than 80 college savings plans, including our analysis and plan data. It's important not to overlook your home state's plan, which may offer valuable state income tax deductions, matching grants or other benefits for state residents. To investigate other issues around 529s and college saving more generally, peruse our articles found here. We discuss alternatives to 529s, investing out-of-state, and a host of other issues.

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Alternatives to 529 College-Savings Plans

By Morningstar Analysts

Saving for college is already a big concern for most families, and with costs soaring higher each year, it's likely to grow even more important. Many investors are turning to 529 college-savings plans to tackle this growing financial burden. No doubt the plans have appeal. Available mainly at the state level, they offer portfolios of mostly mutual funds and come with attractive tax savings for all investors, regardless of income levels. And while once pricey and mostly mediocre, many now boast lower fees and improved investment options, giving them better odds of success, more flexibility, and enhanced diversification.

Still, 529 college-savings plans aren't a perfect solution for everyone. For one, while the industry is improving, some states continue to hawk poorly constructed plans, and even the tax incentives aren't enough to compensate investors for the lackluster returns they'll earn from the mediocre funds and layers of fees. Plus, what if your child opts out of college? Because 529 plans are customized for higher education purposes only, college savers can face taxes and a steep penalty if they can't find another beneficiary to claim. There's no great out for leftover assets, either. If a beneficiary doesn't use up all the assets on approved education expenses, the amount remaining will also be sliced by taxes and penalties. Finally, although college savings are an important concern for most families, financial distress can sometimes mean a college saver needs the 529 assets for different purposes. Sorry, no dice. Whatever the reason, if the 529 assets aren't used for post-secondary education, investors are slapped with big tax bills.

Thus, before jumping into a 529 plan, we'd suggest assessing your particular situation. If 529 plans don't appear to meet your needs, consider alternatives. Below, we discuss the merits and drawbacks of a few of the other options college savers can consider.

Coverdells

Like 529 plans, these savings vehicles are designed to offer tax-free asset growth in the name of education. The structure here is a bit different, though. Coverdells aren’t offered by states. Instead, they’re a wrapper similar to an IRA. You go to a bank, brokerage, or mutual fund company, tell them that you want to invest in a Coverdell Education Savings Account, and then select the investment. And instead of focusing solely on college and grad-school expenses, investors can currently use Coverdell assets to pay for anything from kindergarten on up. There's quite a bit of flexibility, too. Investors retain control over their accounts and have a variety of choices at their fingertips--from CDs to mutual funds.

Before getting too excited about the possibilities, though, there are some serious drawbacks to consider. Not just anyone can invest in a Coverdell: The contributor's annual income must be below a specific minimum (currently $220,000 for married couples filing jointly). And unlike 529 plans, states don't offer tax deductions for contributions to Coverdell accounts, so all contributions are made on an aftertax basis. Age limits make Coverdells a bit unwieldy, too, because contributors can't add to their assets after the beneficiary turns 18 and the beneficiary faces taxes and a penalty if the assets aren't distributed by the time he or she turns 30.

These disadvantages might be worth it, given the other features Coverdells bring to the table. Unfortunately, barring any federal government actions, the most appealing aspects might soon disappear. In 2001, legislation upped what investors can contribute to as much as $2,000 annually, but this level is set to expire in 2010. Unless Congress takes action, starting in 2011 the educationally-minded will be able to sock away only $500 a year. The same is true for applying assets to primary and secondary education costs. If Congress doesn't move to extend this benefit, investors will be able to use Coverdell assets only for college and grad school education.

U.S. Savings Bonds

Before Coverdells or 529s, there were U.S. savings bonds. And while they may be old-fashioned, they're still worth a look for conservative types. The interest earned by U.S. treasury obligations isn't taxed at the state level, and if investors use Series EE or Series I savings bonds to pay for college and beyond, the interest earned won't be taxed at the federal level either. Series I bonds are particularly attractive. They are structured to offer some inflation protection. But regardless of the savings bond you choose, you won't face annual account maintenance fees, and if the student ends up not going to college, you won't pay any penalty besides paying federal income tax on the interests. Also, because U.S. savings bonds are protected by the full faith and credit of the U.S. government, safety isn't a concern.

As always, there's a downside. Barring the unforeseen, U.S. savings bonds aren't going to turn you from a pauper to a tycoon any time soon. Their muted volatility is accompanied by muted returns. Also, beware of the restrictions. Like Coverdells, these bonds aren't designed for everyone; only folks under certain income levels benefit from the federal tax breaks. They're also available for college saving only to those 24 and older.

