# College Savings 101

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We all want the best for our children. After watching them grow from helpless newborns to active toddlers to opinionated teenagers, it's our responsibility to teach them about life and help them find their way as young adults.

One of the best—and most expensive—ways to give our kids a good start is with a college education. According to The College Board, that's going to cost on average approximately $12,800 for a public college and $30,400 for private. (The College Board is a not-for-profit association whose mission is to connect students to college opportunities. To find out more, go to www.collegeboard.org.)

| Tuition & Fees | 2006-2007 | 2005-2006 | %Change |
|---|---|---|---|
| 4-Year Public | $5,836 | $5,492 | 6.3% |
| 4-Year Private | $22,218 | $20,980 | 5.9% |

| Room & Board | 2006-2007 | 2005-2006 | %Change |
|---|---|---|---|
| 4-Year Public | $6,960 | $6,623 | 5.1% |
| 4-Year Private | $8,149 | $7,763 | 5.0% |

| Total Costs | 2006-2007 | 2005-2006 | %Change |
|---|---|---|---|
| 4-Year Public | $12,796 | $12,115 | 5.6% |
| 4-Year Private | $30,367 | $28,743 | 5.7% |

But think about the ramifications over a lifetime of higher earnings. The College Board shows that in 2005 for women aged 25-34, a college degree meant a difference of 70% higher earnings than a high school diploma. For men that difference was 63%.

Convinced? Then your next step will be to figure out how much you need to save each month to put that college education within your child's reach. There are helpful calculators at The College Board website (http://www.collegeboard.com/student/pay/add-it-up/401.html) that can help you do this.

And remember: Even if you don't have the cash flow to put away as much as you know you'll need to send your kids to college, put away as much as you can. Then as bonuses and raises come along, you can always push up your contributions.

### What's New?

If you've been planning for college funding for a few years now, you may want to know what's happened in the past year that you need to be aware of.

*529 Savings Plans*
Pension Protection Act of 2006 makes permanent tax breaks for 529s.

*529 Prepaid Tuition Plans*
Financial aid treatment upgraded to same as 529 Savings Plans

*Coverdell Plans*
Pension Protection Act of 2006 does NOT make tax-breaks permanent for Coverdells

*"Kiddie Tax"*
The Tax Increase Prevention and Reconciliation Act of 2005 raises the age limit to 18 when a child's income will be taxed at their own lower rate. Until age 18, income over $1,700 a year is taxed at the parent's rate.

### Where to Save

Once you know how much to save for college, you need to decide where to put that money. There are lots of options out there, but you're going to need some help sifting through those choices.

Now let's take a closer look at each type of plan:

### Section 529 Savings Plans

529 Savings Plans are by far the most popular vehicle for college savings today. If you have a larger sum you want to put away without worrying about gift tax or you want the best federal tax breaks, this may be the plan for you.

Even though 529 Savings Plans are popular, you need to understand both the pros and cons of investing in them.

You contribute aftertax dollars, so those are never taxed when you withdraw them. Any earnings on your contributions are also never taxed federally if you use that money for college. If you don't use the money for college, you'll have to pay a 10% penalty to get those earnings back.

529 Savings Plans are administered by individual states—and some are a lot better than others. Choosing the right plan can be confusing  The expenses of the investment choices in these state plans can be higher than you would find in a good mutual fund. Some plans may offer sub-par investment and there's even been some legal monkey business with a small number of plans (e.g., the Utah Educational Savings Plan had some embezzlement issues which have now all been resolved).
You should always start by looking at the plan offered by your home state. That's because you'll find the best state tax deals in your own state. But you have to weigh those tax breaks with the other features of the plan. You can use Morningstar's database of 529 plans to learn more about your state plan. Another good source of 529 information is www.savingforcollege.com. See how your plan is rated, what the expenses are, what investment you have and so forth.

If you need some help chosing a plan, Morningstar does a survey once a year that rates 529 plans. Here's the inside scoop from Morningstar analysts on three 529 plans that are directly sold to the public (meaning you don't need a broker to purchase them). Consider these plans even if you don't live in these states.

- The *Maryland College Investment Plan*, run by T. Rowe Price, eliminated its enrollment fee and cut its program management fee to 0.28%. The overall low annual costs of the Maryland age-based options and that state's tax breaks on contributions earn it the nod on Morningstar's 2007 list of the best 529 plans.

- The *Utah Educational Savings Plan Trust* has low costs, sound age-based options, and tried and true index and international offerings from Vanguard. We think Utah continues to provide the best combination of cost and flexibility for investors.

- *Nebraska's College Savings Plan* administered by Union Bank & Trust also offers low-cost index funds from Vanguard but supplements them with actively managed offerings from American Century, Fidelity, and PIMCO as well—all at a decent cost. We like the flexibility of the plan's four age-based tracks plus the availability of six static portfolios and 21 individual fund options.

