Education and Local Government Interim Committee

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60th Montana Legislature

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# Montana Family Education Savings Program

## *STAFF REPORT TO COMMITTEE*

Tuesday, September 25, 2007

## Introduction

During the June 2007 meeting, the Education and Local Government Interim Committee (ELG) discussed complaints that members have received from constituents related to the Montana Family Education Savings Program. Those complaints include:

- That the Pacific Life 529 investment plan charges a 5.5 percent sales fee that significantly reduces the return on investment of the college savings plan
- That this same plan also charges an annual 2 percent expense fee on investment accounts
- That state tax law requires that if Montana resident investors decide to move their funds to a different state 529 investment plan in order to improve their return, that they must pay back taxes for the Montana tax deduction that has been taken in prior years

Committee members asked staff to look into these complaints and provide a report to the ELG on the Montana Family Education Savings Program (MFESP) at the September meeting.

As a result, legislative staff conducted a thorough review of the MFESP and the complaints that primarily originate from an online blogsite at http://leifw.blogspot.com/2007/05/bum-deal.html (see report appendix documents for details).

In addition to a detailed reading of the blogsite and the linked documents, the staff review included a meeting with MFESP management staff, a review of oversight committee meeting minutes, attendance at a meeting of the Board of Regents where the program was discussed, and a review of independent evaluation and analysis reports of the MFESP. Based upon that review, this staff report is intended to address the following for the committee:

- A clear explanation of the MFESP, including statutory authority, program oversight and management, investment options, and the fee structure
- An analysis of the constituent complaints about MFESP
- A review of management options that are being considered by the MFESP oversight committee and the Board of Regents
- A discussion of legislative options in this matter

## Program Authority and Background

The Montana Family Education Savings Plan, sponsored by state government, is a tax advantaged investment/savings plan that helps families to save money over the long-term to pay for higher education costs when their children enter college. Also known as a “529 Plan” for the reference to the Internal Revenue Service code section that authorizes the federal tax savings (26 U.S.C. 529), the MFESP allows families to invest funds that will grow tax free as well as use the disbursements to pay for higher education without paying tax on the withdrawals. In addition, Montana residents are able to claim a state income tax deduction for the annual investments, up to $3,000 per person or $6,000 for married couples.

MFESP is authorized by 15-62-101, MCA and 20-25-901, MCA, which create the tax advantage program and designates the Montana Board of Regents as the responsible party to administer the program, the trustee of the funds invested. The Regents are authorized to create an oversight committee, seven members who are appointed by the Governor including:

- Commissioner of insurance
- State Treasurer
- Board of Regents Chair
- Four members of the general public with knowledge and skills in the investment field

The oversight committee is authorized to hire a management company who will offer the investment products and manage the funds in each of the individual investor accounts. Statute does require that the oversight committee and the Regents consider the fees and management costs to the investor charged by the hired management company as one of the criteria for retaining those services. That investment manager contract may be terminated by the Regents.

According to 15-62-101, MCA, “It is the intent of the legislature to establish the Family Education Savings Act … a program that will encourage and make possible the attainment of an accessible, affordable postsecondary education by the greatest number of citizens through a savings program. The legislature further intends that the board [Regents] achieve this purpose most effectively through a public-private partnership using selected financial institutions to serve as depositories for individuals' postsecondary education savings accounts.”

The Regents administer the program in accordance with Board of Regents policy section 950.2 that outlines specific operating procedures.

As of July 2007, the MFESP had more than 16,000 investor accounts and assets exceeding $200 million. By comparison, other state 529 plans report the following assets as of December 2006:

- Oregon reports 89,383 investor accounts with $761 million in assets
- Washington reports 67,170 investor accounts with $788 million in assets
- California reports 170,663 investor accounts with $2.24 billion in assets
- Idaho reports 12,892 investor accounts with $107 million in assets
- Utah reports 87,087 investor accounts with $1.9 billion in assets
- Colorado reports 200,085 investor accounts with $2.3 billion in assets
- New York reports 487,253 investor accounts with $6.3 billion in assets

In accordance with 15-62-203, MCA, and the prescribed procedures, the Regents hired College Savings Bank, a financial institution, to serve as the program investment manager. College Savings Bank is a wholly owned subsidiary of Pacific Lifecorp of California.

