Asset Allocation in 529 Plans

Parents with young children have two broad choices when investing for higher education. One is to invest as you did before you had children, with assets in taxable and tax deferred accounts, under your own names. This will give you maximum flexibility in terms of investment choices and tax planning. When the time comes, you can peel off assets to pay college bills. (Financial advisers may advise against tapping retirement accounts to pay for college.)

The other approach is to have a dedicated college fund, or one college fund for each student. One advantage of this method is psychological; you may be reluctant to use higher education money for a cruise or a luxury car lease.

In addition, a dedicated college fund has a compressed time horizon. When the child is in his or her late teens and early twenties, the money will be needed. If the portfolio value has dropped sharply before and during those years, there may not be enough time to recover losses, let alone continue to grow.

Why 529 is the Magic Number

For parents and grandparents who prefer a dedicated college fund, 529 plans—named after a section of the tax code—are increasingly appealing. Over $275 billion is invested in these plans, mainly in college savings plans that are similar to 401(k) retirement plans in that account holders choose from a menu and enjoy untaxed investment income. (Some 529 plans are prepaid tuition plans, which operate differently.)

Unlike 401(k)s, 529 plans are largely funded with after-tax dollars. As an offset, all 529 withdrawals can be tax-free, whereas 401(k) distributions are taxable. To qualify for tax exclusion, 529 withdrawals must not exceed the amount spent on qualified higher education costs, which generally include tuition, fees, room, and board.

Age-old Question

The holders of 529 accounts face a dilemma when it comes to investing. To make the most of the benefit of tax-free distributions, 529 plans should be invested for growth. The tax savings from an account that

has gained, say, 2% a year will be much less than the tax savings from a 529 account in which growth has been 7% or 8% a year.

On the other hand, for a 529 account to grow rapidly, investors must put money into volatile assets, such as stock funds. That brings the risk of poor timing; your student might enter college after a bear market has depleted the 529 account, which could leave your student with a smaller college fund.

Investment professionals may suggest a "glide path" strategy to address such concerns. For a young child who is 10, 15, or even 18 years away from high school graduation, 529 money might be invested mostly in equities with a hope for strong growth. As college nears, the asset allocation can shift from stocks to bonds and cash. Some observers assert that a 529 account should be very light (perhaps less than 10%) in equities by the time of college admission, minimizing risk, whereas others suggest a somewhat larger position in stocks for continuing growth potential.

Packaged Portfolios

Parents who like the idea of a glide path can choose from a 529 plan's menu. Every year or so, move money from aggressive to more conservative investment options.

If you don't feel up to such maneuvers, or just prefer not to be bothered, don't fret. "Age-based" portfolios usually are offered to 529 investors. Essentially, these portfolios are on autopilot so that your child's 529 account will become more conservative over time.

Nevertheless, an age-based portfolio in one state's 529 plan may be much different from another state's. Before signing up, look at the details carefully. Are you comfortable with the underlying asset allocation and the way that allocation will shift? There may be multiple options to consider within one state's plan, as well as from different states. Make sure you know just how your college fund will be managed.