Using a 529 plan, anyone can contribute money on behalf of a beneficiary. When making contributions to a 529 plan, investors must choose from a fixed menu of investment options. Many times these investment choices will include an age-based approach, whereby you invest based on your child's age and the investments grow more conservative as your child nears college age.

While age-based plans may make sense for some families, I prefer a plan where you can pick and choose investment options offered by some well-known low-cost mutual fund companies like Vanguard and T. Rowe Price. I like the freedom to choose individual funds because in years like 2000-2002, I could avoid potential losses in younger children's portfolios that were heavily invested in stocks. Keep in mind that you can only change the investments in a 529 plan once a year.

Now let's review the pros and cons of 529 plans in general.

*Pros:*

- Money can be used for any college in the U.S. Possible state tax breaks for contributions. Matches in some states.
- Allows for tax-free distributions for qualified expenses (tuition, fees, books, supplies, required equipment, room and board).
- Can claim HOPE and Lifetime Learning Credits as long as the payout from the 529 plan isn't used for the same expenses for which you're taking the tax credits.
- Can gift up to $60,000 a year per child without triggering gift tax (gift assumed to be $12,000 ratably over five years). Effectively removes this money from your taxable estate (if you die within five years, a portion may be included in your taxable estate). If you gift-split with your spouse, you can get $120,000 out of your estate without triggering gift tax.

- Can contribute to both an Education IRA and a 529 plan, but watch out for gift-tax consequences if you contribute more than $12,000 per person in the same tax year.
- Can contribute more than $60,000 a year and use unified credit to offset gift tax on up to $1 million. Check with each state plan to verify the maximum contribution.
- Donor retains control of account. If beneficiary doesn't go to college, the money can be transferred to another beneficiary. Or the donor can get his/her money back, though he or she would owe tax on the earnings and a 10% penalty.
- No earnings restrictions.
- No limited enrollment period.
- If parent is donor, more financial aid may be available for the family. Parental assets can only be tapped up to 5.6% in the family contribution formula.

*Cons:*

- Must use investment options chosen by the plan.
- You could lose money in more-aggressive investment options.
- You can only change your investment choices once per calendar year.
- Expenses of the plan may be higher than what you'd pay if you invested the money yourself.
- A nonqualified withdrawal (used for purposes other than specified education expenses) will be taxed on earnings and will incur a 10% penalty. Exceptions to the penalty include death or disability of the beneficiary or if the beneficiary receives a scholarship. Nonqualified withdrawals can also negatively affect financial aid.
- Plans may limit contribution amounts.
- Since donor owns the account, it may be tapped by Medicaid if the donor should need nursing home care and does not have other funds available.
- Not all states have protections against donor's creditors.
- If a grandparent is the donor, earnings withdrawn may count as income in financial aid formulas.
- May need to file a gift-tax return if contribution per child is over the annual exclusion of $12,000 per person. For example, if you contributed $25,000 as a single parent, you'd need to file a gift-tax return and show that you've gifted $5,000 in each of five years. No tax would be due, but you'd have the expense (and hassle) of filing a gift-tax return.
- Can only invest cash, not appreciated securities. (If you roll over UTMA/UGMA accounts to a 529 plan, you must liquidate investments prior to transfer. May result in taxable capital gain or loss.)

**Coverdell Education Savings Account**

Coverdell accounts are particularly useful if you want to pay for elementary or secondary school costs. But that feature is only available until 2011. And you may be excluded from using them if you earn “too much”.

Formerly known as an "Education IRA," this type of college savings vehicle was greatly expanded with the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001. However, the Pension Protection Act of 2006 did not permanently protect the Coverdell's tax breaks like it did with 529 Savings Plans. So in 2011, the contribution limit will go back to $500 and you won’t be able to use the funds for elementary or secondary school costs.

Until 2011, contributions are $2,000 per beneficiary per year. Accounts can be set up with most brokers or mutual fund companies.

*Pros:*

- Great flexibility of investment choice.
- Expenses may be lower than in some state 529 plans.
- Money can be used for primary and secondary education expenses (until 2011).
- Allows for tax-free withdrawals for qualified education expenses (tuition, fees, tutoring, books, supplies, related equipment, room and board, uniforms, transportation, extended day programs, computers, Internet access).
- Have until April 15 of the following year to make contributions for the previous calendar year.
- Anyone can contribute if he or she meets the earnings requirements (see below).
- Can contribute to both a Coverdell and a 529 plan, but watch out for gift-tax consequences if you contribute more than $12,000 per person in the same tax year.
- Can claim HOPE and Lifetime Learning Credits as long as the payout from the Coverdell isn't used for the same expenses for which credit is taken.
- If you don't meet the earnings requirements (see below), you can gift $2,000 to the beneficiary and let him or her

set up his or her own account. So, for example, if a grandparent didn't meet the earnings requirement, he or she could gift to the adult child to use for a grandchild's account. (Giving to the adult child is better than giving to the grandchild directly because of financial aid rules.) Coverdells are treated the same as 529 Savings Plans for financial aid purposes (5.6% counted as parental asset in financial aid formulas).

