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# Options abound for college savings

## Pennsylvania has offered a Section 529 plan that charges no tax on capital growth.

By Gregory Karp
Of The Morning Call

For the average parent, saving for a child's college expenses can be a daunting subject, even assuming you have some cash to stash away.

But because there are ways to keep Uncle Sam's hands off money earmarked for college, it's worth getting up to speed on a few issues. And it's a timely subject, because Pennsylvania this month announced a new type of college savings plan that has huge tax breaks.

We'll try to answer three main questions related to so-called Section 529 plans, which are operated through state governments. Experts agree they're among the best ways to save for college:

- How does Pennsylvania's investment-style Section 529 plan stack up against similar plans in other states?
- If I'm choosing a Pennsylvania 529 plan, should I select the investment-style TAP 529 Investment Plan or the Guaranteed Savings Plan?
- Is the much-ballyhooed Section 529 plan really the best way to save for college?

First, a little about 529 plans.

Basically, you deposit money into a special account, usually as lump sums or monthly installments. Often you can do it yourself online, or through a investments broker, which is more expensive but comes with advice.

With many plans, you choose to invest in stocks and bonds, similar to a 401(k) retirement plan or Individual Retirement Plan (IRA). Anyone can contribute to a 529 account — parents, grandparents, relatives and friends.

Withdrawing it is the best part.

If used for college expenses at most any U.S. college or career school, growth on the money — the capital gain — is free of federal tax. The money can be used not only for tuition but for books, supplies and room and board.

"You can find almost any investment style within a 529," said Joseph Hurley, a nation's foremost expert on Section 529 plans.

"If you hear these are bad because the stock market is going down, you don't have to invest in the stock market. If you want to invest aggressively because you think there's going to be a

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## SAVINGS

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# Whatever plan you pick, get started early

rebound in the market, you can find those options in 529s also."

Pennsylvania also offers a guaranteed savings 529 plan, which guarantees your money will grow as fast as tuition hikes at various types of colleges. Unlike mutual fund-based plans, you can't lose any money in this plan.

Before delving into the details of college savings, one important point: The details about Section 529 plans and other college savings strategies can be complicated, but the most important thing is to start saving right away. Even putting money in a below-average plan is likely to put you further down the road of college savings than waiting a few more years to get started, experts say.

And it's a long road. A child born today could cost $132,468 to send to a state college and $288,402 to a private college, according to the College Board.

"You can really tie yourself in knots over what's the best thing and you really don't know without knowing everything about your future," said Kent Hickey, a fee-only financial planner and president of Journey Financial Advisors in Allentown.

"Doing something is better than doing nothing."

**How does Pennsylvania's investment-style Section 529 plan stack up against similar plans in other states?**

This is an important question because you can use many other states' plans even though you live in Pennsylvania. If you're fond of mutual funds by Vanguard, Fidelity, Strong or other companies, that might be good enough reason to seek out a state that offers those funds in its 529 plan.

Pennsylvania's plan is run by Philadelphia-based Delaware Investments, a division of Lincoln Financial Group. It offers seven stock and bond options, as well as two choices for socially conscious funds, which screen funds based on social issues, such as the environment, public health and safety, and human rights.

The options range from aggressive, heavily weighted in stocks, to conservative portfolios, invested in safe bonds. Like other states, Pennsylvania offers age-based options, one aggressive and one conservative, that switch to safer investments as the child gets older and closer to needing the money. This is kind of like putting the investment on autopilot.

Ultimately, the major factor in investing is how well your investment performs. But two ingredients affect investment returns — what the money is invested in and the built-in expenses of the investment.

First, are the investment options.

Some of the Pennsylvania options are seldom seen in other plans. For example, it offers socially responsible options by Calvert Group, of Bethesda, Md., one for stocks and one for bonds.

It also offers an extremely conservative option, similar to a money market fund.

And it has two age-based options — the autopilot choice — for aggressive and conservative investors. Most states offer just one.

But at least one local financial planner isn't crazy about how money within some options is invested. The allocations seem heavy on large U.S. companies and light on international investments, said Christopher Jones, a fee-only planner and president of Keystone Financial Planning in Palmer Township.

For example, an "aggressive" portfolio invests just 5 to 15 percent in an international mutual fund. And of the 80 percent it invests in stocks, 58 percent is in large company stocks.

"I like a lot better diversification across equities," Jones said. "The way the money is allocated has an enormous effect on performance.

"Taxes are a moot issue if you're not making money."

Dan Carlson, a vice president with Delaware Investments who helped set up the Pennsylvania plan, said the allocations were set up with generally accepted models of diversification and that international investments can be tricky.

