FAMILY FINANCES

The Best College Savings Plans

These state-sponsored 529 programs offer tax breaks, low fees and well-managed portfolios. BY NELLIE S. HUANG

HELICOPTER PARENTING MAY NOT BE ALL bad. Those hovering moms and dads, who like to weigh in on which teacher or coach their child gets, seem to be just as passionate about saving for college. So it's no surprise that a record number of American parents—nearly 60%, according to Sallie Mae, a giant in student loans—are putting aside money for their children's education.

What is remarkable is that most parents are stashing their higher-education money in an ordinary savings account. Only 37% of those savers are using a 529 college-savings plan—the best way to accumulate money for a college education.

Sponsored by 48 states and the District of Columbia (Washington State has announced plans to open a college-savings plan, and Wyoming doesn't offer a plan), 529 plans have a slew of incentives for savers. For starters, your money grows tax-free, and the earnings escape tax completely if you use the withdrawals for qualified college expenses, which include tuition, room and board, books, computers, and related tech services and equipment. (You can use withdrawals for graduate school, too.) Most plans have low or no minimums to open an account. They have no income limit, and they set a high cap on contributions. Two-thirds of the states and the District of Columbia offer a tax deduction or credit for contributions. And if your child skips college, you can name a new beneficiary—a sibling, grandchild, niece or nephew—without losing the tax breaks.

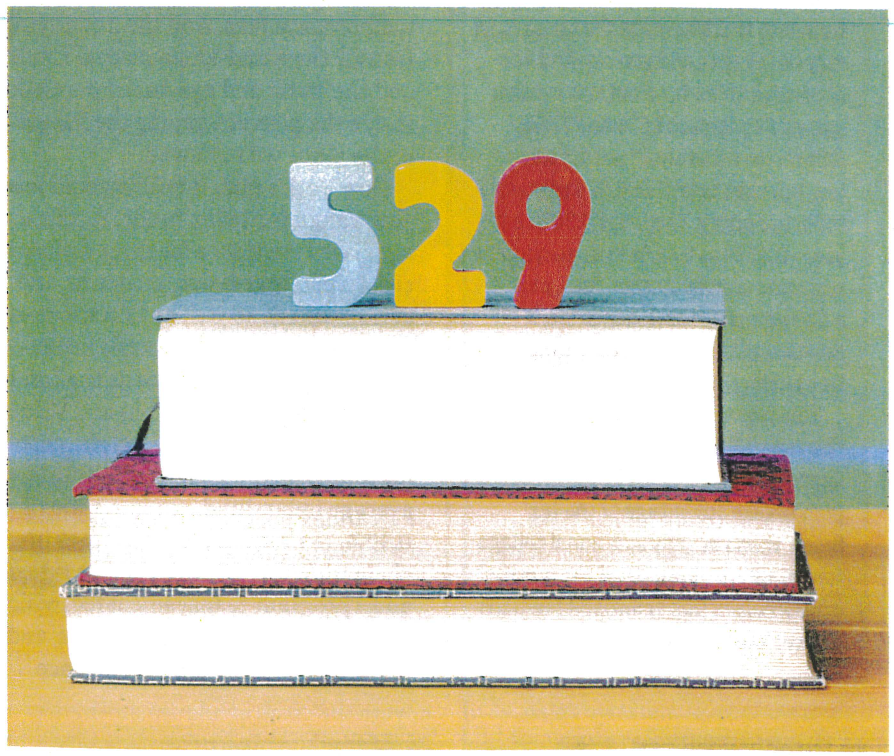
There are some drawbacks. If you cash out for noncollege expenses, you'll owe income tax and a 10% penalty on earnings (but not on contributions). You may have to return any state tax deductions, too. Plus, you're limited to the investment options offered by your plan. And IRS rules limit you to two changes in the investment mix per calendar year per beneficiary. (For more savings options, see "How to Pay for College," on page 38.)

Why aren't more college savers using 529 plans? Many parents say they haven't heard of them or don't know enough about them. Some parents who do know about them say they don't have enough money to save in that kind of account. "There's a lingering mentality that 529s are just for the wealthy," says Maria Bruno, a certified financial planner and a senior investment analyst at Vanguard.

In fact, 529s were designed to ease college saving for all families and all family members. You can open and fund an account for a grandchild, niece or nephew. Or you can deposit birthday or holiday money into a 529 account opened by the parents.

