The Pay You First College Savings Plan

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Student loan debt is reaching epic proportions. It crossed the trillion dollar mark in 2014, becoming the second largest sector of household debt behind mortgages. In fact, two-thirds of college graduates are leaving school with some kind of student loan debt.[1] It's no surprise then that media attention and frantic conversations are occurring about saving for college. Parents want their children to enjoy a lifestyle greater than their own, so the question becomes *what can I do to make sure that happens for my child?* One viable answer may surprise you – pay YOU first.

The 529 plan is arguably the most common tool that's used to save for college. The appeal of a 529 plan is that as the account grows, you don't pay taxes on that growth – even when you take money out, as long as it's used for qualified higher education expenses. Many families consider using this method to save for their children's future educational needs, but why not stop and think about another strategy that may work better for you and your family? While a 529 plan certainly has that attractive tax savings advantage, it can also present some challenges you should consider when deciding what's best for your family, such as:

Your investment options are limited. According to Investment News, the number one College Savings plan with more than $44 billion in aggregate funds is the American Funds 529 Plan.[2] American Funds, similar to other Investment companies, offer their 529 plans with a defined line up of mutual fund choices, and in the case of the number one Ranked Provider, you can only choose from American Funds! Other restrictions include a lack of portfolio flexibility and lack of flexibility across a greater mutual fund spectrum. Rarely can an investor find a tactical money manager in a 529 Plan lineup that will make decisions to get in or out of the market based on market conditions, known as "tactical asset management."

Since 2009, we experienced an extended bull market run that, by some measures, is the fourth longest in U.S. history. While the stock market has continued to go up year after year, funds that hold stocks at all times will go up as well. At the same time stocks went up, interest rates generally have fallen since the epic highs reached in the early 1980s – again, not a problem for bond based investments. However, if the stock market doesn't perform well and interest rates start to go up – what does that mean for regular stock and bond funds? These generic mutual fund investment vehicles are limited in what they can do to

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[1] http://www.forbes.com/sites/specialfeatures/2013/08/07/how-the-college-debt-is-crippling-students-parents-and-the-economy/
[2] http://www.investmentnews.com/gallery/20140311/FREE/311009999/PH/ranking-the-top-10-529-plans&Params=Itemnr=11

stave off these difficult economic conditions and a subsequent poor performance of the mutual funds. These fund limitations would have investors anxious to find alternatives outside of the typical “long only” stock funds and leveraged bond funds that could experience different portfolio results in challenging market conditions.

You pay expensive fees. Fees in the 529 plan are more than many investors consider. Fees include the investment company, the state that covers the 529 plan, mutual fund fees and expenses, and your investment adviser costs (assuming you work with an adviser to figure out how much to budget and save for your children’s college). It’s not uncommon to see a total fee structure in the 1.5% to 2% range per year on the total dollars invested. In addition, you may have paid a sales load to get into the fund which could increase your cost should you ever want to get out of it or access some of the money.

Most people don’t manage their investments. The number of people who actually manage their investments in the plan, or proactively make changes, is little to none. It’s an ignored asset. You set it up at the beginning and then you’ve never touched the investments again. Not proactively reviewing and considering investment alternatives is not a best practice of caring for your finances. Unfortunately, the 529 plan is often the ignored asset in a complicated world of investment options, and left behind as it is an asset on the periphery. It’s a challenge because these assets stay with the donor of the 529 as the ultimate custodian of the account, but are not given the same consideration as an asset purely in that donor’s name.

What’s my other option?

The alternative solution is to focus on *you* first. By doing this, parents’ ability to help their children pay for college could dramatically improve. Rather than directing your monthly surplus cash flow into a 529 plan, take time to illustrate and project what those monthly savings would be if they were used instead to pay down debt – specifically your mortgage. By reducing or eliminating it before your children reach college age, you would then be able to start applying those monthly payments you’ve been making to your child’s college tuition.

Here is a quick example performed on www.bankrate.com:

Mortgage Amount	$250,000
Mortgage Interest	4.5%
Mortgage Duration	30 years
Estimated Monthly Payment	$1,266

Children Start Attending School	In 14 and 16 years

Instead of saving $700/month for the two children, direct $1,400/month towards the mortgage ON TOP of the regular $1,266/month.

This is what happened:

- Mortgage repayment shortened by 20 years and 4 months, thus paid off in a little more than 9 years.
- Accelerating the payments creates a total savings – $147,395 of interest not paid.
- Once the mortgage is paid off, then direct all of the mortgage payments PLUS dollars that were to be saved in the college fund into an account in the parent's name in tax sensitive investments.
- After 4 years growing at 7% that $2,666/month = $148,000 saved in an account that can be used for college.

Why do it this way?

By reducing the total amount of debt you carry, you're reducing a large amount of risk in your financial portfolio. When you're planning for your future, you have no way of knowing over the next period of years if someone in the family will lose a job, face a reduction in income or come down with an unexpected illness or untimely death. By reducing the debt risk in your portfolio, you are better equipped and able to handle any unforeseen events that happen between now and the time your children reach college age.

There is no perfect solution for every family. The cost of college tuition is extraordinary. There are certainly a lot of options and opportunities to save in a 529 plan and that may be the appropriate route for you to go, but we would love to see people consider this alternative way to save for college. Maybe it's time to consider the Pay You First method of college funding. Be sure to spend time illustrating what this plan can do for you, your family, your children and ultimately your financial independence.

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