"It's one of those asset classes where it's difficult to gauge what the investors' appetite is for it," he said. International investments are more complicated because currency exchange rates, among other things, affect returns, he said.

But there's no way to tell how a mixture of these funds would stack up against other investments because the combinations created for Pennsylvania's 529 plan haven't existed before.

A second issue is the cost of owning a 529 plan.

The fees and expenses built into Pennsylvania's plan are higher than some other states, said Jones, who likes low-expense index funds that aim to mimic popular stock indexes, such as the S&P 500.

The main fees are the management fee for administering the plan, which in Pennsylvania is 0.4 percent, and the costs built into the mutual funds that underlie the investment options. Those costs range from 0.45 percent to 1.69 percent, depending on the mutual fund. There's also a $50 per year charge if the account is less than $20,000.

So, assume your investment mix has expenses of 1.5

percent. If the funds are returning 8 percent, you get only 6.5 percent. That might not sound like a big difference, but with thousands of dollars over many years, it adds up to real money.

And if you go through a broker, expect to pay a sizable sales commission, which also eats into the growth of the money.

Officials at Delaware Investments said the goal was to keep expenses and fees in the middle range for such plans.

Analyzing plans strictly by performance is one thing, but there are perks for Pennsylvania residents to choose their own state's plan.

One big advantage to having money in a Pennsylvania 529 plan is that withdrawals are free of state tax and if the account owner dies, a parent or grandparent, the money is free of state inheritance tax.

"You should look at whether your state offers any benefit to you as a resident," Hurley said.

And there are reasons to consider the Pennsylvania plan that aren't directly related to investment return.

In applying for financial aid from Pennsylvania, which can be used for schools in many other states, money in Pennsylvania's 529 plan is not counted as an asset, which increases the aid. However, money in out-of-state 529 plans is considered an asset for calculating aid from state grants.

And if you get into debt trouble, creditors can't go after money in a Pennsylvania 529 plan, but they might have access to out-of-state plans, state Treasury officials said.

So, if you want the greatest flexibility to choose a particular investment mix and must have the lowest expense funds, research 529s in other states. But if you want a good plan that has benefits for state residents, try the Pennsylvania plan. You can always switch later. By federal law, you can roll the money into another state's plan once a year.

**If I'm choosing a Pennsylvania 529 plan, should I select the investment-style or the Guaranteed Savings Plan?**

A couple of years ago, answering this question would seem easy. The investment-style plan was better because many mutual funds were returning more than 20 percent per year. Meanwhile, the rate of college tuition hikes, and thus the growth on the guaranteed plan, was running about 5 or 6 percent.

But recently, it's been the opposite.

Few stock mutual funds are making any money at all, while tuition increases have spiked. For example, tuition at Penn State's main campus has risen 7.8 percent last year and 13.4 percent this year. That means the guaranteed accounts for state schools are growing by that much.

Today, those look like whopping returns compared to most stock and bond investments.

"At least in the near term, tuition seems to be going up quite substantially at Pennsylvania public institutions, and so the value of your contract in that program would seem to be a pretty good value, assuming that the stock market doesn't start performing real well again," Hurley said.

But aside from returns, experts say the answer may depend on your stomach for risk and how old the student is.

If you can't stand to see the college money ebb and flow with stock and bond markets, the guaranteed program might be best. You're essentially buying college credits in the future at today's prices.

"One thing I like about it is once you've bought those credits you know it's going to be there when the time comes," Hickey said.

Jones said it's a good option for people who do not want to take risk. "What if we're in a 15-year bear market here?" he said. "If people put it in the market, not only could it not make up for tuition inflation, it could drop in half."

And if your child is close to needing the money for college, the guaranteed plan makes sense.

"You do not want to stick your money in the market when you have a five-year time horizon. That's foolish," Jones said.

But if you need to grow the money substantially, the investment-style plan might be best.

"The Guaranteed Savings Plan takes the volatility out of it," Carlson said. "But over the long term, the stock market will outperform tuition inflation. If as an investor you can absorb the risk of market, overall you have the potential to do better with the stock market. Of course, you have the potential to do worse."

For some people, it might make sense to put half the money in the guaranteed plan and half in the investment-style plan, Carlson said.

**Is the much-ballyhooed Section 529 plan really the best way to save for college.**

The main competition for 529 plans is what used to be called an education IRA. Today, it's called a Coverdell education savings account.

"Congress made a bunch of changes to the Coverdell, so it's a very viable program for college savings," Hurley said.

Coverdell's advantages are:

■ You can invest with almost any brokerage or mutual fund company, which means you can shop by whatever criteria are important to you, such as specific funds or fund expenses.

