Where to Invest Your College Money

By the Editors of *Kiplinger's Personal Finance* magazine

In partnership with

Investor Protection Trust

Investor Protection Institute

Investor Education in Your Community

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About the Investor Protection Trust

The Investor Protection Trust (IPT) is a nonprofit organization devoted to investor education. Over half of all Americans are now invested in the securities markets, making investor education and protection vitally important. Since 1993 the Investor Protection Trust has worked with the States and at the national level to provide the independent, objective investor education needed by all Americans to make informed investment decisions. The Investor Protection Trust strives to keep all Americans on the right money track. For additional information on the IPT, visit www.investorprotection.org.

About the Investor Protection Institute

The Investor Protection Insititute (IPI) is a nonprofit organization that promotes investor protection by conducting and supporting research and education programs.

Kiplinger's PERSONAL FINANCE

THE FIRST DECISION you need to make once you have decided to start putting money aside for college, is where to save or invest it. Certificates of Deposit (CDs)? Savings bonds? Stocks? Mutual funds? A state-sponsored college-savings plan? The answer depends primarily on the amount of time you have left before you'll start writing tuition checks.

In this booklet, we'll describe the best choices for your long-term investments—funds you don't need to touch for five years or more—and short-term savings. But, because it's fairly common for parents to get a late start at saving, we'll work backward, starting with the safest choices for short-term money, including money-market mutual funds, CDs and government bonds, and progressing to investments that provide better returns but involve a little more risk, such as growth-and-income, long-term-growth and aggressive-growth mutual funds.

All of those investments are among your choices for college savings that you can keep in a Roth Individual Retirement Account (IRA) an Education Savings Account, more commonly known as a Coverdell ESA (and formerly called the Education IRA), a custodial account or ordinary taxable account in your own name.

If you're willing to give up some investment discretion, you might want to consider what many believe is the best college-savings vehicle: state-sponsored college-savings plans, which give you many of the same investment choices in a convenient—and tax-free—package. Before we begin discussing specific types of investments, let's consider why and how your strategy should change with the time you have left before college. In this instance, it makes most sense to begin with a look at the long-term.

Using the Time You Have

If the first tuition payment will be due more than five years in the future, you can put the pedal to the metal—that is, go for the highest possible returns by investing most of your college savings (or as much as your tolerance for risk will allow) in stocks or stock mutual funds. The stock market invariably rises in some years and falls in others, but when you average out the ups and downs, stocks historically have earned more than any other investment.

With fewer than five years until your child heads off to college, you don't need to avoid stocks entirely, but you want to reduce your risk by gradually moving your money out of stocks and keeping more of it in less-volatile investments, such as bonds, certificates of deposit or money-market accounts. By the time you're writing tuition checks, in fact, you probably want your college fund to be entirely or almost entirely out of the stock market.

Here's a rough guideline you may want to follow for allocating your savings among stocks or stock mutual funds (equities) and bonds, money-market accounts or CDs (fixed-income investments).

- **Elementary school years:** up to 100% equities
- **Junior high school years:** 75% equities, 25% fixed-income investments
- **Freshman and sophomore high school years:** 50% fixed income, 50% equities

Where you invest your college money depends on the time you have left before you start writing tuition checks.

- **Junior and senior high school years:** 75% fixed income, 25% equities

- **College freshman year:** 100% fixed income.

This isn't a rigid schedule. The point is to give yourself roughly five years to get out of equities so that you won't be forced to sell in a declining market when you need the money. You don't need to bring your investment mix down to 50% stocks and 50% bonds the very day your child starts his or her freshman year of high school—and you shouldn't if the market has just suffered a big drop. But that's the right time for you to begin looking for a good opportunity to sell some stocks and buy bonds or CDs.

The Safest Safe Havens

If you have a short time horizon before your child is ready to head off to college, you want to concentrate primarily on safety, which means keeping the bulk of your money in interest-bearing accounts or investments, including CDs, bonds and bond funds. Among the short-term selections, your best choice often boils down to the instrument that's paying the best yield when you're ready to buy, for the length of time before you need the money.

Because these investments are designed for safety, there's no need to avoid putting all of your eggs in one basket. You will want to choose your investments so that you can get your money when you need it for tuition, perhaps using a money-market fund for money that you'll be needing in the next year and CDs or bond funds for money that you'll need a little further out. You could reach for a little extra yield by putting some money in an intermediate-term bond fund and the rest in a short-term fund or money-market fund. But using more than two places is probably overdoing it.

A Small Step Up the Risk Ladder

The investment options in this section are nearly as safe as the choices above. But in exchange for taking a bit of risk, you'll achieve a better return, more convenience, or some combination of the two. All are appropriate for money you'll need to use in the next few years and beyond.

TREASURY FUNDS.

SUMMARY: Buying Treasury bills and notes directly may be your best bet if you can hold them to maturity. Otherwise, consider bond mutual funds, which allow you to regularly invest smaller amounts and automatically reinvest your dividends. You can lose some principal if interest rates rise.

Instead of investing directly in Treasury bills and notes, you can put your money into a mutual fund that buys Treasuries (and, often, other government securities). One advantage for going the mutual fund route is that you can automatically reinvest the dividends in more shares of the fund, so you don't have to find someplace else to put your earnings every six months, as you do with Treasuries you hold yourself. In addition, you can withdraw your money at any time. Minimum investments are as low as $1,000.