*Cons:*

- The Pension Protection Act of 2006 did not make current features permanent. Contributions will revert to $500 per year starting in 2011 and funds won't be able to be used for elementary and secondary school costs.
- Current contributions may not exceed $2,000 a year per beneficiary.
- No matter how many people contribute, total contributions per child can't exceed $2,000.
- Earnings restrictions: If you earn $95,000 to $110,000 (single) or $190,000 to $220,000 (married filing jointly), contributions will be limited; if you earn more than $110,000 (single) or $220,000 (married filing jointly), contributions are not allowed.
- Beneficiaries (except special-needs beneficiaries) must be under age 18 when contributions are made.
- Money must be used by age 30 or earnings are taxed as ordinary income plus a 10% penalty (except special-needs beneficiaries). To avoid this taxation, accounts can be rolled over into another family member's Coverdell account.
- If the beneficiary doesn't go to college or use the money for primary or secondary school, the donor can't get the money back.
- No state tax deduction for contributions.
- No guarantee of positive investment returns; account can lose money.
- Can only contribute cash, not appreciated securities.

**UTMA/UGMA (Uniform Transfer to Minors Act/Uniform Gifts to Minors Act)**

If you want to buy specific stocks or funds for your kids, or gift them appreciated securities, you'll probably use a UTMA/UGMA account. A child can't own an account without using this type of arrangement where there is a custodian (you or perhaps a grandparent) for the child.

*Pros:*

- No earnings restrictions, although amounts in excess of $12,000 per person ($24,000 if gift-splitting with spouse) will be subject to the gift tax. (May be able to use unified credit to offset excess gift tax.)
- Can invest in wide variety of investment vehicles.
- Easy to open.
- Less expensive than setting up a trust.
- Psychological benefit of earmarking funds for college.
- Lower tax on dividends and long-term capital gains for most people.
- Donor can gift appreciated securities and/or cash.

*Cons:*

- Child takes control of the money at the age of majority (18 or 21).
- Income taxed to the child each year. When the child is under age 18, the first $850 is not taxed due to standard deduction. The next $850 is taxed at the child's rate (starting at 10%) and anything above $1,700 will be taxed at the parents' rate. At age 18 and older, income is taxed at the child's rate (the first $850 is not subject to tax due to standard deduction). The parent is responsible for making sure an income tax return is filed on the child's behalf.
- If you serve as custodian of the account and you die, the UTMA/UGMA will become part of your taxable estate.
- Because the child owns the account, more of this money will be counted toward the family contribution when determining financial aid eligibility.
- Gifts made to UTMA/UGMA accounts are irrevocable.
- Accounts must be terminated once the child reaches age of majority.
- No guarantee of positive investment returns; account can lose money.

**Saving in the Parents' Names**

As a parent, if you want to maintain control of the assets, have maximum investment flexibility, and keep assets out of the child's ownership (for financial aid purposes), then you may want to consider saving a portion (or all) of your college funding money in your own name. If your child doesn't go to college, you have the flexibility to use the money for any purpose. You also avoid the expense of setting up a trust. The big disadvantage is that you are taxed on the earnings of the investments.

**Section 529 Prepaid Tuition Programs**

Typically, these are state-sponsored programs that allow anyone to purchase tuition credits or certificates on behalf of a beneficiary. In a state-sponsored program,

*Pros:*

- No income restrictions on donor.
- Benefits are federally tax-exempt if used for qualified expenses.
- If the child attends a school within the plan, costs are covered by credits or certificates purchased.
- By buying prepaid tuition credits, you lock in future tuition costs at today's rates.
- There may be state tax breaks when you contribute.
- No investment risk, unless the state mismanages the funds.

*Cons:*

- May have a limited enrollment period.
- Only certain schools participate.
- If child attends out-of-plan school, some costs may not be covered.

**2503(c) Minor's Trust**

- Sometimes a parent will want to set up an account that can be used for unlimited gifting (although those gifts may be subject to gift tax) and the money can be in trust with parental controls for a longer period of time than just until the age of majority.

*Pros:*

- Trustee has ability to spend money on behalf of the minor until he or she reaches age 21 (and in some cases, beyond age 21).
- Can contribute an unlimited amount, but amounts in excess of $12,000 per year per beneficiary ($24,000 if both parents are giving gifts) may be subject to gift tax. (May be able to use other lifetime gift tax credits to offset gift tax.)
- Trustee can invest in a wide variety of investment vehicles.

*Cons:*

- May be expensive to set up.
- Child gains control at age 21.
- Income taxed at trust rates (higher than individual rates).
- Gift to trust is irrevocable.
- May decrease chances of receiving financial aid.
- No guarantee of positive investment returns.

**IRA or 401(k) Withdrawal**

*Pros:*

- No 10% penalty on IRA withdrawals if used to pay qualified higher-education expenses (college tuition, books, fees, supplies and equipment) of the taxpayer, spouse, child, or grandchild.
- You can take a loan from a 401(k) (or similar type of plan) and pay it back over time.