FINDING A GOOD PLAN

Most states offer two types of plans: a low-cost plan you can buy directly from the state and a higher-cost plan sold by a broker. Stick to plans that you can buy direct. Lower costs mean more of your money will go toward building your college fund. Plus, 32



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states and the District of Columbia offer a tax break for contributions. In most cases, a tax deduction will trump lower fees in an out-of-state program. Go to the Vanguard 529 State Tax Deduction Calculator, www.vanguard.com/529taxtool, to find out what your potential tax savings would be in your state plan, given your expected contribution and income.

If your state doesn't offer a tax break—or you live in Arizona, Kansas, Missouri, Montana or Pennsylvania, which offer a tax break no matter which state's plan you invest in—look for a state plan that charges no or low annual maintenance fees and offers a diverse array of investment choices with low expenses. Most plans offer so-called age-based portfolios, which start out holding mostly stocks when your child is a baby and gradually adjust to a blend of mostly bonds and cash as he or she reaches college age. In addition, 529 plans typically offer individual mutual funds or so-called static portfolios, such as a balanced portfolio that holds 60% of assets in stocks and 40% in bonds, or a diversified portfolio of bond funds.

KipTip

When to Save Out-of-State

It's generally a good idea to stay in-state with your 529 savings if you get a tax break for investing in your state's plan. But depending on your state tax rate and the size of the deduction or credit, it may pay to look at the plans in other states that we recommend.

For example, North Dakota's College Save 529 Plan gets points for recently chopping its fees from 0.85% to 0.55% per year for most portfolios. But North Dakota's state tax rates, which range from 1.1% to 2.9%, mean the tax savings may be meager, and you can find less-expensive index-fund options in other states. At between 1.6% and 7.4%, Idaho's tax rates aren't necessarily low, but the state's Ideal 529 plan portfolios are pricey. They cost 0.50% per year—0.45% to 0.46% in management and state-administration fees, plus a $20 account-maintenance fee. A low-cost plan in another state may be a better deal.

You may even consider opening more than one 529 account for your child. Contribute just enough to your in-state plan to take advantage of the tax break, then save any additional college funds in another state's plan—one that offers more or better investing options or lower costs than your state's plan.

To assess the best direct-sold 529 plans in various categories, we relied on several databases, including Morningstar's 529 Plan Center (http://529.morningstar.com/state-map.action), the College Savings Plans Network (www.collegesavings.org) and Savingforcollege.com. These plans are good choices if your own state doesn't offer a tax break for contributions. You may also want to consider them if your state's tax breaks don't outweigh the plan's fees (see the box at left).

Best for low fees. Our top pick in this category, **NEW YORK'S 529 COLLEGE SAVINGS PROGRAM**, doesn't charge account-maintenance fees. And the underlying fees for the stand-alone mutual funds and the static and age-based portfolios inside the plan are among the lowest of the plans we reviewed.

New York's plan is built around low-cost Vanguard index funds. It offers age-based portfolios for three different risk levels (aggressive, moderate and conservative), as well as 13 static portfolios geared toward specific investment goals or styles, such as the Interest Accumulation portfolio and Value Stock Index portfolio. Each one costs just 0.16% in annual fees, one-third the average index-fund expense ratio of 0.49%. (In general, 529 fund fees include underlying fund expense ratios and a program-management fee, which covers the costs of administering and managing the plan.) The plan once shunned foreign stocks in its age-based portfolios. But that changed two years ago. Today, its aggressive age-based portfolio starts with a 70% allocation to U.S. stocks and 30% to foreign stocks.

One potential weak spot is its age-based glide path—the changing stock-bond mix in the portfolio as your child gets closer to college age. The path calls for a 25-percentage-point reduction in allocation to stocks every five years. That's a big shift in a single year and could potentially lock in losses if the stock market is tumbling. But the plan managers always have new money coming in that they must put to work, which can help mitigate that risk.

Although its portfolio fees aren't as rock-bottom as those of New York's plan, the **MICHIGAN EDUCATION SAVINGS PROGRAM** deserves an honorable mention. Michigan's plan, which charges no account-maintenance fees, offers three age-based tracks skewed toward risk tolerance: aggressive, moderate and conservative. The portfolios hold mostly TIAA index funds and cost 0.14% to 0.21% in overall annual fees.

Best age-based plan for aggressive investors. Nevada is the home of the **VANGUARD 529 PLAN**. The name alone is a clue that the program passes the low-fee test. Each of its age-based portfolios—aggressive, moderate and conservative—charges a skimpy 0.17% in annual fees.