As with all mutual funds, the fund company automatically deducts a management fee each year. When you buy the bonds themselves, there's no commission if you buy them directly from the U.S. Treasury and only a small one-time commission if you buy them from a broker.

While income from U.S. Treasuries held in a mutual fund is generally free from state and local income taxes, just as if you held the bonds directly, your returns may not be 100% free from those taxes if the fund also holds other government securities, such as Ginnie Maes (government-backed mortgage issues).

RETURN. The returns on Treasury bond funds will be similar to the returns on Treasury bonds and will fluctuate with market interest rates. The yield on a bond fund is the average rate of interest the bonds in the portfolio pay, independent of any fluctuations in value of the bonds. A bond fund's total return will include the impact of changes in the price of bonds themselves.

RISK. By holding a Treasury bill or note to maturity, you're assured of getting all of your principal back. But bond funds never "mature," so there's always a small risk that if interest rates were to rise dramatically, your investment would lose money. Treasury-fund managers try to keep this risk to a minimum by buying a diversified mix of bonds and, in some cases, by sticking with bonds that have relatively short maturities.

ZERO-COUPON BONDS.

SUMMARY: Just as safe as ordinary Treasuries if you hold the bonds to maturity. Interest is paid at maturity, so you needn't worry about reinvesting earnings. But you may have to pay taxes on "phantom" earnings each year instead of waiting until you redeem the bond.

Zero-coupon bonds are an ideal investment if you know exactly when you're going to need your money—as you ordinarily do when you're counting down to the day that your first tuition bill is due. While ordinary bonds usually pay interest every three or six months, zero-coupon bonds don't pay any interest at all until they mature, at which time you get all of the accumulated interest at once. You can think of it as a bond that automatically reinvests your interest payments at a set interest rate, so that you don't have to worry about putting the income to work elsewhere.

Zero-coupon bonds are available in denominations as low as $1,000 and are sold at discounts from their face value, the discount depending on how long you have to wait until the bond matures. The longer to maturity, the less you pay. A $1,000 Treasury zero yielding 5% and maturing in five years, for example, would cost around $784. A $1,000 Treasury zero yielding 5.5% and maturing in ten years would cost around $585.

You'll need to use a broker to buy zeros. You may want to check with more than one, in fact, to compare yields and find bonds that fit your time frame.

Here's an example of how you might use zeros. Say your child will be a freshman in 2013 and you have about $15,000 already saved toward college expenses. You could buy four zero-coupon bonds, each with a face value of $5,000, one maturing in 2013, the second in 2014, the third in 2015 and the last in 2016 as your child enters his or her senior year. In mid 2008, you would be buying at a significant discount, but each bond would be worth $5,000 when it is redeemed, reflecting the yields to maturity.

Zero-coupon bonds are an ideal investment if you know exactly when you're going to need your money.

The most popular zeros are Treasury zeros, or Treasury strips, so called because brokerages "strip" the interest coupons from the bond and sell you just the discounted bond. They almost always pay more than savings bonds. The brokerage redeems the coupons to collect the bond's interest income (or it might sell the coupons separately to an investor who will redeem them). If you buy the "stripped" bonds, you don't get any interest from the bond. But you pay a discounted price for the bond, as illustrated above, and get the full face value at maturity.

Treasury strips are popular—and are a good choice for short-term savers—because there's no risk that the government will default on its obligations. You can also buy municipal zeros and corporate zeros, described beginning on page 6, which pay you a higher rate of interest to compensate for the additional risk that a company or municipality may fail to repay its bondholders.

THE TAX CATCH. The catch to zeros is that while you might be willing to postpone receiving interest until your zeros mature, the IRS isn't so patient. Taxes on the interest are due year by year as it accrues, just as though you had received it. You'll get a notice each year from the issuer or your broker showing how much interest to report to the IRS. Treasury zeros are free from state and local tax, but you'll still pay federal tax on the "phantom" income.

Taxes on the interest zeros earn are due year by year as it accrues, just as though you had received it.

The prospect of reporting and paying tax on phantom interest is one reason taxable zeros are often found in tax-deferred vehicles, like IRAs.

But don't let the tax consequences scare you away from zeros. You can avoid paying a lot of the phantom income tax if you put the bonds in your child's name so that the income will be taxable to the child. The first $900 of investment income a child reports each year is tax-free, and the next $900 is taxed in the child's tax bracket. After the child turns 19, all the income over the first $900 is taxed in the child's bracket.

A word of caution: Bear in mind that when your child reaches the age of majority—18 in most states—he or she can have access to the money. Perhaps a better alternative to avoid the phantom tax entirely is to accumulate money in a Coverdell ESA and eventually buy the bonds in that account, where the earnings will be tax-free.

RETURN. When shopping for zeros, ask your broker for the yield to maturity. That's the return you're guaranteed to earn if you hold the bond until it matures.

Treasury strips are not callable, but some other zero-coupon bonds can be "called" early, meaning that the corporation or municipality that issued the bond can pay off the principal ahead of time. Usually this is done when interest rates have fallen, which prompts companies to pay off their existing debts (bonds) and refinance them by issuing lower-rate bonds. If your zero is callable, also ask your broker for the yield to call. That's the rate of return you'd earn if the bond was called at the earliest possible date.