*Cons:*

- If it's a traditional IRA, you'll owe ordinary income tax on distributions.
- If the Roth IRA owner has held the account for less than five years, ordinary income tax will be due on only the earnings portion of the distribution.
- Withdrawals may be counted as income in financial aid formulas.
- Dollars used to pay back a 401(k) loan are, in part, taxed twice. You use aftertax dollars to repay the interest on the loan and then pay tax again when you take retirement plan distributions in the future (withdrawals taxed as ordinary income).
- You may be hurting your own retirement funding.
- Dollars used to pay back a 401(k) loan are, in part, taxed twice. You use aftertax dollars to repay the interest on the loan and then pay tax again when you take retirement plan distributions in the future (withdrawals taxed as ordinary income).
- You may be hurting your own retirement funding.

**Savings Bonds**

*Pros:*

- Safe. Backed by the U.S. government.
- EE-bonds purchased after 1989 and all I-bonds allow tax-exempt distributions if used for qualified education expenses (tuition and fees) and if income limits are met (see below).
- Can buy $30,000 each of I-bonds and EE-bonds a year.
- Interest exempt from state and local taxes.
- No penalty if not used for college.

*Cons:*

- You forfeit three months of interest if you redeem within five years.
- You have to be at least 24 years old to buy the bond.
- If your income is more than $80,600 (single) or $128,400 (married filing jointly), your distributions won't be tax-free even if you use the proceeds for qualified education expenses.
- Only tuition and fees are qualified education expenses.
- Only the bondholder, his/her spouse, or a dependent is eligible for the interest exclusion. If the grandparent holds the bond, he/she can't claim any interest exclusion unless the grandchild is dependent.
- The interest exclusion may be reduced by other education tax breaks (HOPE Scholarship, Lifetime Learning Credit, scholarships, Education IRA withdrawals, Section 529 plan withdrawals) when used in the same tax year.

**Education Tax Incentives**

Not only do you have the above college savings vehicles available to you, you may also get additional tax breaks from Uncle Sam.

*HOPE Scholarship:*

- Maximum credit per student per year is $1,650.
- Can use credit for only two years.
- Can't be used if student has already completed two years of college.
- Can't apply same expenses to both HOPE Scholarship and Lifetime Learning Credit.
- Taxpayers can deduct 100% of the first $1,100 of qualified education expenses plus 50% of the amount paid over $1,100.
- Can't claim if modified adjusted gross income in 2007 is more than $57,000 (single) or $114,000 (married filing jointly).

*Lifetime Learning Credit:*

- Taxpayers get a credit on their income tax return of 20% of up to $10,000 for qualified education expenses actually paid.
- No limit to number of years the credit can be claimed.
- Can't apply same expenses to both HOPE Scholarship and Lifetime Learning Credit.
- Can't claim if modified adjusted gross income in 2007 is more than $57,000 (single) or $114,000 (married filing jointly).

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# The Best and Worst 529 College Savings Plans

Kerry O'Boyle

It has been another year of substantial change, much of it for the better, within the fledgling 529 college savings universe. Since our last review in February 2006, significant improvements on the tax front--on both the state and federal levels--have enhanced the appeal of 529 plans relative to other college-savings vehicles. In addition, management upgrades and fee reductions at a number of plans show that states are getting serious about providing competitive options for investors saving for their children's education.

**Tax Changes**

In the 529 world, the big news of 2006 was the signing into law of the Pension Protection Act of 2006. Among its many features, it made permanent the changes to Section 529 of the federal tax code made by the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA)--including investors' ability to withdraw earnings from 529 plans, free of federal taxes, for qualified college expenses. Until passage of the law, federal tax breaks on 529 plan earnings were set to expire at the end of 2010, casting a shadow over one of the most appealing aspects of these plans. Now, with that uncertainty removed, college savers can invest confidently in 529 plans knowing that their earnings will remain tax-free into the future.

The new tax law did not make permanent the EGTRRA changes to Coverdell Education Savings Accounts, however. Thus, unless Congress acts to address the college savings issue again, contributions to Coverdell accounts will revert to a maximum of $500 per year (down from $2,000) after 2010, and withdrawals for elementary or secondary school expenses will no longer be allowed without penalty. Coverdell accounts can still be rolled over into a 529 plan at any time, but the long-term appeal of these accounts now pales to a large extent in comparison with 529 plans.

On the state level, Maine, Kansas, and Pennsylvania all passed so-called “tax-parity” laws in 2006, which extend each state's tax deductions on contributions to residents who invest in out-of-state 529 plans. Previously, the standard practice had been to extend state tax breaks only to those who stuck with one of the home-state plans. It's unclear, however, how much traction this trend will gain among states, many of which have historically doled out benefits to encourage participation in their home-grown plans. Seven other states have reportedly considered similar legislation in the past, with nothing to show for it thus far. In general, we favor such tax-parity because we think it empowers investors with greater flexibility to choose investment options more suited to their needs and personal risk tolerances. Still, tax parity is potentially a double-edged sword for college savers tempted to flit back and forth or chase performance, or for those persuaded to take their tax break and go out of state to a more expensive or conceivably worse plan.