The Standard Brokerage Account

First the bad news: Unless you stick with tax-exempt bond funds or rely on successful, tax-conscious funds, you won't evade the tax collector with a traditional brokerage account. Even with tax-managed offerings, you'll likely have to pay the piper every now and then--albeit in smaller amounts. Nonetheless, there are still two very important reasons to consider opening a plain-vanilla brokerage account to save for college. First, investors have complete control over their investment decisions and can stack their portfolios with best-of-breed mutual funds. Second, while there are expenses associated with brokerage accounts, and they can add up if you are a frequent trader, investors can avoid the layers of fees at 529s or Coverdells. That means investors can put more of their money to work for them. So while the tax bill is a significant disadvantage, a cheap, well-constructed portfolio might still put an investor in a great position for college expenses.

Home Equity Loans

There's more than one way to skin a cat. Instead of saving and investing to pay for college, homeowners can also tap their home equity, or the difference between what their home is worth and what they still owe in mortgage payments. The upside is that the interest on a home equity loan is tax-deductible. Plus, while 529 plans and Coverdells can make for less financial aid, if college payers rely on a home equity line of credit, the loan shouldn't come into consideration. (A home equity line of credit means the borrower gets the money as it's needed, and not as a lump sum at the beginning of the loan.) Of course, as the current market showcases, real estate prices don't always go up. So, college savers should do what they can to ensure they aren't biting off more than they can chew by taking on another loan. In the worst-case scenario, a home's value falls at the exact time the borrower needs to move. Saddled with two loans and a cheaper house, he or she could face a painful financial situation.

IRA

For investors who are torn between saving for college and retirement, an IRA can be a decent way to split the difference because it allows you to withdraw assets prior to retirement under certain conditions. If your child ends up not going to college or receives a scholarship, or if you have money left in your Roth after paying for college, you'll be able to put that money toward retirement.

On the flipside, you won't receive a state tax break on your IRA contributions, unlike a 529. If you earn too much, you may not be able to contribute to a Roth or deductible IRA. Moreover, while parents' retirement accounts are not counted as assets in financial aid formulas, assets withdrawn from a Roth IRA can be counted as income in the formulas. And perhaps the most important drawback is that if you withdraw IRA assets to pay for college, you'll be reducing the assets you can draw upon for retirement.

If you do decide to save for college within an IRA wrapper, the Roth IRA allows for the most flexibility in terms of withdrawals. Because you've already paid taxes on Roth contributions, you can withdraw them at any time without penalty or taxes. If you withdraw investment earnings from your Roth to pay for higher education before you're age 59-1/2, you'll owe taxes on those earnings but you won't face a penalty.

You can also use a traditional IRA to pay for college, but you won't have quite as much flexibility as you'll have with a Roth. If you withdraw assets from a traditional IRA before age 59-1/2 to pay for college costs, you'll owe taxes on the whole withdrawal, assuming your contributions were tax-deductible, though you won't owe any penalties. If you made nondeductible contributions and withdraw your assets before age 59-1/2 to pay for college, you'll owe taxes on any investment gains but not on your contributions.

Additional Considerations

There are still more ways to handle the price of a college education. Trust funds aren't just for the silver-spoon set, for example. College savers don't need millions to set one up, and although there are lots of associated fees, an appropriately drafted trust protects the money in case of catastrophe and also doesn't incur a penalty if it's not used for education purposes. Borrowing against a life insurance policy is also an option, although the downside here is if the loan is outstanding when the owner of the policy passes away, the payout is reduced by the loan balance.

Don't forget financial aid, either. There are reams of scholarships and loans available, offered by schools, private organizations, and the government. And remember: The college-bound don't have to go to four years at a private school. Be sure to consider alternatives, such as state schools or community colleges, many of which offer sound education at a much lower price.

Summing Up

With costs of college climbing at a rapid clip, it pays to be creative. Investigate 529 plans, but don't forget to explore whether other options might be a better fit for your financial situation. You can even combine different options if that works best. After doing your homework, you might realize the best option is one you never considered before.

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Managing Your 529 College-Savings Plan

By Morningstar Analysts

So you've decided to go with a 529 college-savings plan, and you've narrowed it down to the one that best fits your needs. Congratulations! You've tackled the hardest part of the 529 college-savings process. But how do you go from where you are now to generating tax-advantaged distributions? If you're working with a broker, he or she should guide you through the savings process (the advisor's guidance is what you're paying the broker fees for, after all). For those going it alone, this article walks you through the next steps, including opening a 529 account, maintaining it, and withdrawing assets.