RISK. Zero-coupon Treasuries, or Treasury strips, are just as safe as ordinary Treasury notes or bills if you hold them to maturity. Like any Treasury, the value of a zero fluctuates with interest rates in the meantime. But because investors wait until the bond matures to get their money and get no interest in the meantime, zeros are more volatile. If interest rates rise, for instance, a five-year zero-coupon bond will fall further in value than an ordinary five-year Treasury will. That's because the "yield" that you're getting doesn't include any interest payments; it's all built into the discounted price of the bond. So the discount shrinks or swells with greater magnitude in response to interest-rate changes than it does on a bond with the buffer—so to speak—of a steady income stream. Treasury strips are a bit riskier than Treasuries in the sense that if you must cash out early, the penalty for doing so may be higher.

ZERO-COUPON BOND FUNDS.

SUMMARY: Here's a good way to buy zeros with small monthly contributions.

Individual zero-coupon bonds primarily make sense for money you've already accumulated toward college bills. They generally aren't practical for ongoing contributions of, say, $100 a month. The smallest zero you're likely to find is $1,000, and $5,000 is more typical. In 2008, to buy a $1,000 bond that matures in five years you would have needed to invest about $872. You could save $100 a month and buy one $1,000 bond every eight or nine months, but a more practical solution may be to invest in a zero-coupon bond mutual fund.

You can hang on to the fund until maturity, at which time you're paid 100% of your principal plus interest, or you can cash in your shares at any time prior to maturity.

If your child will begin college in 2020, you'd probably want to buy a fund that matures in 2023. That way you could withdraw some money in 2020, some in 2021, some in 2022 and the last of it to pay for your child's senior year when the fund matures in 2023. A more conservative approach would be to buy the fund that matures in 2018, take your principal and interest all at once, then move the money to a money-market fund. The discussion of risk, below, explains why.

TAXES. The tax treatment of phantom income is the same as for Treasury strips themselves—you must pay tax on the interest as it accrues, instead of when you redeem your shares.

RISK. There's little risk in buying a zero-coupon bond fund if you plan to hold it to maturity. But the value of the bonds can rise and fall dramatically in the meantime, so you could lose money if you had to sell shares early. The further away the fund's final maturity, the greater your risk of a loss should interest rates rise. As the fund gets within a few years of maturity, the bonds (at that point, they're short-term bonds) are less volatile, meaning that interest-rate swings will have less of an impact on your return. So, if you're not going to wait until the fund matures, the next best thing to do is to wait to cash out within those last few years when the fund is close to maturity.

More Risk, Better Returns

Some parents with five years or less until the college bills come due will want to stick entirely with the low-risk choices discussed so far, even if it means that they'll have to settle for a return on their money that may just keep pace with college-cost inflation. If you have low tolerance for risk—in other words, you would lose sleep if your investments dropped in value even temporarily—that's probably the best course for you.

But if you're willing to tolerate a modest amount of risk in order to reach for better returns on your money, consider putting some of your college savings in higher-yielding bond funds or in conservative stock mutual funds. These choices, particularly the conservative stock funds, are also appropriate for parents who have a longer time to save but who don't care for the ups and downs that more-aggressive funds are susceptible to.

CORPORATE-BOND MUTUAL FUNDS.

SUMMARY: You can reach for a bit more return than you'll get with Treasuries by buying shares in a short-term or intermediate-term high-quality corporate bond fund. In exchange for the higher income, you risk that your shares may lose some value if interest rates rise or if some bonds in the portfolio default.

Although not as secure as Treasuries, corporate bonds and municipal bonds are another option for short-term savings. Usually, those bonds pay a higher rate of interest to compensate for the extra risk. But since you may need $50,000 or more to build a well-diversified portfolio of individual bonds, most investors are better off using bond mutual funds.

Bond funds invest in a pool of bonds with varying interest rates and maturities and pass the interest payments on to you. Apart from the income, the shares you buy may fluctuate in price due to interest-rate changes in the economy. High-quality funds invest in bonds issued by top-rated companies with the best prospects for paying interest and principal on time.

You can invest in some corporate-bond funds with only $1,000 and add contributions, usually of $100 or more, at any time. You can also automatically reinvest the income from the fund in additional shares, and you can redeem shares at any time.

RETURN. Corporate bonds—and corporate-bond funds—typically earn a bit more than Treasury bonds or funds, to compensate for the additional risk.

RISK. As has been mentioned above, the shares in a bond fund can fluctuate in price—they go down when interest rates rise and go up when interest rates fall. Usually those swings are modest, especially when the fund buys short-term and intermediate-term bonds—that is, bonds with maturities of less than about seven years. Funds that restrict themselves to short-term bonds, with maturities of three years or less, are even less volatile, but they pay correspondingly lower returns. A short-term bond fund, in fact, is only a small step up in risk from a money-market mutual fund.

The other risk in investing in corporate bonds is that the company that is issuing the bond will default (that is, it will fail to pay interest or principal on time). Owning a corporate bond fund minimizes that risk because even if one bond defaults, there are many others in the portfolio.

You can also minimize your risk by buying high-quality bond funds (those that invest in top-rated companies) rather than high-yield, or junk, bond funds (which reach for extra yield by investing in lower-rated companies). A fund's prospectus should tell you what kind of bonds it's investing in, but its name may tip you off first; junk-bond fund names often include the words "high-yield."

MUNICIPAL-BOND FUNDS.