**Quality Is Improving**

Despite some ongoing issues concerning broker sales practices, occasionally Byzantine disclosure documents, and layers of fees, 529 plans have in general improved over the past few years. Since 2004 Congressional hearings on some of the above issues and industry concerns about less-than-expected asset growth, the states seem to have taken to heart the need to offer more competitive offerings. Until recently, few parents were tempted by 529s, given that so many featured lackluster offerings, high fees, and added complexity. Thus, wholesale changes have occurred at a number of plans in recent years.

Indeed, four of the seven plans from our 2006 worst list no longer exist or have changed providers. As expected, Wyoming got out of the 529 business entirely by merging its plan into Colorado's offerings. Arizona closed its high-priced PF and SM&R plans to new investors pending their eventual liquidation. And North Dakota dumped its poorly diversified Morgan Stanley plan for another of the seemingly ubiquitous Upromise/Vanguard options.

The trend toward lower fees also continues. The disappearance of high-priced plans, like that from Wyoming and South Dakota's Core4College, has eliminated some of the most egregious offenders. The arrival of new providers with lower-cost options, not to mention a

handful of fee cuts at other plans, has sparked an increased measure of price competition among the states. That escalated to what one might call a price war in the fall of 2006. The planned introduction of a 0.50% all-index age-based option in California by Fidelity prompted Vanguard to cut fees by 10 basis points (0.10) at its flagship Nevada plan to match it. Plus, economies of scale from industry-wide asset growth have also helped to push costs down at a number of plans.

### Compiling Our List

Still, with more than 80 plans available from 48 states and the District of Columbia, there remain a number of holdouts. We can't emphasize enough the impact that high costs have on long-term performance, which can potentially outweigh the benefits of state tax breaks on deductions as well as cause providers to take on more risk in an effort to boost returns to overcome their expense hurdle. Proper diversification and sound asset allocation also remain critical for investors facing such a finite savings period and rapid drawdown time for these assets.

Thus, as before, our best and worst lists are built around these crucial characteristics as well as the quality of underlying investments, the flexibility of the investment options, clarity of the program disclosures, and the investment managers' record of treating shareholders well--based on Morningstar's Stewardship Grades. (While we don't give Stewardship Grades to state 529 plans, we consider the grades of the primary provider and the underlying fund options where applicable.)

As always, we recommend that investors look first to their home-state plans for additional incentives such as matching grants and state-tax deductions on contributions. The widespread availability of state tax deduction calculators on the Internet can help investors determine how much some of those benefits are worth. While these incentives can be meaningful, they don't necessarily overcome the disadvantages of a poor or costly plan.

Without further ado, here are this year's top 529 plans, as well as six to avoid.

### The Best

| Best 529 College Savings Plans | |
|---|---|
| Colorado Scholars Choice* | Legg Mason |
| Maryland College Inv Plan | T. Rowe Price |
| Nebraska College Savings | Union Bank & Trust |
| Utah Educational Savings | Utah (Vanguard) |
| Virginia College America* | Virginia (American Funds) |

*Broker Sold

We've made only minor changes to our best list from last year. The Maryland College Investment Plan run by T. Rowe Price edged out the Alaska T. Rowe Price College Savings Plan after the Maryland plan eliminated its enrollment fee and cut its program management fee to 0.28%. The plans are almost identical, and the Alaska plan remains a fine option for those who already invest there, but the overall lower annual asset-based costs of the Maryland age-based options and that state's tax breaks on contributions earn it the nod.

The Utah Educational Savings Plan Trust remains among our favorites for its low costs, sound age-based options, and tried and true index and international offerings from Vanguard. True, a number of states offer Vanguard index options as part of their plans, but we think Utah continues to provide the best combination of cost and flexibility for investors.

Nebraska's College Savings Plan administered by Union Bank & Trust also offers low-cost index funds from Vanguard but supplements them with actively managed offerings from American Century, Fidelity, and PIMCO as well--all at a decent cost. We like the flexibility of the plan's four age-based tracks, which we think will suit the risk tolerances of most investors, plus the availability of six static portfolios and 21 individual fund options.

Our favorite plans for investors using a financial advisor or broker continue to be Colorado's Scholars Choice. Steady, reasonably priced, and long-term focused funds from American Funds are the key attractions of the Virginia plan, by far the largest 529 plan in the country. Brokers have the full lineup of the shop's funds to choose from in crafting a portfolio for their clients. The Colorado plan underwent a makeover after the acquisition of asset manager Salomon Smith Barney by Legg Mason in

December 2005, but that has only served to improve the plan. Now, investors here have access to noted Legg Mason manager Bill Miller, as well as offerings from small-cap specialist Royce Funds and fixed-income stalwart Western Asset Management--both subsidiaries of Legg Mason.