First Things First

Direct investors first need to fill out the application, which can be found on the 529 Web site. The application will ask you basic information about yourself, your beneficiary, your investment choices, and your contribution method. Let's stop here for a moment. Contribution methods range from sporadic payments to automatic deposits, either from your bank account or your paycheck. If your goal is flexibility, you might be tempted by the sporadic payment option, but many investors benefit from the discipline imposed by the automatic options. If you aren't forced to contribute on a regular basis, you might find yourself sidetracked from your college-savings goals by short-term concerns. And if you're eligible for state-tax deductions on your 529 contribution, payroll deductions mean you don't have to wait for an annual refund; the adjustment will be made at the time of the contribution.

While there's no limit to how much you contribute to a 529 plan annually, gift taxes can apply, depending on your relationship with the beneficiary and the amount you contribute in any given year. In 2009, you can give up to $13,000 ($26,000 for joint filers) to any individual without triggering gift tax. College savers can also make a $65,000 ($130,000 for joint filers) contribution to a child's 529 in a single year--essentially five years' worth of gifts--without triggering the tax, presuming they make no further contributions during that five-year period.

Also, most 529 college-savings plans have a cap on account size. If that's a concern, investors can open up another college-savings account elsewhere to house additional funds, but college savers are taxed and penalized on what they don't use for secondary education expenses. Overall, it makes sense to plan your contributions judiciously and consider how long it will take you to reach your goals so you can keep the taxes and penalties to a minimum.

Monitoring Your Choice

After you've submitted the application and planned your contribution method, you're in the game. But that doesn't mean you can forget about your 529 college-savings plan. All 529 college-savings plans allow you to change your investment choices once a year, and it's important to check in with your plan at least that frequently (even if you've chosen the age-based option, which is designed to grow more conservative as college draws near). The overall plan isn't static, because taxes, fees, and even investment options often change, and neither are the underlying funds. Managers come and go, strategies evolve, and expenses rise and fall. You may find that the features you initially liked about a particular fund or collection of funds are no longer there.

Also, if you've chosen a static allocation with a fixed mix of equity and/or fixed-income mutual funds, you'll likely want to grow more conservative over time. For instance, when the beneficiary is still five to 10 years away from college, it makes sense to invest heavily in equity mutual funds, with healthy stakes in international and small-cap stocks, in hopes of growing your principal. In the years before college, however, it's typically wise to stick mostly with fixed income. Bonds are less likely to earn monster returns, but their muted volatility will generally better protect your assets at a time when you don't have long to make up any losses.

In all, while you don't want to chase performance (which rarely turns out well) or change your investments willy-nilly, it pays to consider whether you should make an adjustment given new information.

In the Event of...

Remember, college-savings plans are designated for postsecondary education, and using the assets stored there for nearly anything else will invoke taxes and a penalty. This is true even for emergencies. If your beneficiary foregoes college and you can't find another beneficiary to name, you are stuck with federal and state tax bills on the investment earnings, a state-tax bill on deducted contributions, and a 10% penalty. The same is true if you've faced financial setbacks and need the 529 assets for other concerns. The only exceptions involve either tragedy or financial aid. Any distributions resulting from the beneficiary's untimely death or severe disability trigger taxes, but the penalty is waived. The same holds for financial aid: If the beneficiary earns a full scholarship or gains another type of financial aid, the investment-earnings component of the distributions made to the beneficiary are still taxable but not penalized. (Whether you are taxed at your rate or the beneficiary's rate depends on the circumstances. Keep this general rule of thumb in mind: If the distributions are to or for the benefit of the beneficiary, you'll be taxed at the beneficiary's tax rate.)

Distribution Time

When you've finally reached the point when you call on your 529 assets, there's more to consider. To ensure the tax benefit and to avoid the penalty, the distributions must cover qualified education expenses, such as tuition and room and board. At this point, any nonqualifying distributions result in tax consequences for the beneficiary, not the account owner. So plan carefully. Be sure to custom-fit the distributions to the expenses you're facing and keep a paper trail of what you've paid with what distributions. You'll have to report the distributions on Form 1099-Q when you file taxes.

