Morningstar Testimony to the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

Subject: 529 College Savings Plans

Hearing Date: June 2, 2004

Thank you for the opportunity to appear before this distinguished Committee. My name is Dan McNeela. I am a senior analyst with Morningstar Inc., an independent investment research firm that provides data and analysis on mutual funds and other investments. More than 150,000 individual investors and 80,000 financial planners subscribe to our services. In addition, our investment Web site, Morningstar.com, has more than two million registered users.

More than a year ago, we began to cover 529 savings plans, which, as our research has shown, have much to offer. I now lead a team of four analysts that reviews all 529 plans in existence. Our analysis shows that a well-chosen 529 plan is an attractive investment vehicle. To inform their investment decisions, we write commentaries that detail the benefits afforded to 529 investors. Such advantages include considerable investment flexibility, tax advantages, high contribution limits, and diversification.

Today's hearing is important because 529 savings plans are increasingly becoming a valuable tool for parents saving for their children's education. Our most recent figures show that investors have assets totaling more than $47 billion in 529 savings plans. Studies show that after retirement savings, putting money away for college is often parents' top financial goal.

That said, my testimony focuses on the shortcomings of 529 plans. Several areas need substantial improvement. All too often, high costs, poor disclosure, and an unreasonably complex structure greatly diminish their potential value.

Complex Cost Structure

Some of our greatest concerns relate to the myriad costs investors pay to participate in a 529 plan. Investors face enrollment fees, account-maintenance fees, administrative fees, management fees, and in many cases broker fees. Some of those costs are dollar-based, while others vary depending on the amount invested in the plan.

Calculating the specific fees associated with a particular investment option can be a major undertaking. Most plans are set up as funds of mutual funds, whereby a single investment option represents a basket of underlying funds. To arrive at the total expenses of a single investment option, investors first must prorate the costs of the underlying funds depending on their weighting in the portfolio and add the costs of all those funds together. Any associated administrative fees and broker fees, if applicable, must be added to arrive at a total. Even at that point, dollar-based fees are left unaccounted.

That process is frustrating enough for investors, but most 529 plans exacerbate this problem by burying this important cost information in the back of a 100-page program-disclosure document. At its worst, the complexity of the cost structure and the reluctance to make the information easily accessible amount to deceit on the part of 529 providers.

The simplest solution is to require plans to prominently feature cost information on their Web sites and in their literature. Costs should be presented both at the base level, so investors can see what they're paying for; and in aggregate, to summarize a plan's expenses. In situations where costs vary depending on the chosen investment option, total costs for each investment option should be clearly outlined. In effect, this summary expense data would serve the same purpose as that of expense ratios for mutual funds.

Finally, 529 plans should heed the calls that mutual funds are hearing for better cost disclosure by providing cost estimates in dollar terms as well as percentage terms. A projection of total costs based on a $10,000 investment would serve investors by making comparisons between competing plans much easier.

Exorbitant Fees

Clear disclosure of costs in both percentage terms and in dollar terms should help alleviate the other major problem of 529 plans. In short, too many 529 plans are prohibitively expensive. One reason plans are so expensive is that several groups are in line to collect fees. With states, fund companies, brokers, and third-party administrators all putting their fingers in the pie, it's no wonder that investors can end up with a knuckle sandwich.

Anyone who says that costs don't matter is most likely a recipient of those fees. Plan costs come out of investors' pockets on a dollar-for-dollar basis. Although the debate between low-cost index funds and more-expensive actively managed options is worthwhile, overcharging for lavish advertising campaigns and bloated administrative expenses is reckless and unfair.

Our recent review of 529 plans turned up several plans with investment options whose costs approach or exceed 2% of assets for class A shares. This figure does not include front-end sales costs, which can be as much as 5.75% of assets or any dollar-based fees. Collectively, these expenses significantly diminish potential gains. If long-term returns before fees average 6% annually, expenses could consume more than a third of an investor's potential gains.

The difference between paying 1% or 2% in annual asset-based fees may seem minuscule to uninformed investors, but presenting those costs in dollars and cents, and projecting them over a multiyear period, will shed light on this issue. In the aggregate, we can see how meaningful the potential differences become. With $47 billion in 529 plans, a 1% asset-based fee costs 529 investors $470 million annually. At a 2% fee level, annual costs to 529 investors rise to $940 million.