### The Worst

| Worst 529 College Savings Plans | |
|---|---|
| Alabama Higher Education 529 | Van Kampen |
| Alaska John Hancock Freedom 529 | John Hancock |
| Missouri MOST 529 Advisor | Upromise |
| Nebraska AIM College Saving | AIM |
| West Virginia Cornerstone SMART 529 | Hartford |
| West Virginia Leaders SMART 529 | Hartford |

The Alabama Higher Education 529 Fund and Nebraska's AIM College Savings Plan again make our list of worst plans. Alabama, as the last holdout, did finally pass legislation in 2006 making earnings from 529 investments free of state tax for residents, but only if they invest in the home-state plan. Although the state waives its program and state fees for residents, more than 90% of assets come from out of state. Those nonresidents pay the full 1.35% to 1.63% in annual asset-based fees for a clunky age-based program and lackluster lineup of Van Kampen funds. While AIM has announced an overhaul of its age-based portfolios in the Nebraska plan for March 2007, investors are still paying a pretty price (1.35% to 1.61%) for an aggressively allocated, growth-leaning option with some weak and unproven underlying funds.

We're also singling out the broker-sold Alaska John Hancock Freedom 529 plan for its exorbitant fees. While we think highly of the standout lineup of underlying funds from T. Rowe Price, Davis Advisors, PIMCO and others, and the asset-allocation scheme is sound, the annual fees of 1.41% to 1.70% of assets for the age-based plan are nearly double that of direct-sold T. Rowe Price alternatives. Those high costs come from a 0.75% program fee for the Class A cost structure, which includes a 0.25% distribution fee. That distribution fee is disappointing as a number of the underlying holdings invest in fund A shares instead of cheaper institutional share classes; the A shares already levy 12b-1 marketing and servicing fees as ongoing compensation to financial advisors and broker/dealers.

Both the Cornerstone SMART529 and Leaders SMART529 plans from West Virginia land on our worst list for a similar reason. A 0.34% administrative fee and 0.30% annual distribution fee layered on top of underlying A shares add up to total yearly asset-based costs of 1.59% to 1.71% and 1.65% to 1.79%, respectively, for each plan's Class A age-based option. Some uninspiring underlying funds, plus the lack of dedicated small-cap exposure and limited mid-cap and foreign diversification, also limit the appeal of these plans. West Virginians, who enjoy a full state-income tax deduction on contributions to home-state plans, have better options within the state.

Disappointingly, a new plan rolled out in May 2006, Missouri's MOST 529 Advisor, also makes our list for its high costs and mixed bag of underlying investments. The plan doesn't offer an age-based option, instead providing 24 funds from which brokers can construct portfolios suited to their individual client needs. Again, though, a 0.30% program management fee and 0.25% distribution fee for the Class A shares are piled on top of mostly more expensive A fund shares. Indeed, the total annual asset-based costs for the individual fund options range from 1.22% to 2.70%, including a rich 1.45% for the plan's three ETF offerings. Missouri does offer a state tax deduction on 529 contributions to the home-state plan, so residents have good reason to consider the state's direct-sold option.

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# How to Allocate Assets for College Savings

Kerry O'Boyle

The task of building a great portfolio is a job that can easily overwhelm even experienced investors. Many savers beat themselves over the head when they miss out on a great-performing area of the market, and then compound that error by jumping into sectors or asset classes that have been hot for a few years and may be near their peaks.

Most of us don't have a crystal ball to tell us where the market is headed over the next month, year, or decade, so the best strategy for retirement planning is to build a diversified portfolio based on the investor's goals and risk tolerance and to gradually move the portfolio toward more-conservative investments leading up to and during retirement.

Yet it would be a mistake to adopt an identical asset-allocation strategy when investing for college, because there are some important differences between college and retirement investing. Investors can save for 30 or 40 years before needing to draw upon retirement assets and typically only slowly tap into those assets over a postretirement period that could run as long as 20 or 30 years or more.

Contrast that with a typical situation that proud new parents find themselves in: On the day their child is born, the clock starts and it's only 18 years until college. College savers will also need to draw down their assets over a compressed period of just four years. Parents can't afford to be too aggressive and risk losing capital in the years immediately prior to matriculation. Nor can they be too conservative, lest they fall substantially short of their goal. Getting the right mix with a tolerable risk level is a tough task, one made more stressful because college savers don't have as much time to recoup losses if things don't go as planned.

Unfortunately, there are no easy answers to this predicament. Even professionals who determine asset allocations for college-savings plans aren't on the same page. In putting together age-based college-savings portfolios for 529 college savings plans—which number more than 80—managers have come up with a wide array of asset mixes. Most use some kind of quantitatively based Monte Carlo simulation to assess the risks of varying asset-allocation strategies, but their solutions vary widely because they use different inputs. Return and risk assumptions based on past market data aren't necessarily a reliable predictor of future events, just as past mutual fund performance isn't the best indicator of future returns. A plan overloaded with small- and mid-cap U.S. stocks or international stocks that has been tearing it up the past three to five years might not be ideal from a risk standpoint in the future. Thus, we'd advise investors to take a moderate tack in saving for college.