SUMMARY: A good choice among bond funds for investors in the highest federal tax brackets.

If you're in the 28% federal tax bracket or higher, you may want to take a look at municipal-bond funds, which pay lower yields but are free from federal (and sometimes state and local) taxes. A municipal-bond fund that's yielding 5% is the equivalent of a taxable fund yielding 6.94%, if you're in the 28% tax bracket. (In the 33% bracket, the taxable-equivalent yield jumps to 7.5%, and in the 35% bracket it's 7.7%.)

These funds buy pools of tax-free bonds that are issued by state and local governments and their agencies. Many funds buy a broad range of issues from around the country. But if you live in a state with a high income tax (such as California, Maryland or New York), you can do even better buying single-state municipal-bond funds, with income that is free from both federal and state taxes, and perhaps even local taxes, too.

RETURN. Over the past ten years, the annualized total return on high-quality municipal bond funds (including yield and appreciation in the price of the shares) was 5.0% tax-free.

RISK. Your shares could lose some value if interest rates rise. As with corporate-bond funds, investors with short time horizons should stick with funds that invest in high-quality bonds. In an ideal world, you would also stick with funds that buy bonds with short-term or intermediate-term maturities, which also reduces risk. But good short-term muni-bond funds are relatively rare. So you may have to accept a bit more interest-rate risk in a muni-bond fund than you would in a corporate-bond fund bought for the same purpose.

Growth-and-income funds won't soar in the best markets, but won't crash in the worst ones, either.

CONSERVATIVE STOCK MUTUAL FUNDS.

SUMMARY: Growth-and-income funds are a good bet for investors seeking steady returns. These funds won't soar in the best markets, but they won't crash in the worst ones, either.

Stock mutual funds, which buy a pool of stocks and then issue shares in the pool to investors, come in every stripe, though they fall between these two extremes:

- **Low-risk growth-and-income funds** concentrate their portfolios on steadily growing blue-chip stocks that pay good dividends.

- **High-risk aggressive-growth funds** look for promising small companies that could increase significantly in value—but could also drop just as significantly.

Investors with a short time horizon—or a low tolerance for risk—want to stick with the growth-and-income variety, which aim to provide long-term growth without much fluctuation in share price, even in declining markets. They may not have the potential for spectacular returns, but they also won't fall as hard when the stock market is down.

RETURN. Over the past ten years, the average growth-and-income fund returned more than 8.5% per year. That's a little below the historical average for the stock market—about 10% per year going back to 1926.

RISK. As in any stock fund, you can lose money in any given year. But because they invest in large, well-established companies that traditionally pay good dividends, growth-and-income funds have had only a few losing years in the past decade.

Long-Term Investments

A long time horizon allows you to pursue the higher returns that you can earn by investing in growth stocks or growth-stock mutual funds. In any given year, stocks can lose money—the Standard & Poor's 500 (S&P 500) index tends to fall in one year out of every four. But historically the index has returned an average of around 10% per year, compounded. A long-term investment horizon allows you to ride out the fluctuations of the market so you can take advantage of those double-digit returns.

How much of a difference does a couple of percentage points make?

- **A hundred dollars** invested every month at 8% produces $48,329 at the end of 18 years.
- **At 10%,** the same contributions grow to $60,557.
- **At 12%**, they reach $76,544.

Such above-average returns may be possible with a long time horizon and growth-oriented mutual funds.

LONG-TERM-GROWTH FUNDS.

SUMMARY: These funds are appropriate as core choices for a long-term stock portfolio. Returns will be similar to the stock market as a whole.

Growth mutual funds seek long-range capital gains —gains in the value of the shares themselves—by investing mostly in medium-size and large, well-established companies, regardless of whether or not they pay big dividends. They'll produce returns that should keep pace with or exceed the large-company stock indexes, such as the Dow Jones industrial average. They're good choices primarily for long-term investors, but even parents of high schoolers may want to keep up to half of their money in growth funds in order to give their savings a chance to beat college-cost inflation.

RETURN. The average long-term-growth fund has earned about 7% annually over the past ten years.

RISK. Growth funds are considered a bit more risky than growth-and-income funds because they don't seek the extra cushion of high dividends (which companies don't guarantee but usually pay regardless of whether the market goes up or down). When the stock market drops, you can expect a growth fund to drop by at least a similar percentage.

AGGRESSIVE-GROWTH FUNDS.

SUMMARY: These funds will rise sharply in good markets and drop just as sharply in bad ones. But average out those ups and downs and they outperform other funds over the long term. They may be appropriate for a portion of a long-term investor's portfolio.

Aggressive-growth funds typically specialize in stocks of small- to medium-size, fast-growing companies and will usually outperform the averages during a boom market and lag well behind the averages during a down market. You don't want to build your entire investment plan around such funds, but having one-fourth to one-third of a long-term portfolio in aggressive funds may give you the opportunity to have your investments outperform the averages. Over the long term, stocks of small companies have returned about two percentage points more a year than stocks of larger companies, albeit with greater volatility.

RETURN. The average aggressive stock fund returned about 8% per year over the past ten years.

RISK. In down years, double-digit losses are not unusual in aggressive-growth funds.

INTERNATIONAL FUNDS.

SUMMARY: Risk-averse investors might want to limit international-stock funds to 10% or less of a long-term, college-saving portfolio. But if you have lots of time and are aiming for maximum returns, consider putting as much as 20% of your money in international funds.

