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'529' Plans: Why So Many Flunk Out

By KAREN BLUMENTHAL

After posting dismal results during the market downturn, operators of "529" college-savings plans have been cutting expenses and adding lower-risk investment choices in hopes of making their plans more attractive.

The changes are welcome. But they only go so far to improve a savings option that seems to have promised more than it delivers.

Inherently, saving for college is challenging because we only have a fixed number of years before the bill is due. So no matter how disciplined we are, timing and luck will play a big role. But that often is ignored by investment firms and state and federal policy makers, who have pushed 529 plans as the answer to soaring tuition costs.

Investors use after-tax dollars to fund 529 accounts, which typically offer a range of funds and other products. Distributions and earnings are tax-free, as long as they're used for higher education.

Here are some common sales promises about the plans—and the starker reality:

• *529s are a simple way to save for college.*

Hardly. Every state offers its own plan, and many offer multiple plans. Within each plan, you may have more than a dozen different investment combinations to choose from, including conservative, aggressive and moderate options that vary widely based on your child's age. Altogether, says Joe Hurley of Savingforcollege.com, there are more than 3,000 possible investment options.

There is no uniformity in reporting results or fees, so comparing plans is hugely time-consuming. Though you can make broad comparisons at Web sites like Morningstar.com and Savingforcollege.com, you have to dig into each plan individually to see, for example, which mutual funds are offered and how much of your money would be invested in stocks when your child is six or 16. The alternative is to let a financial adviser select a plan for you, but if you buy a broker-sold plan, you will pay commissions and much steeper expenses.

• *The tax breaks on 529 plans are lucrative.*

True, you won't pay federal taxes on investment gains if the money is used for college expenses—but that is a meaningful benefit only if you have meaningful gains. People who invested their 529 money in stocks in the last two or three years may still have losses right now and wouldn't owe taxes anyway. And with a top capital-gains tax rate of 15%, you need to record impressive gains for your tax savings to be significant.

State-tax deductions, if your state allows them, can be more attractive. A married couple in New York who sock away $10,000 a year in 529 accounts can save almost $500 in state taxes. But there are no state tax breaks in Texas, California, Florida, New Jersey, Massachusetts, Minnesota and about 10 other states, and only modest ones in Illinois, Georgia and several others.

• *529s are a good fit for everyone.*

The longer you wait to save for tuition, the less valuable stock and bond funds are. If you start socking away money regularly before your child is out of diapers, you will have 15 to 20 years to weather the natural volatility of markets and build up decent savings.

But if you start when your child is 12 or older, you have little time to recover from a bad stock market—and we have seen a few lately.

Financial advisers often tell clients to keep money that they will need in the next three to five years in low-risk investments, like certificates of deposit or short-term bonds. Surely that advice should apply to college funds as well. And if you don't save very much or are in a low tax bracket, the complexity and higher fees of 529 accounts may eliminate much of their benefit.

• *529s are the best college savings option.*

Arguably, the best way to save for college is to set aside money regularly, starting as soon as possible, and to mix up your investments. If you plan to save a lot, a 529 plan should be part of the mix. But since it is fairly inflexible—-you can only change your investment choices once a year, for instance—you also may want to buy some municipal bonds, designate some of your regular investments for tuition and keep a college savings account.

You will have company. In a recent report, Financial Research Corp., a Boston research and consulting firm, found that the most common college-savings vehicle was a plain bank account. Less than 25% of college savings today are in 529s.

Write to Karen Blumenthal at karen.blumenthal@dowjones.com