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## College Savers Stuck in Stocks as Market Falls

### IRS Rule on 529 Plans Allows Just One Portfolio Shift a Year; Weighing a Cheaper School

By JANE J. KIM

A rule designed to protect investors in 529 college-savings plans is having the unintended side effect of preventing them from shifting to more-conservative investments as the stock market swoons.

When Charles Strawbridge of Ashtabula, Ohio, got nervous about the markets this past spring, he wanted to boost the bond allocations in the 529 plans he had set up for his 16- and 19-year-old sons. But because he and his adviser, Matt Olver of Cleveland, had already changed his investment mix in January, he had to keep his current allocation of 20% and 25% in equities for his older and younger sons, respectively.



Getty Images

### The School of Hard Knocks

The market turmoil is causing many investors in 529 college-savings plans to rethink their strategies. Here's what to consider:

- If you have a young child, consider increasing your equity allocation.
- Move to more-conservative options if your child will be starting college soon.
- [Research 529 plans at Savingforcollege.com or Morningstar.com.](#)

Now, after watching the accounts drop in recent weeks, he's telling his older son -- who is in the process of transferring colleges -- to consider less-expensive schools. "We do have to keep in mind the downturn that the market has had on his available funds," says

Mr. Strawbridge, a 55-year-old accountant. "It was unfortunate that we couldn't have made the move. It takes a little bit off the table."

With 529 plans, investors put after-tax dollars into an account that typically offers a range of mutual funds and other investments. Distributions and earnings are tax-free, as long as they're used for higher education. The plans have grown in popularity in recent years -- they held about \$110 billion in assets at the end of the second quarter -- although the pace of net new investments into the plans has started to slow, according to [Citigroup Inc.'s Financial Research Corp.](#)

Amid the current market turmoil, more investors like Mr. Strawbridge are running into one of the quirkiest restrictions of these state-sponsored plans: an Internal Revenue Service rule that limits investors to one investment change per calendar year. The rule is intended to keep people from making knee-jerk reactions to market moves, but some investors and financial advisers say it makes the plans overly restrictive. Indeed, the College Savings Plan Network, a membership organization of state 529 officials, investment firms, program managers and others, is considering asking the Treasury Department to raise that limit to four times a year.

But that's not the only feature of 529 plans that's causing investors grief right now. Many investors use age-based portfolios that automatically shift to more conservative investments as the child nears college. Yet some of these conservative portfolios may actually hold a high percentage in stocks. North Carolina's National College Savings Program has an age-based portfolio that can hold just over 50% in stocks, including real-estate securities, just one year before the child starts college. That portfolio, which is part of the state's CollegeHorizonFunds managed by J.&W. Seligman & Co., was down 15.7% for the 12 months ended Sept. 30. Given the big market drops this month, the plan has likely posted additional losses.

Seligman's age-based portfolios were designed to create "the opportunity for capital appreciation" while becoming "extremely conservative" in college, says Charles Kadlec, the firm's managing director. The CollegeHorizonFunds move to 100% cash in the last two years of college, he says.

Other plans with more-aggressive portfolios include Nebraska's broker-sold AIM College Savings Plan, which can have as much as 40% in equities when the child is one to three years away from college, and South Carolina's Future Scholars direct-sold plan, which can have up to 33% in equities with college enrollment one to two years away.

### Keeping Pace With Tuition

Such equity exposure may help investors keep pace with tuition increases, some investment managers say. "If you're a senior in high school, you still have five years before you hit your senior year of college," says Tom Kazmierczak, senior product manager for T. Rowe Price Group Inc.'s 529 unit, whose portfolios for students starting college in 2009 can hold up to 28% in stocks and up to 20% while the child is in college.

## College-Savings Plans Take a Hit

Hurt by the market turmoil, some investors in 529 college-savings plans are reevaluating their options. Here's what to consider if you fit into one of these categories:

- **Scenario: You have a young child, and your savings have taken a big hit.**

- **What You Can Do:**

Don't panic—you should have time to make up losses if your child is very young. Keep in mind that if you switch to more conservative options now, you may miss out on future stock market gains.

Increase your equity allocation or contributions to buy more stock at cheaper levels.

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- **Scenario: The market volatility has made you realize you're a more conservative investor than you thought.**

- **What You Can Do:**

Switch to more conservative investments, such as bonds, money-market funds and CDs. But keep in mind that you may miss out on future market gains.