### This Porridge Is Too Hot

North Carolina's Seligman-run age-based portfolios exemplify college-savings plans that are too bold, in our view. First, their asset mixes are aggressive. They devote more than 80% of assets to equities for an 11-year-old beneficiary and only gradually decrease that stake to 60% for a 16-year-old before moving quickly to mostly cash during the college years. Second, the portfolios have high allocations to noncore groups of stocks. The portfolios geared toward young beneficiaries stake roughly 50% of total assets in small- and mid-cap U.S. stocks and 30% in international (two thirds of which is in emerging markets and small caps). That leaves only 20% for traditionally stable U.S. large-cap stocks. The portfolios retain those aggressive leanings even for beneficiaries who are in their early teens.

Seligman argues that over long periods of time (the firm cites performance over 10- and 20-year stretches), smaller companies offer greater risk and potential for volatility but also greater potential for reward. That line of thinking might be fine for retirement planning, but will it hold true over the next 10 years—the time horizon of many college savers? After all, smaller stocks' gains have trounced larger stocks' over the past five years, and many market watchers expect that trend to reverse itself over the next several years. The odds of big losses over a 10-year stretch may be small, but we think Seligman should

be cognizant of the effect that returns of the recent past may have on the near future. And investors here could possibly be playing a dangerous game of high-stakes poker with their children's college savings.

**This Porridge Is Too Cold**

Conversely, consider another 529 plan with conservative, moderate, and aggressive age-based tracks that put all beneficiaries (regardless of track) into a portfolio at age 15 that's composed of 60% cash and 40% bonds. Safe? Sure, but with an annual price tag of 0.97%—roughly the median cost of a large-cap domestic-stock fund—investors are likely losing ground at the Kansas Schwab 529 College Savings Plan by going with a high-cost, ultraconservative choice. A little equity exposure isn't a bad thing, even when approaching one's goal, and can offer a welcome boost without undue volatility when kept to a reasonable portion of the portfolio.

Just Right?

So which 529 plans have managed to find a healthy middle ground? In analyzing target retirement funds such as T. Rowe Price Retirement 2040, we've noted T. Rowe Price's relatively aggressive approach toward asset allocation, one that the firm maintains even when shareholders reach retirement. So is T. Rowe equally aggressive when it comes to the 529 plans it oversees? The answer is no, not by a long shot. As we've pointed out, different goals typically warrant different allocation strategies.

With both the Alaska T. Rowe Price College Savings Plan and Maryland College Investment Plan—the latter of which has earned a spot on our list of the best state-run 529 college savings programs—the age-based portfolio starts out with 100% of assets stashed in equities but ramps down to 58% stock for a 12-year-old. In the year the beneficiary is to attend college, T. Rowe employs a roughly 40% cash, 40% bond, and 20% equity allocation. T. Rowe, like Seligman, uses Monte Carlo models, but notice the dissimilar conclusions. It's likely that T. Rowe's solution is the result of less-aggressive assumptions.

Is this the right mix for everyone? Not necessarily, but it seems to provide a reasonable midpoint for helping investors to gauge how much risk they're taking on with their own college savings.

**A Word of Caution about Past Performance**

Many states and fund companies tout the performance of their plans, but investors have reason to be wary. Few plans have records much longer than five years—a brief period by which to judge their asset-allocation schemes compared with the 20-year time frames for which these plans are designed. What has worked well in the past won't necessarily look as favorable in a different, future market environment. That's why we think investors should seek a well-diversified portfolio with a moderate asset mix that puts their money to work but also allows them to sleep at night.

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# The Late-Start Guide to College Savings

Christine Benz

Is your child hurtling toward college but you haven't given more than a few anxious thoughts to how you're going to pay for it?

Join the club.

For every parent who has been dutifully socking it away since the baby was in onesies, I seem to run into 10 more who feel like they're playing an unwinnable game of catch-up. School is drawing closer, tuition projections seem to grow more outlandish by the year, and the stock market is moving sideways—and that's on a good day.

With mortgages to pay and sneakers to buy, many families have difficulty finding the extra money to save for college. But judging from feedback from my friends and acquaintances, a time crunch has been an equally important deterrent against creating a college-savings program. The alphabet and number soup of college-savings vehicles (529s, Coverdell Education Savings Accounts, UTMA/UGMAs) seems hopelessly complex—surely more than anyone could tackle on a Saturday morning or a Wednesday night before going to bed.

True, there are many different avenues to college savings, and your own savings rate and tax bracket play a significant role in determining which route is best for your family. But there are a handful of college-savings solutions that make sense for a broad swath of parents, even those who think they're getting a late start.

Read on for a look at our best tips for getting going today.

**Resist the urge to stand still.**
I'm a lifelong procrastinator; heck, as a high-school student I was once so behind on a term paper that I had to dictate it to my sister while she typed. (As you might expect, that was the first and last time she let me get away with that.) So trust me when I say I know the sick logic that we procrastinators employ. If I haven't done anything yet, you think, why start this minute?