How Fees Are Used

Although fees and their transparency are important issues, 529 plans also have the responsibility to disclose how fees are used. This concern focuses on administrative fees, which vary greatly among plans. Tennessee's plan, for example, is cheaper than average because it uses low-cost index funds and lacks a broker-sold option. Its cost structure is also simple, because it charges a flat 0.95% regardless of the investment option. But Tennessee's administrative costs are unreasonably high. The plan's disclosure documents do not explain why it costs nearly 50% more than nearly identical plans offered by Michigan and Missouri. Tennessee charges as much as 0.88% in administrative fees, without accounting for how that money is being used. By comparison, Utah reports that it has been able to cover its operating costs by charging a mere 0.25% in administrative fees.

States that offer 529 plans need to be accountable for fees. Citizens have a right to know how their money is used. The first step toward achieving that goal is improved disclosure. We believe that states should tell investors how much money they collect and where that money ends up. Are fees paying for splashy advertising campaigns or defraying the costs of other projects? To date, states haven't felt compelled to provide answers.

Selection of Investment Manager

In a similar vein, residents receive little information regarding how their states selected fund company partners. States should be forthcoming about the selection process and the criteria used. They should fully explain the terms of the deal, including any benefits the states will receive and how their choice serves citizens.

Evaluating Performance

The final area in need of improved disclosure is evaluation of performance. Investors currently receive information regarding the performance of the various investment options for both short-term and long-term periods. But to grasp how well their plan is performing, investors need to see the performance of relevant benchmarks alongside the plan's returns. These benchmarks should reflect the asset classes in which the investment options are invested. Because many of the investment options include both stocks and bonds, blended benchmarks-which combine returns from different asset classes--are most appropriate. It is important that this comparison relates to the actual performance of the investment options net of all asset-based fees. If this is done properly, plans saddled with poorly performing funds and high cost structures will have few places to hide.

As a supplement to those numbers, plans should provide investors with a written commentary explaining why the investment options did better or worse than their benchmarks. This analysis, which need not be lengthy or complicated, would markedly demonstrate accountability.

Spark Competition

One problem plaguing citizens in many states is an uneven playing field. Twenty-six states offer a deduction on contributions, but typically that benefit is not bestowed on those who invest in an out-of-state plan. Seven states that grant tax-free withdrawals for citizens who opt for the home-state plan withhold that benefit from those who choose an out-of-state plan. In Illinois and Mississippi, residents who choose an out-of-state plan give up both benefits.

The end result is that citizens in many states become captive to their home-state plan. Their decision is based on weighing the advantages of a mediocre in-state plan with state-tax benefits versus those of a superior plan that foregoes in-state benefits. Often the choice is not determined by which is the best plan. Without having to compete head-to-head with other plans, states can raise fees and craft a plan that favors state interests over citizens'.

Wisconsin residents are acutely aware of this problem. Not only were they saddled with above-average costs and a subpar investment manager in Strong Capital Management, but then the market-timing scandal tainted Wisconsin-based Strong. Wisconsin's citizens are stuck with hoping for improvement or with leaving the Wisconsin EdVest College Savings Program, which means giving up state-tax deductions.

To address this issue, we suggest that federal legislators consider changing the definition of a qualified tuition-savings plan to include only plans from states that don't discriminate against out-of-state plans. Individual states are reluctant to act unilaterally based on fears that competing plans will raid their plan without providing equal opportunity. A federal law requiring equal treatment would put those fears to rest, but more importantly it would allow investors freedom to select the best plans in the market.

Make Sunset Provisions Permanent

The Economic Growth and Tax Relief Act of 2001 boosted 529 plans significantly by making qualified withdrawals from 529 savings plans free from federal taxes. The hitch is that the federal tax exemption is set to expire in 2010. Although we recognize the need for fiscal restraint, this uncertainty is troubling for 529 investors. Saving for college is a long-range goal, and investors need to know that promised tax benefits will be there when the tuition bills come due. Each year the tax exemption is not extended, investors become less certain that the benefits will remain. We encourage you to secure the federal tax exemption on qualified withdrawals as soon as possible.