## College Savings Bank 529 Investment Plan Options

As the program investment manager, College Savings Bank has put together two investment product options for Montana 529 investors to select:

1. College Sure Certificate of Deposit (CD) is a traditional CD product that matures with the option of one to twenty-two years and the earnings on the CD are indexed to college costs. Specifically, the annual percentage yield is to be no less than the college inflation rate less a 1.5 percent margin, with that inflation rate identified each year as part of the Independent College 500 Index kept by the College Board. From the website of the College Board at http://www.collegeboard.com/highered/res/ic/ic.html:

> ***The Independent College 500 Index (IC 500) is compiled annually from College Board data about the costs of enrollment in higher education.***
>
> ***Using enrollment-weighting techniques, the College Board can calculate a student's average annual expenses and compute average prices charged by institutions.***
>
> ***The IC 500 measures the rates of change in direct charges for most first-year, full-time students at 500 participating independent colleges. At least 15 percent of full-time undergraduates live in college housing at these institutions which also represent the highest aggregate direct charges (enrollment times total direct charges).***
>
> ***A look at the last two academic years helps to illustrate the changes in cost:***
>
> ***IC 500 value for 2006-07: $33,270***
> ***IC 500 value for 2007-2008: $35,272***
> ***This represents an increase of 6.02 percent over one year—important information for anyone concerned with the cost of higher education today.***

So using this formula, the rate of return for the College Sure CD for an investor during the year noted above would be 4.52 percent, the annual inflation rate of 6.02 percent minus the 1.5 percent margin.

The College Sure CD has no application, enrollment or other management fees or charges, and the CD is FDIC insured. As part of the Montana 529 program, Montana resident investors are entitled to a state income tax deduction of $3,000 per individual or $6,000 per married couple. And the interest on the investment would be tax free.

The only fees associated with this CD product involve changes made by the investor to an existing account, including a $50 fee for more than one change to the designated beneficiary, and $50 for more than one change to the account owner.

The logic behind this indexed investment product lines up with the legislative intent, as the rate of return tracks with the higher education inflation rate so that the family is able to purchase college costs in the future at the value of the dollars invested today.

There have been no known constituent complaints registered against the College Sure Certificate of Deposit.

2. Pacific Life Funds 529 College Savings Plan is a mutual fund product that allows the investor to either purchase direct from Pacific Life or work through a broker, though only Montana residents have access to the direct purchase mutual fund product.

   It is the mutual fund product that has been the target of citizen and constituent complaints to legislators, the Governor, and to the Board of Regents. The Commissioner of Higher Education reports receiving approximately 12 complaints while legislative staff have received reports of three complaints from legislators, and it is unknown how many have been received by the Governor, though a number have been passed to the Regents from the executive office. Again, many of these complaints appear to trace their origin from the blogsite discussed above, specifically that the issues raised and the supporting references are identical.

   A primary focus of the complaints received are directed at the 5.5 percent annual broker's fee that has been charged to Montana investors. It should be noted, however, that this 5.5 percent fee is an industry standard fee charged to investors by their brokers and, in the case of the Montana 529 plan, this fee is not charged by Pacific Life.

   Of course, Montana residents can avoid paying this 5.5 percent annual fee if they work directly with Pacific Life and not through a broker as the direct sale option is available for Montana residents only under the 529 plan. Non-residents may only buy into this plan through a broker and so cannot avoid this fee.

   Like all mutual fund products, the Pacific Life 529 Plan offers investors a series of portfolio options based upon type of company stock or bonds offered (e.g. large capital, international, managed bonds, etc.) that are also rated by risk level that correlates to the potential rate of return; the higher risk products offer the higher interest rates.