The theory goes that in today's global economy, a well-diversified stock portfolio should include some exposure to international stocks. But over the past decade, international funds have disappointed investors with consistently low returns. Some professionals feel that investing in large U.S. corporations with overseas operations (the kinds of companies that you'd find in a growth-and-income or long-term-growth fund) provides enough international exposure. Others believe that after a decade of weak performance for international funds, the pendulum is sure to swing the other way.

Investors who want the extra diversification of international stocks are probably better off sticking with broad-based international funds—that is, funds that spread their money in stock markets around the world. Funds that invest in just one country or region, such as Latin American funds or Pacific Rim funds, may top the charts one year but suffer dismal losses the next because of a single political or economic event.

RETURN. The average international-stock fund returned about 9% annually over the past ten years.

RISK. International funds that specialize in a given region tend to have the same kind of up-one-year, down-the-next volatility as domestic aggressive-growth funds. But broadly diversified funds that spread their investments into Europe, Asia and developing markets tend to be more stable.

Overwhelmed by the number of investment choices? Consider a fund that replicates the S&P 500 index.

Putting It All Together: A Shortcut

We'll give you an easy way out first. The prospect of choosing from among the thousands of mutual funds available today can be overwhelming, even paralyzing, to new investors. If your instinct is to flee for the safety and simplicity of CDs or money-market funds, consider instead buying shares in an index fund that replicates the S&P 500-stock index. By simply buying the 500 widely held stocks in the index, these funds aim to match rather than beat the market. But since most stock funds don't outperform the S&P 500, an index fund should put your returns well above average.

Because the S&P 500 index funds all buy the same stocks, there isn't much difference between them except in the annual expenses that you will pay for fund management.

Different Portfolios for Different Time Horizons

The downside to investing in a single fund is that the market is fickle. Some years the pendulum swings toward stocks of large companies (like those in an S&P 500 index fund). Other times small companies are in favor. Growth stocks are "in" some years and "out" others. You'll be "in" all the time if you own a diversified portfolio of mutual funds that own stocks of different-size companies and that reflect different investing styles.

A MIDDLE PATH.

Want to consider something that's well-rounded, but that's also a little easier to manage? By combining two or three index funds, you can diversify your portfolio to include bonds, large and small domestic stocks and international stocks. And by keeping the funds all in the same fund family, you'll receive a single statement each month, instead of having to hassle with many.

WITH FIVE YEARS TO GO.

Parents of junior high school students have the time to keep roughly half of their money invested in stocks. A likely portfolio might be invested 40% in bond funds, with the other 60% spread among four stock funds—two growth-and-income funds, one long-term-growth fund, and one international fund.

As college gets closer, you would look for a good opportunity to redeem your shares in the long-term-growth fund first, shifting that money to bonds or CDs.

WITH SIX TO TEN YEARS TO GO.

Parents of elementary schoolers who want to go for maximum growth might consider being fully invested in stock mutual funds, including international funds. But this portfolio probably should include a small investment in bonds, to reduce volatility and to give you a convenient place to begin shifting your money to as the college bills get closer.

WITH 11 OR MORE YEARS TO GO.

Parents of newborns and toddlers have plenty of time to go for maximum growth, so this portfolio might include an aggressive-growth fund, two long-term growth funds, an international fund and a growth-and-income fund.

State-Sponsored College-Savings Plans

State-sponsored college-savings plans—also known as 529 plans after the section of the tax code that governs them—are the savings vehicle of choice for many parents, thanks to improved plans from the states, along with changes in the tax law that make earnings in the plans tax-free. All 50 states and the District of Columbia have some kind of 529 plan to offer.

Tax-free earnings give your college savings a potent boost. To appreciate the power of the federal tax break, consider what could happen to a single $1,000 investment over 18 years, assuming a 10% annual return. In a taxable account, with the IRS claiming 25% of the earnings each year, the account would grow to $3,676. In a tax-free college-savings plan, it would grow to $5,560. That gives you 51% more money to pay college bills. Even better, some states allow residents to deduct their contributions on their state-tax returns.

There are two types of 529 plans to choose from: a savings plan, which invests your money in mutual funds or similar accounts, or a prepaid-tuition plan, which promises that your payments today will cover tuition tomorrow no matter how much costs rise.

If you're saving over the long term, savings plans let you reach for stock-market returns, which are likely to outpace tuition inflation. There's a risk, of course, that you'll lose money in a prolonged bear market, the same risk you'd take investing in stocks and bonds outside a savings plan. But most plans offer investment options that favor stocks when your children are younger and gradually ease you into bonds as they get older.

Prepaid plans are more conservative. Although you're not likely to lose money in a prepaid plan, only about half the states that offer them actually back their "guarantee" to provide for tomorrow's tuition with the full faith and credit of the state. But in exchange for less risk, you can expect lower returns.

You can participate in either kind of 529 plan no matter what your household income and can take advantage of low minimum contributions. And because the account owner—usually a parent—controls the money until it is used for college, there's no way your child could have access to it.

Using a state-sponsored plan does not restrict you to using the money at a college in the sponsoring state—you may use the proceeds at any accredited college in the U.S. and at some foreign institutions as well. The main catch is that you'll pay a penalty (usually 10% of earnings, although often higher in prepaid plans) if you don't use your 529 plan account for college. If the beneficiary never goes to college, you can avoid that penalty by transferring the account to a sibling or other family member.