But look at it this way. Thanks to compounding, a dollar saved today is much more valuable than a dollar saved 10 years from now. And even if you manage to save only a small amount between now and the time your child is ready for college, he or she is going to have to borrow that much less for tuition. The key is taking that first step.

**Don't play catch-up by chasing overly risky investments.**
Instead of sitting still, some parents who fear they won't be able to afford skyrocketing college costs might be tempted to do the opposite: swing for the fences in the hope of hitting it big.

But as anyone who bought an Internet stock in the late 1990s will tell you, investments that have posted big past returns often carry extreme risks. Thus, the best way to save for college isn't to concentrate in a single risky stock or sector, but instead to build a well-diversified portfolio with a stock/bond mix that suits your child's time horizon. Bear in mind that if your child's college years are drawing near, you'll want to be taking fewer risks with any money you have earmarked for college, not more. While savings for children under 10 may safely be invested in stock funds, the majority of your child's college savings should be in cash and bonds by the time he or she hits high school.

True, bonds and cash don't have the same return potential as stocks do. But if you're afraid that your college savings will come up short when it comes time to matriculate, your best option is to plan to save more rather than venturing into inappropriately risky investments.

**Consider a 529 savings plan.**
529 plans have been getting a lot of negative press lately, with critics citing high expenses, hidden fees, and substandard investment choices. But given that 529s permit extremely generous contributions and offer tax benefits to boot, these programs can be ideal for late-start college savers who need to sock away as much as possible in a short period of time. The key is to choose carefully.

Although Section 529 prepaid tuition programs essentially allow you to lock in today's tuition rates, such plans can be somewhat inflexible. If your child wants to go to school in another state, for example, some of the tuition costs many not be covered.

In contrast to the prepaid programs, money invested in Section 529 savings plans can be used at any college in the U.S. There are no earnings restrictions on who can contribute to a 529 plan, and you can contribute up to $60,000 per year per child without triggering the gift tax. Aggressive 529 savers could, in theory, sock away enough to cover a child's complete education. Your contributions to a 529 plan can grow tax-free, you can take tax-free withdrawals to pay for college expenses, and you may also enjoy a state-tax break. (Beware, however: Some states, essentially cancel out the 529's state-tax benefits if you opt for an out-of-state plan. Finally, the 529 assets are held in the parents' name, meaning these assets receive more favorable treatment than the child's assets in financial-aid calculations.

Not all 529s are created equally, however. Although you may enjoy a state-tax break by sticking with your own state's plan, high costs and poor investment returns could outweigh that benefit. Thus, it pays to shop carefully, and to look beyond your home state's plan if it's not up to snuff.

**Simplify with all-in-one funds.**
For college savings, I'm a fan of funds that "mature," or grow more conservative, as the child nears college age. (The closer your child is to needing to tap into those assets, the thinking goes, the less fluctuation you want to see in your principal value.) Many 529 plans, including the topnotch Utah program, feature such one-stop, "age-based" options, and they make perfect sense for parents who would prefer to select a plan and tune out.

If the costs and complexities of 529 plans lead you to opt to save for college in your taxable account or via a Coverdell Education Savings Account (the old Education IRA), you can still find plain-vanilla mutual funds that grow more conservative as college draws closer. Most such funds are designed for people nearing retirement age, but I think they're equally useful for college savings. Vanguard's Target Retirement funds, Fidelity's Freedom funds, and T. Rowe Price's Retirement series funds are all solid, low-cost, low-maintenance options. All of these funds carry specific years in their names (e.g., Fidelity Freedom 2020); simply choose the fund with the year that corresponds with your child's college start date.

**Cheap out.**
If your investment horizon is relatively short, it's all the more important to pay attention to how much you're shelling out in fund fees. That's because cash and bonds—which should form the bulk of your child's portfolio as college draws near—have low returns to begin with. If you layer on excessive expenses, your take-home return will be that much lower. For your college-savings plan, focus on stock funds that charge less (preferably much less) than 1% per year in annual operating expenses; look for bond funds with expense ratios of 0.75% or lower.

For similar reasons, late-start college savers will want to be careful about how much they're shelling out in brokerage charges and other administrative fees.

**Accentuate the positive.**
Even if you haven't established a dedicated college-savings fund, you may be able to tap valuable assets right under your nose. After a decades-long runup in real estate prices, for example, many homeowners are sitting on fat home-equity balances that you can draw upon to pay for education expenses; you're also likely to enjoy a tax break on the interest from the home-equity loan.

Similarly, parents might also consider tapping their own IRAs to pay for college. Depending on the type of IRA, you'll pay taxes on part or all of the withdrawal, but you won't pay the usual 10% early withdrawal penalty if you use the money to pay for qualified education expenses. If you engage in such a maneuver, however, bear in mind the costs to your own retirement savings plan. Loans and financial aid may be available to your college-bound child, but you'll have fewer options available if your own retirement-savings plan falls short.

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