### *Pacific Life Mutual Fund Fees*

At the time of the blogsite postings in the spring of 2007, a comparison of the fund expenses and fees for the Montana 529 Plan offered by Pacific Life indicated that only Arizona and South Dakota had higher expense costs than the Montana plan (ranked against 85 plans with more than 700 investment options). At that time, the Pacific Life Montana Plan fees ranged from .95 percent to 2.05 percent, and this would be in addition to the 5.5 percent annual broker fee for those investors who did not work directly with Pacific Life. Of course, Montana residents do have the direct purchase option that avoids the 5.5 percent fee.

An analysis of fee rates offered by 53 state 529 plans that was completed by Savingforcollege.com, LLC in early 2007 illustrated that over a ten year period of time with a $10,000 investment portfolio yielding a 5 percent return, the Montana 529 Plan offered by Pacific Life would charge fees that range from a low of $1,966 to a high of $3,502. These were the highest expense levels among the 53 plans that were reviewed.

Therefore, based upon the fee/expense structure illustrations and the ratings by independent industry analysts, the Montana 529 Plan did indeed rank among the top plans in the nation for costs and expenses, those charged specifically by Pacific Life.

## Consultant Conclusions and Response by the MFESP Program

In response to the complaints received and concerns expressed by Montana investors, the MFESP oversight committee commissioned an independent consultant to evaluate the Montana 529 Plan in early 2007, hiring Gardner Financial Group, LLC to conduct that evaluation and report to both the committee and to the Board of Regents. In addition, the oversight committee tasked MFESP staff to complete an informal "Request for Information" (RFI) that involved meetings with at least 6 other state 529 program/investment managers.

As a result of these evaluations, the independent Gardner review concluded about the MFESP program and its 529 Plan products, in a report dated March 19, 2007:

- The Montana 529 Plan has very high fees relative to other 529 plans
- There are very high fees relative to similar mutual fund categories
- That higher fees are having an impact upon investor returns
- That most of the individual funds are performing below the industry category averages and benchmarks
- That there is average overall performance in static portfolios
- Most assets are flowing to the CD option (College Sure Certificate of Deposit), which eliminates opportunity for higher investor returns and compounding of investments

Based upon these conclusions the oversight committee charged staff with negotiating with Pacific Life for specific improvements in the investment products, including a reduction in the fee and expense structure. These discussions have resulted in the following:

- The fee and expense structure charged by Pacific Life for the Montana 529 plan has been reduced so that according to industry analyst Morningstar, the Montana plan fee/expense range is 1.18% to 1.44% as of May 31, 2007. This range is very much in line with the other 529 plans across the nation
- Pacific Life, through the College Savings Bank, has designed a new investment product to offer MFESP, the Investor Sure CD, which would, like the College Sure CD, have no enrollment or other management fees, but would have a higher rate of return as it would be similar to an indexed mutual fund. The Regents will be considering whether to approve this new CD product for the MFESP at their September meeting

The discussion with Pacific Life also clarified why their specific 529 product tends to have higher fees relative to other fund management companies. Specifically, Pacific Life uses an investment model based upon the "Modern Portfolio Theory" that utilizes a "fund of funds" approach to offering a diverse portfolio to investors. Under this model, each fund may likely have its own fund manager or sub-advisor for each individual fund in that "fund of funds." Each of these sub-advisors charges a fee and must be paid, so that the overall cost of the investment product to the investor is an incremental sum of the costs of multiple sub-advisors. MFESP staff discussed with Pacific Life the concept of adopting an alternate investment model that would reduce these sub-advisor costs, but Pacific Life is committed to this model and has no plans to change.