SAVINGS-STYLE PLANS.

The majority of state-sponsored 529 plans are savings-style plans—often considered the best choice for most parents. Maximum investments (whether defined as total contributions or total balance, including earnings) are high—usually exceeding $200,000. Typically, you can choose from three or more investment "tracks," and one of them is usually an "age-based" portfolio that may be 80% or more in stocks when a child is in his or her preschool years and shifts gradually into bonds as the child ages.

The good news is that such a choice puts your college savings on autopilot, so you don't have to worry about rebalancing your investments over time. The bad news is that once you've chosen your investment track, you must stick with it—you can't later shift from the age-based portfolio to another track your state offers or to an investment mix of your choice.

Under the current tax law, you can, however, roll your 529 plan from one state to another as frequently as once a year, giving you a roundabout way to make new investment choices if you're unhappy with the performance of your plan or if your investment philosophy changes. Still, because each state has only a few choices, a savings plan does not give you as much investment discretion as you would have in a taxable account, an IRA or a Coverdell ESA, where you have complete control. This is the chief disadvantage of 529 savings plans—but the overall merits of the plans may outweigh the investment limitations.

Most states offered savings plans that are open to any U.S. resident (although some

Tax-free earnings in state-sponsored 529 savings plans give your college savings a potent boost.

THE INDEPENDENT 529 PLAN ALTERNATIVE

The Independent 529 plan lets you pay tomorrow's tuition (or part of it) at today's prices for more than 270 private colleges. (See www.independent529plan.com for the list of participating colleges.) Basically, the money you invest represents a percentage (possibly 100%) of a school's current tuition. For example, say you prepay $10,000 today to cover one year of tuition and current tuition at the school your child ultimately attends is $20,000. Your $10,000 investment is 50% of that current tuition, so you'll be covered for 50% of the future tuition once your child starts college. If current tuition is $30,000 your $10,000 investment represents one-third of the total tuition, and you'll be responsible for coming up with the remaining two-thirds tuition in the future.

If your child doesn't go to a participating school, you get your money back but, the annual return is capped at just 2%. If you worry that your child won't attend one of the schools on the list, you might be better off investing in a traditional 529 state college savings plan.

plans are open to non-residents only through brokers and financial advisers or with higher fees), so you're not restricted to the plan offered by your home state. However, if your state offers a generous tax deduction for contributions, you have an added incentive to use your state's plan. Taxation of 529-plan earnings also varies from state to state, so check your state's plan.

Aside from any tax benefits, consider whether the investment choices reflect your own philosophy, and take a look at fees, which eat into your return. If you don't like your own state's offerings, consider other states' plans. You can compare plans at www.kiplinger.com by going to "Tools & Calculators," clicking on "College Tools," then clicking on "Compare state 529 plans."

PREPAID-TUITION PLANS.

The older sibling of 529 savings plans, prepaid-tuition plans are based on the idea of paying for tomorrow's college education at today's prices. Prepaid-tuition plans let you buy up to four years' worth of tuition at current prices, either in installments or as a lump sum. The appeal is the guarantee that when your child is ready for freshman year, your account will cover tuition, no matter how much it has risen. By paying costs in full now or in installments over several years, you lock in current prices and guarantee that your investment will appreciate at the same rate that college costs rise.

There are two kinds of prepaid plans:

"CONTRACT" TYPE PLANS. In "contract" type plans, you commit in advance to buying a certain amount of future tuition—such as a year's worth, or a full four years' worth. In Florida's plan, for instance, the parents of an eighth-grader could put up a lump sum of $11,702 to prepay four years of tuition at any public university in the state. Or they could pay in 55 monthly installments of about $235, for a total of $12,925. Tuition at Florida's ten, four-year universities is about $3,270 a year, so if costs rose 6% annually, today's eighth-grader would expect to pay about $19,150 in the future in tuition for a four-year education.

One major disadvantage to contract-type plans is that you commit to a long-term schedule of payments—not unlike a car loan. The only way to stop paying is to discontinue the plan, withdraw your principal and incur a penalty. Because they're tied to the cost of lower-priced public colleges, a prepaid contract plan will also make only a minor dent in the tab if it's transferred to a more expensive private school. Many contract plans also cover only tuition and fees, not room, board, books and personal expenses. Savings plans can be used to cover all of those costs.

TUITION UNITS. Prepaid unit plans sell units that represent a fixed percentage of tuition, with one unit typically corresponding to 1% of a year's tuition. Everybody pays the same price for the units and the price of a unit increases each year. The parents can buy as many units as they want each year.

In prepaid plans that offer "tuition units," you can be more flexible with your investment. In Tennessee, for instance, tuition units sold for $63.63 apiece in 2008; you can buy as many or as few as you like, as regularly or erratically as you want. If your goal is to cover four years of tuition at an average-priced institution in Tennessee, you would aim to amass 400 units. That would leave you with a small refund if your child attended Tennessee Tech University (which costs 93 units a year) or leave you a bit short at the University of Tennessee in Knoxville (110 units a year). You could aim to save even more than 400 units if your goal is to save for a private college.

RETURN. In either kind of prepaid plan, your return is roughly equivalent to the rate of tuition inflation at public colleges and universities in your state—which made the plans extremely attractive when tuitions were rising at 10% and more a year. Even today, with the average rate of tuition inflation closer to 7%, prepaid plans remain a good deal, but many plans have run into trouble because of the continuing rise in tuitions and weak investment returns. And the plans are no match for investing in the market when you have many years before you'll need the money.