Consider rolling over your investments to a 529 prepaid plan.

If you're in an age-based portfolio, check to make sure you're comfortable with the asset allocation as it progresses.

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- **Scenario: The market has wiped out your investment gains and your child is about to start college.**

- **What You Can Do:**

Delay tapping the plan until your child is in his third or fourth year of college.

Change the beneficiary to a younger sibling to give the investments time to recoup their losses.

Be prepared to tap other resources, such as other investments and federal student loans.

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- **Scenario: You want to change your investment allocation but you're limited by the once-a-year restriction.**

- **What You Can Do:**

Change the beneficiary. Doing so will allow you to change the investment allocation immediately.

Redirect how your future contributions are invested.

If your child is already in college, consider making a partial qualified withdrawal. If you specify which investments you want the distributions to come from, you can use that to help rebalance the allocation.

Source: WSJ research

But the market is proving to be too nerve-wracking for some investors. After watching her 529 college savings plans fall by about 20% in recent weeks, Jeanine Clark of Poway, Calif., is considering pulling money out of the plans altogether -- even though she would get hit with taxes and penalties. "I can't afford to lose it all," says the 43-year-old physical therapist, who has close to \$200,000 invested in two Nevada 529 plans for her 6- and 14-year-old sons.

Ms. Clark's financial planner, Mary Van Nostrand of San Diego, says she moved many of her clients with other types of accounts into conservative investments in recent weeks. However, she decided not to do so with Ms. Clark because the restrictions in the 529 plan meant Ms. Clark wouldn't be able to switch back into equities until next year, and thus would miss out on gains if the market bounced back in that time.

"If you're trying to avoid some of the craziness that's going on in the markets right now, you're kind of stuck," says Ms. Van Nostrand.

Executive directors for the Virginia, Ohio and Utah 529 plans say they're seeing a jump in the number of account holders who are switching their investments to safer investments such as certificates of deposit, stable-value funds or money-market funds. The Utah Educational Savings Plan received more changes last week than it typically processes in a given month, says Lynne Ward, the plan's director. TIAA-CREF, which manages eight state 529 savings plans, says it is seeing similar trends, especially with account owners who have kids close to college age.

### Paring Back Equities

Families who are planning to tap their funds in the next year or two should be looking at paring their equity exposure and transferring their money to more conservative assets, say financial planners. Some plans, such as Ohio, Montana and Arizona, offer CDs as investment options. Others may want to move their savings to a "prepaid" 529 plan, in which families can lock in current tuition rates, says Fred Amrein, a financial planner in Wynnewood, Pa. He has been transferring some of his clients' investments to Pennsylvania's guaranteed savings plan, which resembles a prepaid plan.

The market turmoil is hitting families with children who are juniors and seniors in high school the hardest, since there is less time to make up the losses. In those cases, investors may have to delay, if possible, tapping their plans until the child is in their third or fourth year of college, says Jason Cole, a financial planner at Abacus Wealth Partners LLC in Philadelphia. Parents can also use the funds for graduate school or change the beneficiary to a younger sibling, he says.

On the other hand, investors with younger children may want to boost their equity allocation to take advantage of lower prices. T.J. Kohler of West Bloomfield, Ind., says that while his plans are down about 30%, he has boosted his contributions for his 4-, 3- and 1-year-olds, since they are years away from needing the money. "Ten years from now, this will be a blip in the marketplace," says the 35-year-old software engineer.

Investors can also get around the once-a-year investment restriction by changing plans or switching beneficiaries. And since the limits apply only to money that has already

been invested, savers can always redirect how their future contributions are invested to gradually change their allocation.

Those investors whose 529 plans are "under water" -- that is, whose value is less than what they've put in -- could completely cash out of the 529 plan without paying federal taxes and penalties no matter what they use the money for, since federal taxes and penalties are assessed only on earnings, says Mr. Olver, the financial planner. Investors can also claim the loss as a miscellaneous itemized deduction, though they may be hit with state taxes, says Joe Hurley of Savingforcollege.com.

Paul Saam of Austin, Texas, says that while his two 529 savings accounts are down by about 20%, he's not overly worried. "With two kids under two, I'm not too concerned about how the market affects their college savings," says the 33-year-old, who works at a medical-devices company.

Still, he says the lack of flexibility with the plans is a "little bit frustrating. When you're tied down to one change a year, it's a little scary. The market downturn made me think about asset allocation a little bit more than I had before."