Also, don't forget about the impact on financial aid. Because 529 college-savings plans are considered the account owner's assets and not the beneficiary's, they don't have a major impact on financial aid. However, nonqualified distributions to the beneficiary will not only require the beneficiary to pay taxes, they may also be penalized with reduced need-based awards in later years.

Wrapping It All Up

Overall, 529 college-savings plans have plenty of advantages, but they do require upkeep. Make sure you understand your financial situation and the nature of your investments. That will allow you to manage your distributions and also help you to monitor your 529 plan along the way.

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529s: Should You Stay In-State or Shop Around?

By Morningstar Analysts

With 529 college-savings plans, there's an advantage to staying close to home. States often offer tax deductions to residents who contribute to their own state's plan, but most will let you invest in another state's plan only using aftertax dollars. That's an argument in favor of sticking with your own state's plan, to be sure, but the value of the tax incentive may be far outweighed by other factors. After taking other plan features into account, you might find it pays to shop out of state. In this article, we'll discuss what college savers should look for when determining whether to stay in-state or search for greener pastures elsewhere.

Pinch Pennies

As dull as it sounds, expenses matter. Morningstar research has shown expenses are the best predictors of long-term returns, so the cheaper the fund, the better the chance it will outperform. This makes intuitive sense. There's no guarantee that the market will favor a fund's strategy or that the manager will make the right calls, but how much you pay will be a sure thing.

In the 529 world, fees are even more important. Not only are you paying the underlying fund expenses, 529 plans tack on added administrative and management fees, not to mention the commissions you'll pay if you're investing through a broker. After summing it all up, investors can lose quite a bit of their returns to expenses. Consider, for example, the Nebraska AIM College Savings Growth Allocation Fund 529 Portfolio. Investors pay 1.61% in total annual asset-based fees, along with a sales charge and a $25 annual account fee. College savers invested in a similar growth-focused portfolio at the Virginia CollegeAmerica 529 College Savings Plan would also pay a sales charge, but they would pay only a $10 annual account fee and 0.76% in annual asset-based fees. That gives investors in the Virginia's plan a big head start, and the money saved from lower expenses will compound over time.

Stocks, Bonds, and Everything in Between

The structure of your portfolio is also something to carefully consider, particularly because many studies demonstrate that asset allocation is one of the primary drivers of returns. Of course, some investors can handle more volatility than others, so there's no one-size-fits-all solution, but there are some general rules of thumb. First, diversification matters. Some plans, including Florida's College Investment Plan, offer very little in the way of international exposure. That not only limits your potential return, it also makes your portfolio too reliant on domestic stocks.

Your time horizon is another important consideration. The more time you have before your beneficiary reaches college age, the better you will be able to handle the fits and starts that come from more-aggressive asset classes. So, it makes sense to stick mostly to the more volatile, but higher-returning, equity market early on. Conversely, if you have only a few years to save until college, your portfolio may not have time to recover from a painful drop in the market. Thus, sticking more assets in bonds is typically a more sensible asset allocation, because bonds tend to offer a steadier ride than stocks. It's a straightforward enough strategy, but not every state offers reasonable transitions between stocks and bonds. New Jersey Best 529 College Savings Plan is one culprit with its aggressive weighting towards equities, up to 35%, even when a beneficiary is enrolled in college. Garden State residents might want to check out what's available elsewhere.

Underlying Funds: The Bread and Butter

A cheap 529 plan with a reasonable asset allocation can still disappoint if it isn't filled with good underlying funds. And while some 529 plans are chock-full of worthwhile offerings, there are plenty with the lackluster variety, and lots of dogs, too. So how do you determine whether your state is offering you best-of-breed or runners-up?

Investigate manager skill at the mutual funds, for starters. If the management team has proven itself in many different market environments, it makes sense to have more confidence in the fund. Also, look for sensible strategies. Given that the key is a well-diversified portfolio that can handle the market's fits and starts, you'll want to see most funds offering broad-market exposure to major asset classes, instead of lots of specialty options that won't play a major role in your portfolio. And, of course, low-priced funds are critical.

Taken together, good management, prudent strategies, and low fees can have a big impact on your portfolio's return. Case in point: A $5,000 investment in Ohio's broker-sold Putnam CollegeAdvantage Savings Growth Portfolio, which relies on mostly mediocre funds with unimpressive track records, would have shrunk to $4,593 since mid-2003. The same investment in a similarly constructed portfolio from Virginia CollegeAmerica 529 College Savings Plan, which sticks with proven management teams from American Funds, would have climbed to $5,950 over the same period. For most people, that difference more than makes up for the tax savings from deductible contributions.