But prepaid plans are a good alternative to low-paying savings bonds or CDs for short-term college savings. With five years or so to build a college fund, parents should invest most of it for safety, as described earlier, perhaps in zero-coupon bonds, bond funds, certificates of deposit—or prepaid-tuition plans. Compared with fixed-income investments, prepaid plans' returns have been competitive, particularly considering their tax advantages.

You can transfer the value of a prepaid tuition plan to any accredited school in the U.S.

TRANSFER. As with 529 savings plans, you can transfer the value of a prepaid plan to any accredited private or out-of-state public school in the U.S. In most cases, using the funds at a school outside the plan won't affect your return because the state will transfer the full value of your account to any school. But a few states limit your return if the beneficiary doesn't attend an in-state public college.

AFFECT ON FINANCIAL AID. Prepaid plans may be a bad idea for families that expect to be eligible for substantial need-based financial aid because prepaid tuition is considered a resource that reduces your financial need dollar for dollar. College-savings plans reduce your financial need, too, but to a lesser degree. They're included among the parents' assets, which reduces your financial need by up to 5.6% of the balance in the account each year. There's a chance that Congress will eventually grant prepaid-tuition plans more favorable treatment in financial-aid formulas, but for now savings plans have the edge.

THE APPEAL OF A SURE THING. Financial advisers have been lukewarm to prepaid plans because of their restrictions and below-market returns. But many parents have enthusiastically signed up for them anyway because prepaid plans deliver what savings plans and the stock market don't—a sure thing. Whether college costs rise by 2% or 10% annually, prepaid-plan participants know that their contributions will cover all or a predetermined portion of the tuition bill at a public college—or even a private one in a few states.

If that reassurance is a sufficient return for you, then a prepaid plan may be your preference. But you may need to save separately for room and board (only a few plans include it) or for the cost of a private college over a public one. Savings plans, on the other hand, seldom guarantee returns and can even lose money, depending on how the plan invests. The prospectus or annual report should specify what kinds of investments the plan may make and whether you can expect a minimum return. (Kentucky, for instance, guarantees at least 3%.)

PENALTIES AND ALTERNATIVES. If you have doubts that your child will attend college at all, a prepaid plan is not for you. In many cases you pay a significant penalty (higher than the 10% of earnings that's standard on 529 savings plans) if you withdraw entirely, either because your child doesn't attend college or because you can't keep up the payments in a state where monthly payments are required. Be sure to check the terms of your contract.

However, in most states the beneficiary can wait up to ten years after graduating from high school to use the account. Or you can avoid the penalty by transferring the account to another family member, such as a sibling. In addition, penalties are usually waived if the beneficiary dies, becomes disabled or earns a scholarship that makes the state savings account unnecessary.

Protect Your Money: How to Check Out a Broker or Adviser

Federal or state securities laws require brokers, advisers, and their firms to be licensed or registered, and to make important information public. But it's up to you to find that information and then to use it to protect your investment dollars. The good news is that this information is readily available, and one phone call or a web search may save you from sending your money to a con artist, a bad broker, or disreputable firm.

This is very important, because if you do business with an unlicensed securities broker or a firm that later goes out of business, there may be no way for you to recover your money — even if an arbitrator or court rules in your favor.

BROKERS AND BROKERAGE FIRMS.

The Central Registration Depository (or "CRD") is a computerized database that contains information about most brokers, their representatives, and the firms they work for. For instance, you can find out if brokers are properly licensed in your state and if they have had run-ins with regulators or received serious complaints from investors. You'll also find information about the brokers' educational backgrounds and where they've worked before their current jobs.

You can ask either your State Securities Regulator or the Financial Industry Regulatory Authority (FINRA) to provide you with information from the CRD. Your State Securities Regulator may provide more information from the CRD than FINRA, especially when it comes to investor complaints, so you may want to check with them first. You'll find contact information for your State Securities Regulator on the North American Securities Administrators Association (NASAA)

Web site (www.nasaa.org). To contact FINRA, go online to www.finra.org, or call 800-289-9999.

INVESTMENT ADVISERS.

People or firms that get paid to give advice about investing in securities must register with either the U.S. Securities and Exchange Commission (SEC) or the State Securities Regulator where they have their principal place of business. Investment advisers who manage $25 million or more in client assets generally must register with the SEC. If they manage less than $25 million, they generally must register with the State Securities Regulator.

Some investment advisers employ investment adviser representatives, the people who actually work with clients. In most cases, these people must be licensed or registered with your State Securities Regulator to do business with you. So be sure to check them out.

To find out about advisers and whether they are properly registered, read their registration forms, called the "Form ADV," which has two parts. Part 1 has information about the adviser's business and whether they've had problems with regulators or clients. Part 2 outlines the adviser's services, fees and strategies. Before you hire an investment adviser, always ask for and carefully read both parts of the ADV.

You can view an adviser's most recent Form ADV at http://brokercheck.finra.org. The database contains Forms ADV only for investment adviser firms that register electronically using the Investment Adviser Registration Depository, but will expand to encompass all registered investment advisers—individuals as well as firms.