The aggressive portfolio gets a special nod because of the way assets are allocated. The glide path starts at age 1 with 100% in stocks—60% in U.S. stocks and 40% in foreign stocks. Among plans that hold that much in foreign stocks, Nevada's has the lowest costs. The aggressive portfolio reverses its early go-go allocation later, at age 19, when your child (at least theoretically) has started college and the bills are due. At that point it all but abandons stocks, switching to 10% stocks and 90% bonds. That's exactly what the investment advisers at Altfest Personal Wealth Management in New York would prescribe. "With a child already in college," says Paul Palazzo, an Altfest certified financial planner, "we want to preserve capital."

The **NEW YORK 529 COLLEGE SAVINGS PROGRAM**'s aggressive age-based portfolio is a standout, too. It tops the charts of Savingforcollege.com's most recent three-year performance rankings. Like other plans, it starts at age 1 with 100% in stocks (70% in U.S. stocks and 30% in foreign companies), and uses Vanguard index funds. It has a moderate-risk finish at age 19, with about one-fourth of assets in cash and three-fourths in bonds.

Best age-based portfolio for conservative investors. For nervous investors who would rather hold fewer stocks and more bonds, our top choice is the **OHIO COLLEGEADVANTAGE 529 SAVINGS PLAN** conservative age-based portfolio. Of all the plans we reviewed, it offers the least risky path from beginning to end. At age 1, the plan's conservative portfolio holds 50% of assets in stocks and 50% in bonds and cash. At age 19, all assets sit in cash.

The plan is built around funds from Vanguard—both index and actively managed—and Dimensional Fund Advisors. And among its 17 static investment options, which include both portfolios and individual mutual funds, are the low-cost Admiral share class of two actively managed Vanguard funds that are members of the Kiplinger 25, our favorite no-load mutual funds: Vanguard Wellington and Vanguard High-Yield Corporate.

Best for hands-on investors. Some parents want to devise investment strategies of their own. For them, there's the **UTAH EDUCATION SAVINGS PLAN** and **ALABAMA COLLEGECOUNTS 529 FUND.**

Utah has a unique option within its age-based portfolios: You can create a tailor-made portfolio and have it automatically shift at three-year intervals according to your preferences. The plan uses index-based funds—18 from Vanguard and nine from Dimensional Fund Advisors. This custom feature, combined with low fees and a solid fund lineup, make Utah's plan a winner for investors who want to do the driving.

Alabama's 529 plan is for savvy investors looking to use more standalone options to build their own portfolio. It has a roster of 26 individual mutual fund offerings. On the list: low-cost index funds and reliable actively managed funds from DFA, Dodge & Cox, Fidelity, MainStay, Pimco, T. Rowe Price and Vanguard. Alabama's is also one of the few plans to offer index funds with the full complement of investment styles, such as Vanguard Small-Cap Value Index and Vanguard Mid-Cap Index.

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Best for keeping it simple. If you're overwhelmed by too many investing options, the **MARYLAND COLLEGE INVESTMENT PLAN** is a plain-vanilla solution. The plan has only one age-based portfolio, so you don't have to decide whether you're conservative, moderate or aggressive. Just choose the portfolio with the year that's closest to the time your child will enter college. It doesn't get much simpler than that. We like the aggressive glide path, too, which starts with 100% in stocks and ends in the college years with 20% in stocks. One snag: T. Rowe Price active and index funds fill the age-based glide path, so annual fees for the "enrollment based" portfolios, at 0.61% to 0.80%, are higher than for other age-based, index-fund portfolios highlighted in this story.

Less-aggressive investors looking for simplicity should check out the **CALIFORNIA SCHOLARSHARE COLLEGE SAVINGS PLAN.** It offers an age-based plan using TIAA index funds, with fees that range from 0.11% to 0.17%. Depending on the age of your child, the ScholarShare glide path incorporates a mix of cash and up to seven funds that invest in U.S. stocks, foreign stocks (in developed and emerging nations), real estate securities, inflation-linked bonds, investment-grade bonds and high-yield debt. The glide path is best described as moderate: It starts with 74% in stocks, 20% in bonds and 6% in a real estate securities index fund. At the end of its glide path, the portfolio holds 50% in cash, 35% in bonds, 14% in stocks and 1% in real estate securities. ■