## Options Considered by the Board of Regents

In addition to considering a new CD investment product to expand investor options in the MFESP discussed above, the Board of Regents is considering the following additional options as recommended by their staff RFI and the independent consultant report:

- Launch a "request for proposal" (RFP) process in order to locate a new fund manager for the Montana 529 Plan to replace Pacific Life.
    - ***Complication:*** The statute does not allow the transfer of 529 funds without the individual investor paying a surrender penalty so that existing accounts would have to pay in order to switch to a new investment manager product. So this option would not necessarily provide relief for current investors. A new company could potentially pay this transfer fund in order to build its investor accounts, but the small size of the MFESP asset base would likely preclude this from being a good economic investment for a new program investment manager.
- An RFP process to locate an **additional** fund manager that could offer additional investment products that may provide better options than the Pacific Life products.
    - ***Complication:*** Similar to the prior option, this may not provide relief for existing account investors.
- Work with the current investment manager, Pacific Life, to continue to negotiate changes to the existing plan, including negotiating lower fees, additional options, etc.
- Partner with another state 529 plan in order to pool account assets that may allow leveraging superior investment products. During the staff RFI it was noted that at least two states, Colorado and Oregon, expressed interest in considering a multi-state program consolidation.
    - ***Complication:*** The current statute requires that the Montana 529 Plan have a local administrator, the Board of Regents, so that any consideration to partner with another state would require a statute change to allow a non-local administrator.
- Allow the current contract with Pacific Life to expire (June 2009) and then consider new options with an RFP to locate a new investment management company.
    - ***Complication:*** Similar to the prior options, this may not provide relief for existing account investors.
- Montana could administer its own direct sold investment products, as Utah does, and eliminate the need for an investment manager company.
    - ***Complication:*** This would require a large upfront administrative cost including detailed planning, creating specialized key FTE staff positions, etc., though a partnership with the Montana Board of Investments could be considered to ameliorate those costs.
- More aggressively educate Montana resident investors to use the direct-sold option to make investments, rather than the broker sold option, in order to reduce their expenses associated with the industry standard 5.5 percent management fee charged by brokers.

- *Complication:* One can argue that the broker "adds value" to the investment decision through the individualized advice provided to the investor. To encourage the elimination of this broker and the associated value may create the perception of MFESP liability for the future performance of the investment products as well as place MFESP into the role of broker-advisor.

It should be noted, in considering the options that include moving to a new program investment manager to replace Pacific Life, that the Gardner consultant report states the following:

- "Based upon my knowledge and experience with other 529 college savings programs and large institutional accounts nationally, it is my opinion that based on the current program in place in Montana that it will prove difficult to easily transition to a new program manager…based on how institutional accounts are priced and placed on asset size, average account balances, record keeping fees, and program costs."

Essentially, given the size of the existing Montana asset portfolio, the statutes that require penalties for account transfer, and the future investment asset potential of the Montana market, there is concern about how attractive the MFESP would be to other investment management companies. For comparison example, see the asset base of other states' 529 plans on page 2 above.

## Legislative Options

Should the legislature wish to take action to address the issues and complaints raised by constituents about the MFESP and the Montana 529 plan, the following are options to consider:

- The legislature may want to "weigh-in" by making a recommendation on the above options being considered by the Board of Regents, including consideration of any role the legislature may play in any "complications" related to any option
- The legislature may want to consider expanding the State of Montana income tax deduction eligibility to include 529 programs offered by other states so that Montana residents would have more investment options to consider (those products from other states) and still receive the Montana income tax advantages ($3,000 to $6,000 annual income tax deduction)
- Change the recapture tax provision so that Montana residents who wish to change their investments to another state's account would not be required to pay the recapture tax rates for the prior years state tax deduction, thus allowing current investors to change 529 plans without paying these back taxes
- Do nothing at this time

Respectfully submitted:

Alan G. Peura
Fiscal Analyst II
Legislative Fiscal Division

## Appendix Attached

Attached is a copy of the LeifW blogsite documents that appear to be the primary driver to the complaints that have been received by legislators, Regents and the executive.

# leifw

## About Me

**Name:** leifw

View my complete profile

## Links

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Tuesday, May 29, 2007

## A Bum Deal

Montana's families are getting a bum deal.

