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Avoiding Fee Pitfalls as College Savings Climb

By LYNN O'SHAUGHNESSY

IN a short time, the state-sponsored 529 savings plan has become one of the nation's most popular ways to invest for college. About $30 billion is now spread among more than three million accounts, and the flood of cash is rising exponentially.

The tax benefits have been a powerful lure. Contributions to 529 plans — named for the section of the tax code that established them in 1996 — are sheltered from federal income taxes, and no taxes are owed when the money is withdrawn for college expenses. Some states, like New York, also provide tax breaks. But those incentives might be blinding some parents to a major drawback of many of the plans: high fees.

The costs for starting and maintaining an account in some state plans can easily offset some of these tax savings, not to mention part of the returns, said Ilene Malitz, who is president of the financial planning firm IB Malitz & Associates, which has offices in Milford, Pa., and Naples, Fla. "I look at them and think, `Are people out of their minds? Why would they put their money in them?' " Ms. Malitz, who is also a former Georgetown University finance professor, said of the expensive plans.

Determining total costs, however, can be a challenge because fee structures vary by state, and often by investment choices within a state plan. For example, there may be initial enrollment fees, annual maintenance fees, plan management fees and fees for the underlying investments. Those who invest in a 529 through brokers may also have to pay commissions, which now run as high as 5.75 percent in many states.

State-sponsored 529 savings programs allow residents to invest directly in one of their own state plans without paying a commission, and in some cases out-of-state residents can do the same. But many people seem to be bypassing the more moderately priced state plans, investing instead in plans offered through brokers, industry experts say. "People are afraid to make choices by themselves," said Jamie Canup, a partner at the law firm of McGuireWoods in Richmond, Va., which advises states on 529 plans.

According to the Financial Research Corporation in Boston, 68 percent of the cash Americans funneled into 529 plans in 2002 passed through commissioned brokers and financial planners, compared with only 20 percent in 2000.

More states have been embracing broker-sold savings plans, partly because of pressure from the financial industry, which wants to participate more in this growing area. But some state officials say that it has become necessary. "We are not financial advisers," said Diana Cantor, the executive director of the Virginia College Savings Plan and chairwoman of the College Savings Plans Network, which is an affiliate of the National Association of State Treasurers. "We have to tell people, `We can't give you financial and tax advice.' "

In February 2002, Virginia rolled out a 529 plan offering a standard commission of 5.75 percent, which at the time was above the prevailing rate of 3 to 3.5 percent for state plans. To stay competitive in the financial industry, many other state plans raised their commission rates as well, including those in Ohio, Rhode Island, Alaska and North Carolina.

The annual price tag for state plans can differ significantly, according to Morningstar, which tracks fees and returns. Many of these plans have several investment options, and fees will vary based on which funds or investment options are chosen. Among those on the low end of the fee scale are the College Savings Iowa plan, which uses Vanguard funds and has an annual fee of 0.65 percent, and Nevada's Vanguard 529 Plan, which has an annual fee ranging from 0.65 percent to 0.85 percent. Neither charges a commission. At the other end is Wyoming's College Achievement Plan. Morningstar calculated that a resident investing directly in a portfolio in the Wyoming plan divided equally among stock and bond funds would pay annual expenses of 2.21 percent. If a parent used a broker, the annual charge would rise to 2.71 percent.

OME parents may not understand how much high annual costs can seriously erode returns, which were already hurt by the stock market's decline over the last few years. Suppose, for instance, that a couple opened a Wyoming account through a broker with $500 and then contributed $150 monthly for 18 years. If the plan generated an annual return of 8 percent, the portfolio would grow to $54,545. If the couple had invested the same amount in the Iowa plan, assuming the same performance, the college fund would have reached $67,193 — a difference of $12,648.

There are some families that do pay attention to expenses. Cost was a big consideration for Jane and Ted Reedy of Pleasanton, Calif., who have invested in California's 529 program, which uses TIAA-CREF funds, for their children Jack, 10, and Kate, who is 15 months old. With exercised stock option money, Ms. Reedy, 43, a medical device consultant, last year moved about $30,000 into the children's plans. In addition to the plans' low price tag of 0.8 percent, the couple said, they based their choice on the sound financial reputation of TIAA-CREF.

The Reedys said they rejected a 529 plan that was offered through Ms. Reedy's former employer, the Thoratec Corporation in Pleasanton, because of the fees. "When I looked at the literature, I noticed that the costs were huge," Ms. Reedy said. "They were so ridiculously high, they stuck out."