Don't Forget

Everyone's financial situation is different, so be sure to carefully consider your tax situation and college-saving goals before making your decision.

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Are 529 Prepaid Plans All They're Cracked Up to Be?

By Morningstar Analysts

When people talk 529s, they are usually referring to 529 college-savings plans. Offered by nearly every state and the District of Columbia, these plans allow college savers to invest for college without paying federal taxes on the earnings. (States generally offer their own tax incentives to 529 savers, too.) However, for those with a tidy sum of college savings on hand already, 529 prepaid plans make a different offer: Buy tomorrow's college tuition at today's prices, tax advantages included. Considering the rate of inflation for college tuition (somewhere between 6% and 9% over the past several decades), that's an enticing proposition.

Be careful. Although prepaid plans seem like a great way to get a handle on ballooning college costs, they have a few distinct disadvantages, and at least one prepaid plan has already disappointed college savers. In this article, we'll discuss the details of prepaid plans and what you need to consider before buying in.

Understanding the Basics

When a college saver purchases a prepaid plan, he or she is usually buying a percentage of college tuition at today's prices or locking in the cost of a set number of semesters for various state colleges and universities. Thus, even if the market takes a downward turn, the prepaid plans should allow investors to keep pace for college inflation. The tax advantages add to these plans' appeal: Qualified distributions from in-state plans are exempt from federal and state taxes and contributions to prepaid plans are tax-deductible in many (but not all) states. Formerly, there was one major disadvantage related to financial aid. Because the assets were counted as the beneficiary's, they reduced financial aid awards dollar-for-dollar. Now, however, the assets are considered the account owner's, so their impact on financial aid isn't anywhere near as adverse.

Taking a Closer Look

For the right college saver, the plans might sound like a great deal. Before jumping in, however, consider these restrictions. Prepaids generally require the account owner or the beneficiary to be a resident of the state offering the plan, at least at the time the account is established. Plus, college savers generally can't open accounts for older beneficiaries just a few years away from college.

There's not a lot of flexibility, either. College savers can usually contribute to the plan only at certain times each year, and unlike college-savings plans, prepaid plans often cover just tuition and mandatory expenses, so costs like room and board need to be funded separately. Plus, these plans are generally aimed at in-state colleges and universities. While many plans can also be applied to private or out-of-state schools, the prepaid dollars likely won't go as far, because private schools can cost more and many plans don't promise to keep up with out-of-state college costs. Finally, should you need to terminate the plan, you may receive back only your original contribution without much adjustment for locking it away (you'll likely also face cancellation fees).

These limitations are bad enough, but it can get worse. Prepaid plan program managers assume specific increases in college costs and manage the portfolio of prepaid-plan contributions to meet those expenses. (In essence, the university and the plan manager are wagering that their investment results will best the rate of inflation for tuition and other college costs.) College costs aren't always predictable, though, and neither is the stock market. Should college costs spike or the stock market plummet, prepaid plans could end up facing quickly approaching obligations without the

funds to meet them. Some states, including Texas and Virginia, say they will cover shortfalls with other state revenue if the plans' assets don't keep up with college costs. But that isn't always the case. In 2002, the combination of rising college costs and the prolonged 2000-02 bear market forced the Colorado Prepaid Tuition Fund to close its doors to new contributions. The plan gave current participants the
choice of either withdrawing a full refund of the money they had invested so far or earning a maximum return of 5.5% in each coming year, regardless of how high college costs rose.

Factors to Consider Up-front

Given the drawbacks, prepaid plans require careful consideration. If the student you're funding has rock-solid plans to attend an in-state university, you've already got some cash socked away, and you want to take a conservative approach to college planning, it might make sense to investigate your prepaid options, but read the fine print closely. Understand whether your particular state guarantees the payout and get a sense for the kind of fees you'll be paying to buy at today's costs (aside from the plan application fee and other niggling expenses, you're paying a premium for college tuition, because the assets aren't managed for free). Compare what you expect to get from your prepaid plan with other options, such as 529 college-savings plans, home equity loans, and the like. For the savvy investor willing to risk the chance of falling returns, it might be a better choice to open a standard brokerage account and aim to earn higher returns than the rising costs of college, even though you'd be giving up the tax advantages. Remember that saving for college is one of the bigger financial goals you'll face, so it makes sense to make a thoughtful decision.

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