■ Money can be used for kindergarten through 12th-grade expenses, not just for college.

Coverdell disadvantages are:

■ You can only contribute $2,000 a year. Section 529 plans are capped at $11,000 annually.

■ Couples can't use a Coverdell if their modified adjusted gross income is more than $220,000. (Half that for singles.) People of all incomes can invest in a 529.

■ The money becomes property of the child at some point, so they could use it irresponsibly — like buying a sports car instead of attending college. And because it's an asset of a child, it likely will decrease whatever financial aid the student is eligible for. For now, 529 plans are considered a parent asset, which has less impact on financial aid calculations.

"That's another part of the Rubik's cube they've created with these financial tools for college planning, is they all interact differently with federal financial-aid formulas," Hickey said.

So, on balance, an appealing option for many people might be to use both, experts say. Invest the first $2,000 a year in a Coverdell and the rest in a Section 529 plan.

"There are some strings attached to the Coverdell that you don't have with the 529," Hurley said. "But certainly, anyone who qualifies for the Coverdell might want to consider where their first $2,000 goes."

One note about Section 529 plans: There's some uncertainty for those investing for young children. Congress only made withdrawals tax-free through 2010.

"Certainly, I expect Congress to extend the exemption, but maybe on a more limited basis than it is right now," Hurley said. "But I certainly cannot guarantee that."

Worst case scenario is the tax benefit reverts to how it was before last year — growth on the money is taxable at the student's low rate, which is still a tax advantage, he said.

Coverdell tax-free withdrawals do not expire in 2011.

**Pennsylvania's 529 plan:** www.patap.org or 800-440-4000. Information on 529 plans in general: www.savingforcollege.com or Joseph Hurley's book "The Best Way to Save for College — A Complete Guide to 529 Plans."

## INSIDE PENNSYLVANIA'S 529 PLAN

Below are the mutual funds that underlie Pennsylvania's new investment-style Section 529 college savings plan. Past returns, operating expenses and Morningstar ratings are factors to look at when judging any mutual fund, experts say.

| Fund | 5-yr return (%) | 10-yr return* (%) | Annual operating expenses | Morningstar rating (5 is best) |
|---|---|---|---|---|
| Delaware Corporate Bond Fund, DGCAX | NA | 5.75 | 0.55 | 2 |
| Delaware Diversified Growth Fund, DGDAX | 0.65 | -0.39 | 1.20 | 1 |
| Delaware Diversified Value Fund, DDVAX | NA | 8.97 | 1.20 | not rated |
| Delaware International Value Equity Fund, DEGIX | 2.72 | 7.60 | 1.69 | 3 |
| Delaware Limited-Term Government, DTRIX | 6.01 | 5.40 | 0.60 | 2 |
| Delaware REIT Fund, DPREX | NA | 8.06 | 1.10 | 4 |
| Delaware Small Cap Value Fund, DEVLEX | 14.42 | 12.69 | 1.28 | 2 |
| Delaware Trend Fund, DELTX | 14.35 | 14.04 | 1.05 | 3 |
| Calvert Social Investment Fund Bond Portfolio, CSIBX | 7.19 | 6.99 | 1.19 | 3 |
| Calvert Social Investment Fund Equity Portfolio, CSIEX | 13.41 | 10.43 | 1.28 | 4 |

* 10-year return or life of fund if in existence less than 10 years.
Returns are as of March 31, as reported in TAP 529 disclosure statement.
Sources: TAP 529 disclosure statement and Morningstar.com

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**GENERAL TIPS:**

■ Fund your retirement before putting money in a college savings plan. You can always borrow money later for education expenses, not so for retirement.

If you don't want to spend the time and energy to learn about college savings options, just choose a Section 529 plan and choose the age-based option, which puts your savings on autopilot. Or choose one that grows with the rate of tuition hikes. Pennsylvania has both.

**REASONS TO CONSIDER PENNSYLVANIA'S 529 PLANS**

1. Growth on the money is free of state income tax. Out-of-state plans are subject to state tax, as are Coverdell education savings accounts.

2. Pennsylvania's 529 plan is excluded from state financial-aid grant calculations. Out-of-state 529 plans count as an asset. Such state grants can be used to attend college in many other states.

3. If the account owner dies, Pennsylvania's 529 plan is exempt from state inheritance tax. Not true for out-of-state 529 plans.

4. By state law, creditors trying to collect on debts cannot go after a Pennsylvania 529 plan. Out-of-state plans might be vulnerable to creditors.

Sources: Financial planners and Pennsylvania Treasury Dept.