Smoke and Mirrors inside 529 Plans

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Background

529 Plans are education savings plans that allow the account holder to plan for the beneficiary's future education expenses by letting their money grow within an individual investment account. Investments grow tax deferred within the 529 Plan, and are distributed tax free for the beneficiary's qualified educational expenses. Distributions are completely income tax free at the federal level and are generally tax free at the state level. In addition, many states offer tax incentives to choose the in-state plan over out-of-state plans. Most plans have a large number of investment options to choose from.

Assets in 529 college-savings plans have been steadily growing, with plans marketed directly to college savers gaining over those sold through financial advisors. At year-end 2012, the plans' aggregate assets topped $166 billion—a 25% increase in assets over the year-earlier figure (Morningstar).

Every state now has at least one 529 plan available. Each of these plans is different and varies in terms of underlying investments and fee structure. According to Savingforcollege.com, states structure the investment options in Section 529 plans for the benefit of participants who are not experienced investors. For example, most plans offer age-based investment options that automatically re-balance assets based on the age of the beneficiary, making it easy for families to save without having to worry about asset management. Yet many plans also offer a plethora of static options which complicate an already difficult decision.

Purpose

Many investors and financial planners choose their own state's 529 plan because of familiarity, lack of understanding of the options, the tax benefit available in some plans, and because of sales incentives. Other investors pick based on analysts' reviews from Morningstar, and information from private companies including the previously mentioned Savingforcollege.com.

Yet investors, and also some advisors and planners, continue to lack a firm understanding of how to rationally choose a plan. Furthermore, once a plan is chosen, investors and advisors are confused about how to choose an investment option, when typically more than a dozen are available. How does one compare investment choices across plans and within a plan? How does one pick a target date fund when more than one choice is available?

This study aims to help financial advisors, financial planners and their clients make more informed choices for 529 investment.

Conceptual Background

Many companies that analyse 529 plans (Morningstar, Savingforcollege.com), do so across plans (i.e. Utah plan vs Nevada plan), but rarely do so within the plan. The data that is provided is then summarized, as with the Morningstar star system, indicating that plans with the same star rating are equivalent.

Theoretically, it makes sense to choose a target date fund as it relieves the parent and the adviser from having to manage the investment actively. However, it is possible that target date funds do not serve the needs of the investors, as many of them end up investing in static options. In fact, some 529 Plans have an abundance of static options against very few target date plans (e.g. AZ Plan).

Academic research of 529 plans has revolved around the reasons for the flow of funds to a particular plan, especially in the analysis of fund characteristics that attract investors. To date there has been very limited research on how investors should navigate the plethora of information that is available to them. Table 1 below gives a brief outline of relevant academic research on 529 Plans. Alexander and Luna have found that consumers are financially unsavvy and choose 529 plans, and presumably the investments therein, based on media coverage and company marketing documents (2005). Alexander and Luna also find that consumers, as with other investments, choose their 529 investments based on past performance (2009). Further the authors find that mandatory disclosures have no impact on consumer choices. Still shocking, DeGennaro finds that the plan asset allocations are so conservative that investors may be better off investing outside of 529 plans.

Choosing Investments inside a 529 Plan

Currently, choosing a 529 plan is hit-or-miss for the investing public. When it comes to investment options within a 529 plan or across 529 plans, there is a lack of comparable data to help choose a rational investment strategy. 529 plans offer a mix of target date funds based on mutual funds and ETFs, static options with labels such as “conservative” and “aggressive”, and various other options.

Until now, there has been a lack of adequate data to help consumers make a decision. Assuming an investor has chosen a plan, because they are most familiar with it, or because their advisor sells it, there is no obvious way for a consumer to choose an investment option.

One example is the Fidelity plans offered in Massachusetts, Delaware, Arizona, and New Hampshire. The Fidelity plans offers three different target date funds: one based on Fidelity proprietary index ETF funds, another based on Fidelity proprietary active mutual funds, and a third option based on third party mutual funds. In addition, Fidelity offers two static options and a bank fund. How is a consumer supposed to make a rational choice? How are they supposed to choose between static options and target funds? How are they supposed to choose between three different target date funds?

This state of affairs is not unique to Fidelity. Nevada has 4 plans managed by USAA, Putnam, Vanguard and SSgA. Vanguard’s plan in Nevada has 3 target date options, 5 static plan options and 14 individual fund portfolios, not even counting the options from the other three companies. There should be an easier way to choose the right plan, and to choose the right investment within a plan.

Table 1: Brief Literature Survey on 529 Plans

Author	Issue	Key Finding
Alexander, R. and Luna, L.	Factors that affect investor's choice of 529 Plans	State- tax benefits are negatively related to investment choice, that is, investors in general are not tax-savvy Investors choose plans based on media coverage and company marketing documents
Alexander, R. Luna, L.	Impact of plan disclosure on investment decision	Voluntary information disclosure by plan providers has no impact on investor choice. State tax disclosures have no impact on investment decision. Investors choose plans based on past investment performance.
Buttell, A.	Future of 529 Plans	Many prepaid plans have been shut down to new enrollment simply because they cannot afford to bring more families into those plans.
Bogan, V.	Impact of state tax deductibility on fees of 529 plan	Positive link between state-tax benefit and 529 plan fees. Market frictions lead to high fees in 529 plans Direct-sold and broker-sold 529 plans have statistically significant different fee structure.
Clancy, M. Joavanovich, J.	Investment options, Safety and Policy Implications	Need to establish basic standards for the states regarding investment options and on-going investment oversight. States need to adopt investment policies that assure a range of options and 'sensible asset allocation.
DeGennaro, R.	Asset Allocation and 529 Plans	Prespecified asset allocations used by many Section 529 college savings plans are not only suboptimal, but that they are also so conservative that many investors would do better by avoiding such plans entirely
Dynarski, S.	Incentives of 529 Plans	The advantages of the 529 plans rise sharply with income because of higher marginal tax rate. Top-tax bracket families can use 529 inadvertently to tax-shelter their assets even with non-qualified withdrawal penalty. 529 plans lead to disproportionate penalty for low-income families that are at the margin of receiving financial-aid.
Dynarski, S.	Real beneficiaries of 529 Plans	College savings plans can actually harm some families because of poor coordination between the income tax code and the financial aid system.
Russell, J. Brooks, R.	Managing college tuition inflation	U.S. Treasury inflation-indexed securities should be included in the asset allocation decision for college tuition inflation management.

Methodology

Our goal is to investigate whether there is a statistically significant difference in risk adjusted performance using Fidelity plans in Delaware and Massachusetts between the three main age based options: Fidelity index ETF option, Fidelity mutual fund option, and Multi Fund option. In addition, the analysis will compare age based options with static options.

The analysis will use standard statistical tools such as ANOVA and Dummy Variable Regression Analysis. The analysis will attempt to identify the factors that contribute to the differences between the various options including, fees and expenses, asset allocation and taxes, as applicable.

Analysis and Results

Work-in-progress

Discussion and Financial Planning Implications

Although we understand that many investing decisions can be based on emotions, we believe that Financial Planners ought to recommend investment choices based on rational factors. We anticipate that the results will show that most investors should pick an age-based fund. The results will discuss the options available and will offer a rational analysis for choosing the appropriate age based fund in the Fidelity plan sold in Delaware and Massachusetts.

The results will delimit some of the cases in which static options could be used. Obviously, should the results be different than those anticipated, we will show those. Although we are starting this study with an analysis Fidelity plans, we will continue it with other major 529 plans. Ultimately, we will provide data that will enable consumers and their advisors to choose across 529 plans, and within the plans themselves.

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