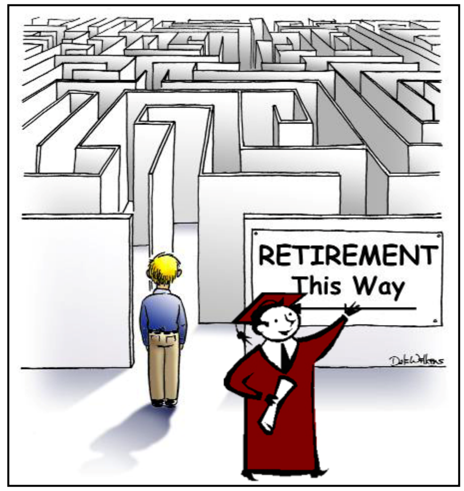
For the Best 529 Plans, Skip Town

Navigating the Retirement Maze



"An investment in knowledge pays the best interest."
- *Benjamin Franklin*

Saving for college has become a standard procedure for families with children, and the creation of the 529 plan in 1996 – named after Section 529 of the Internal Revenue Code –provides an additional incentive for doing so. 529 plans allow investments to grow tax-free, and then withdrawn to pay for most college-related expenses. (Sorry, kids, but pizza and beer aren't "qualified education expenses.")

Not surprisingly, the plans that parents typically use are the ones offered in their particular state, as those are the ones that get heavily advertised locally. What most people don't realize is that they can use 529 plans offered in most other states. Like mutual funds, fees and performance for 529 plan funds differ, and some are better than others. In fact, Massachusetts residents are eligible to enroll in any of 78 different plans offered across the U.S., according to Morningstar, an investment research firm. Judging by several evaluations of the 529 plans available in the Northeast, there's good reason to "get outta town" when choosing a 529 plan.

New England Gets an "F"

Savingforcollege.com recently published the performance of 529 plans nationwide for 3- and 5-year time periods. The results? Massachusetts, New Hampshire, and Rhode Island scored in the bottom quartile. (Maine was in the middle of the pack.) Morningstar publishes an annual evaluation of 529 plans using a broader set of criteria including management teams, fees, and risk-adjusted performance. New England plans didn't fare much better here. Massachusetts, Maine and New Hampshire scored a "Neutral" rating and Rhode Island a "Negative", compared to 27 other plans which earned ratings of Gold, Silver or Bronze.

Some states give state income tax incentives to 529 plan savers, but that's not an issue here in New England. Massachusetts offers no tax breaks, New Hampshire has no state income tax, and Maine offers a tax deduction for contributions to any 529 plan. Rhode Island offers a small tax break that works out to less than \$100 per family per year. Thus, New England residents have little or no incentive to stick with their state's 529 plan, and can benefit by going out of state.

Choosing a plan

With so many plans from which to choose, how do you narrow down the choices? The first cut should be plans for which residents of your state are eligible. Morningstar provides a free Web tool for this. Next pass could be limiting your choice to the 27 plans that Morningstar rated higher than Neutral. (For those of you not inclined to browse for the answer, the plans with a Gold rating are in Maryland, Arkansas, Nevada and Utah.)

Fees are an important factor, as funds with lower expense ratios typically have better long term performance. For 529 plans, annual fees range from 0.13 percent to 1.88 percent. Another factor which significantly impacts cost is whether you purchase the funds directly or get them through a financial advisor or broker, the latter of whom will add on their own fee. Speaking as an advisor, I can honestly say that individuals can do nearly as well choosing a good 529 plan as an advisor can, given the limited number of plans available and the fact that the composition of the funds based on student age aren't dramatically different. (On the other hand, choosing from 7000-plus mutual funds and over 1400 exchange traded funds for your retirement assets can benefit from the help of a professional.)

Heed the Rules

Like any tax-advantaged plan, there are a few rules of which you should be aware. The main one is that you can only make one change to existing investments per year, which includes changing investments within a plan or moving them to an out-of-state plan. More than one change, and you may incur rollover fees. Withdrawals for non-qualified expenses incur a 10 percent penalty on the earnings portion of the withdrawal. Also pay attention to the rules governing transfers between family members.

The Most Important Rule

As much as I value education, I place even greater importance on how people choose to pay for it. The biggest mistake I see parents making is funding their kids' education at the expense of their retirement savings. There are many ways to pay for college, including financial aid, loans, and grants if your child applies to colleges where they are among the top tier of applicants. Just keep in mind: you can borrow to pay for college, but not to fund your retirement.

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