A 529 plan is a college savings account that has a number of tax advantages. Most significantly, earnings are untaxed if used for college education. In Montana, another benefit is that contributions to the state's plan are deductible from income taxes. Unfortunately, Montana's plan† suffers from fees so high as to more than offset the benefits.

A deduction against Montana income tax is worth at most 5.175%‡. The Montana plan charges a 5.5% fee* against each contribution, a larger percentage than the value of the deduction. Compare that to Vanguard's 529 plan which charges no sales fee. If you contributed $1,000 to each plan, the Vanguard plan would have a $1,000 balance, while the Montana plan would have a balance less than the original contribution, even if you also contributed your tax deduction. Sadly, the state is offering a tax break to encourage families to act against their best interest.

The Montana plan is also a bum deal in subsequent years. Mutual funds make money by charging a percentage of an account's balance each year. This percentage is called the fund's expense ratio. The funds in Montana's plan have ratios ranging from 1.18% to 1.44%*. The funds in Vanguard's plan have ratios ranging from 0.5% to 0.7%, less than half that of Montana's funds.

To flesh out this comparison, I've published a spreadsheet comparing the growth of a moderate risk fund from each plan. Despite the income tax deduction advantage Montana's plan enjoys, it has a lower balance in every year compared to the Vanguard plan. By the child's 18th birthday, Montana's plan has fallen nearly $20,000 behind. The difference is entirely due to the plan's excessively high fees. For each 1% of Montana's population that uses the Montana-529 plan, an out-of-state corporation earns nearly one million dollars in unnecessarily high fees.

Should we feel some fealty toward the plan because it is Montana's? Absolutely not. The plan is operated by a California company with no offices in Montana. The state's government has essentially licensed Montana's good name to this company in exchange for a bad deal for its citizens.

I'm not the only one who's noticed the deficiencies of Montana's 529 plan. SavingForCollege.com published a report showing that Montana's plan had the highest fees in the country, fees that were usually double, if not triple, those of other states' plans. Arizona dropped Pacific Life's plan last year in favor of plans with lower fees. Montana is now the only state using that company's funds. SmartMoney singled out Montana's plan for having high fees. Morningstar also mentions the plan's high fees and that parents of relatively young children are better off going to another plan.

Clearly something should be done. I propose three changes.

1. Montana should either find a new 529 plan with lower fees or should require Pacific Life to lower its sales load and expense ratios. We should fix what's broken.
2. Montana should offer an income tax deduction for contributions to any 529 plan, not just the state's own. We should not use tax breaks to entice Montanans to settle for a bad deal. We should reward Montanans for saving for college even if our plan remains uncompetitive and they're forced to look elsewhere.
3. We should prevent Montana from slipping into this situation again. The legislature should order periodic reports of the competitiveness of our 529. The Board of Regents, the government body responsible for the plan, has been negligent. Which of the Regents knows that their fund has the highest fees in the county? Hopefully, periodically shining a light on this dark, dusty corner of its

duties will make the Board more mindful.

Please contact your state legislators and the governor and complain about this sorry state of affairs for Montana's families. You can find a sample letter and contact information here.

**Footnotes:**

† There are actually two 529 plans offered by Montana. The plan I'll refer to throughout is the Pacific Life plan. The other plan is offered by College Savings Bank. That plan only offers stable-value investments, such as CDs. These investments yield less than the rate of college inflation. An investment in these options is essentially a money losing venture, as the purchasing power of the funds will be less at the time they're needed than at the time they were invested. Consequently, I consider plans like Pacific Life's, which invest in stocks and bonds, which can achieve average returns above the roughly 6% college inflation rate, the only option. Within the Pacific Life plan, three classes of shares can be purchased. I'm only considering the class A shares, as they're the best long term investment.