So what should be considered reasonable costs? Langdon Healy, an analyst at Morningstar, said a 529 plan that is divided among stocks and bonds is reasonably priced if the yearly expense ratio remains below 1 percent. A plan charging more than 1.25 percent is considered expensive, he said. Mr. Healy noted that the states using Vanguard or TIAA-CREF funds, like New York, California, Oklahoma and Nevada, offer low prices. (Both California and New York, however, are considering adding adviser-based 529 plans.)

The college savings movement started with the aim of keeping things simple. The first-generation were prepaid plans, introduced in the 1980's, that didn't require participants to make any investment decisions. The prepaid plans were guaranteed to increase in value at the same rate as college tuition. But these plans began looking stodgy in the bull market. Parents decided the place to park their children's education savings was in stocks.

Initially, 529 plans focused on age-based portfolios, which would grow more conservative in investment choices the closer a child came to college age. A parent only needed to fill in a child's birthday and the plan would automatically select the appropriate asset mix. But parents and brokers began clamoring for more options, particularly the ability to invest in funds that they could mix and match. They got what they wanted: today, according to Morningstar's calculations, nearly 2,500 investing options exist within the nation's 529 savings plans.

With so many choices, some industry observers say, it's only natural that parents have turned to financial professionals for advice. "You can't devalue what an adviser brings to the table," said Whitney Dow, director of educational savings research at Financial Research. "It is a complex universe of products." Plus, he said, "you have to be aware of unique state tax deductions, as well as penalties with certain plans."

Philip Johnson, a financial planner in Clifton Park, N.Y., said focusing solely on cost and avoiding the use of an adviser won't always be a wise move, especially with plans evolving so quickly. "Expenses are part of the picture, but they are not the only issue in picking a plan," Mr. Johnson said. "I think performance and flexibility are also important."

He acknowledged that some people may not really need a financial adviser, but added, "There isn't much in auto mechanics and plumbing that people couldn't do if they were willing, but many people aren't willing."

NOT everyone, however, thinks that commissioned advisers provide valuable, much less unbiased, advice. "I don't believe there is a good understanding at all of 529 plans among many brokers," said John C. Heywood, a Vanguard principal who is in charge of the firm's education markets group. Mr. Heywood said many parents can make a wise choice after devoting an hour or so on their own to research. "We don't believe that people, who spend a little time or effort, need a broker to make the right decision."

In the spirit of do-it-yourself investing, Vanguard distributes a free booklet, "Vanguard PlainTalk Guide: Saving for College." It can be viewed online at www.vanguard.com or ordered by calling (800) 716-4078. Those who have questions about the best way to prepare for college costs, including 529 plans and Coverdell Education Savings Accounts, can call Vanguard's Education Resource Center at (866) 734-4524. You don't have to be a Vanguard customer.

The Web site Savingforcollege.com keeps track of all the state plans and even rates them through a "five cap" system. The site recently began comparing the performance of a plan's underlying funds with investment benchmarks, with fees reflected in the index. Joseph F. Hurley, a certified public accountant from Pittsford, N.Y., who runs the site, said that in most cases fees would not significantly influence a plan's rating. "As an investor, I don't care what the cost is as long as I get the best returns," he said. "When you pay for anything, whether it's professional services or something in a store, you want quality."

But Mr. Hurley's proprietary scoring methodology has triggered some grumbling among 529 providers. "I don't think the expense ratio is factored heavily enough in the equation," said Timothy Lane, vice president for tuition financing at TIAA-CREF. "You don't know what performance will be, but you know expense ratios are predictable."

Morningstar also devotes an area of its Web site (www.morningstar.com) to college savings and has stockpiled several articles on selecting 529 plans. The free service can be accessed on the site by clicking on "college savings" in the "investing centers" area. Morningstar provides data on each savings plan and itemizes costs, including the yearly expense ratio and loads, as well as management, maintenance and enrollment fees. Morningstar refrains from grading individual plans, but it does provide what percentage of funds in a specific plan has earned either four- or five-star ratings.

As the 529 market matures, some industry insiders predict that prices will eventually drop. "If you are running a high-cost program, you will have to look at ways to offer it at a better rate to stay competitive," said Ms. Cantor, of the Virginia College Savings Plan. "If managers aren't performing, there will be new seating at the dinner table."

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