You can also get copies of Form ADV for individual advisers and firms from the investment adviser, your State Securities Regulator (page 16), or the SEC, depending on the size of the adviser. To contact your State Securities Regulator go online to www.nasaa.org. If the SEC registers the investment adviser, you can get the Form ADV for $ .24 per page (plus postage) from the SEC.

> **Investment advisers must register with either the SEC or State Securities Regulator where they do business.**

WRAP UP.

While the costs of sending a child to college continue to rise faster than the rate of inflation, there is an abundance of investment vehicles available to you in which you can build your college fund, whether your child is far away from freshman year or already in middle or high school. Stocks, bonds and mutual funds, invested through tax-favored programs such as the Coverdell ESA and state-sponsored 529 plans, can provide the extra lift you need to make the most of the money you put toward that diploma.

STATE SECURITIES REGULATORS

State Securities Regulators have protected investors from fraud for nearly 100 years. Securities markets are global but securities are sold locally by professionals who are licensed in every state where they conduct business. State Securities Regulators work within your state government to protect investors and help maintain the integrity of the securities industry.

Your State Securities Regulator can:

- Verify a broker-dealer or investment adviser is properly licensed;
- Provide information about: prior run-ins with regulators that led to disciplinary or enforcement actions; serious complaints that may have been lodged against them; their educational background and prior work history
- Provide a computer link or telephone number or address where you can file a complaint; and
- Provide non-commercial investor education and protection materials.

For contact information for your State Securities Regulator, visit the North American Securities Administrators Association (NASAA) Web site at www.nasaa.org and click on "Contact Your Regulator."

GLOSSARY

Accrued interest— Interest that is due, on a bond for example, but that hasn't yet been paid.

Bond— An interest-bearing security that obligates the issuer to pay a specified amount of interest for a specified time, usually several years, and then repay the bondholder the face amount of the bond.

Bond rating— A judgment about the ability of a bond issuer to fulfill its obligation to pay interest and repay the principal when it is due.

Call— The ability of a bond issuer to redeem a bond before its maturity date.

Capital gain (loss)— The difference between the price at which you buy an investment and the price at which you sell it.

Coupon rate— A way of expressing bond yield, this is the fixed annual interest payment expressed as a percentage of the face value of the bond. A 9% coupon bond, for example, pays $90 interest a year on each $1,000 of face value.

Face value— Amount an issuer pays to a bond holder when the bond reaches full maturity.

Maturity— The amount of time it takes for a bond to pay the face value. Bonds are issued with varying maturity dates.

Mutual Fund— A professionally managed portfolio of stocks and bonds or other investments divided up into shares.

Prospectus— A document that describes a securities offering or the operations of a mutual fund.

Risk— The possibility that you may lose some (or all) of your original investment. In general, the greater the potential gain from an investment, the greater the risk is that you might lose money.

Secondary market— The general name given to marketplaces where stocks, bonds, mortgages and other investments are sold after they have been issued and sold initially.

Stock— A share of stock that represents ownership in the company that issues it. The price of the stock goes up and down, depending on how the company performs and how investors think the company will perform in the future.

Yield— In general, the annual cash return earned by a stock, bond, mutual fund or other investment. Bond yields can take many forms. Coupon yield is the interest rate paid on the face value of the bond. Current yield is the interest rate based on the actual purchase price of the bond, which can be higher or lower than the face value. Yield to maturity is the rate that takes into account the current yield and the face value, with the difference assumed to be amortized over the remaining life of the bond.

The following booklets from the Editors of *Kiplinger's Personal Finance* magazine and the Investor Protection Trust are available at your public library through the Investor Education in Your Community™ program and offices of State Securities Regulators.

FIVE KEYS TO INVESTING SUCCESS

- Make investing a habit
- Set exciting goals
- Don't take unnecessary risks
- Keep time on your side
- Diversify

THE BASICS FOR INVESTING IN STOCKS

- What is a stock?
- Types of stocks and their relative risks
- How to buy stocks
- Stock terms you need to know, such as price/earnings ratio (P/E), book value, dividend yield and dollar-cost averaging
- Selling your stocks and determining earnings
- Mistakes even seasoned investors sometimes make—and how to avoid them

A PRIMER FOR INVESTING IN BONDS

- What is a bond?
- How bonds work
- Types of bonds and their relative safety
- Why bonds can be an important part of your investment portfolio
- Yield and how it relates to bond prices
- Bond ratings and how they can help you reduce risk

MUTUAL FUNDS: MAYBE ALL YOU'LL EVER NEED

- What is a mutual fund?
- Advantages of investing in mutual funds
- Cost of investing in mutual funds
- Find the right mutual funds for you
- What to look for in a mutual fund prospectus
- Types of mutual funds and relative risk
- Determining your earnings

GETTING HELP WITH YOUR INVESTMENTS

- Choosing a broker
- Full-service, discount and online brokers
- Opening a brokerage account
- Records you need to keep
- Problems with your broker
- Financial advisers
- How to choose an adviser
- Investment clubs

WHERE TO INVEST YOUR COLLEGE MONEY

- Creating a college fund portfolio based on your time horizon
- College investment vehicles
- State-sponsored college savings plans

MAXIMIZE YOUR RETIREMENT INVESTMENTS

- Three fundamental truths about retirement investing
- Stocks, bonds and mutual funds to consider for your retirement portfolio
- Determining your portfolio mix, depending on your time horizon and risk tolerance
- Retirement investment vehicles

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