‡ The highest personal income tax rate in Montana is 6.9%. Any amount deducted from state taxes is taxed by the federal government. If a taxpayer qualifies for the 6.9% Montana bracket, then he will pay at least 25% in federal taxes. The net value of the state tax deduction is calculated by: (deductible amount) * (state rate) * (1-federal rate), or 6.9% * 75% = 5.175%. See this tax deduction calculator for a better explanation.

* Please see the Pacific Life 529 Prospectus pages 21 through 23.

# posted by leifw @ 8:53 PM

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# leifw

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### Friday, June 29, 2007

## Quote o' the Night

We saw *Heartbreak House* by George Bernard Shaw tonight. Wow. I had no idea he was so good. The quote of the night:

> Give me deeper darkness. Money is not made in the light.

That pretty much sums up how I feed about the ideal office place. Blinds drawn? Check. Lights off? Check. Computer monitor the brightest point in room? Check. Totally reinterpreting another era's social commentary for my own purposes? Check.

# posted by leifw @ 12:00 AM 0 comments

### Tuesday, June 05, 2007

## Write State Leaders About Montana's 529

Perhaps you saw my post about the woes of Montana's 529 plan. Would you be willing to consider writing state officials to let them know how you feel?

Here's a sample letter that you can use.

> Dear *[State Official]*,
>
> Montana has a 529 educational savings plan to help our families save for college. Unfortunately, a recent report by SavingForCollege.com found Montana's plan has the highest fees in the country. These fees add up in a major way, nearing $20,000 when saving

enough for an MSU-Bozeman education. It's hard enough to save for our children's educations without being hindered by one of the most expensive plans in the country.

Please encourage the Board of Regents to investigate why their plan has the highest fees in the country.

Currently contributions to Montana's 529 plan are deductible from state taxes. Please also consider supporting legislation to extend that tax benefit to contributions to any 529.

Finally, please consider how we can keep the Board of Regents accountable in the future. Perhaps mandatory periodic reports comparing the fees and performance of Montana's plan to other plans are appropriate.

See http://montana529.info for more.

Thank you for considering this matter.

Sincerely,

*[Your Name]*
*[Your Address]*
*[Your City, State ZIP]*

To write to the governor, please use this form.

The email addresses of the regents are listed on this page.

To find email addresses for your state legislators, please use Project Vote Smart. On the left side of the page, you'll find a box to enter your zip code. Provided that they'll give contact information for your legislators and a bunch of other folks.

Thanks for thinking about writing. If you do, feel free to post a comment saying you did.

# posted by leifw @ 8:51 PM 0 comments

Story available at

Published on Sunday, June 10, 2007.
Last modified on 6/10/2007 at 2:46 am

# Letter: Montana college plan rips off participants

*Sunday, June 10, 2007*

Montana families are getting a bum deal.

A 529 plan is a college savings account with significant tax advantages. Earnings are untaxed if used for college education. Contributions to Montana's plan can be deducted from state income taxes.

Unfortunately, with every contribution, Montana's 529 plan charges an exorbitant fee of 5.5 percent. Since the net value of a state income tax deduction is about 5 percent, with each contribution, your account actually loses value, even if you contribute your tax deduction.

Compare that to many states' plans that charge no fee for contributions.

Annual fees are another problem. In Montana they are double the annual fees of better plans.

The end result: When you contribute enough to cover the cost of an MSU-Bozeman education, you lose nearly $20,000 to excess fees.

Should we feel loyalty to the plan because it is Montana's? Absolutely not. All these fees flow to Pacific Life, a California company with no offices in Montana. SavingForCollege.com's recent study found our plan had the highest fees in the country.

Arizona dropped Pacific Life last year in favor of funds with lower fees. Montana's is now the only plan using that company. Morningstar and SmartMoney have also noted our plan's high fees.

Clearly something should be done.

1. Our plan should have competitive fees.

2. Contributions to any 529, not just Montana's, should be deductible.

3. The Legislature should require periodic, comparative reports on our 529 plan. The Board of Regents has been negligent. Please see montana529.info for more.

**Leif Wickland**
**Belgrade**