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Investing for college is Economics 101



John Schooler

With two kids in college I sure know what it is to pay the college bills. I want us to focus first on the benefit of having a college degree.

I recently heard a story about a college biology professor who spent the first day of class — a two-hour lab period, no less — explaining to his students mathematically how they were being paid to attend college.

It went something like this. The average college graduate earns X more than a non-college graduate. Subtract the cost of the college education from X , divide the remainder by the number of hours spent getting the college education. The result is a college student's hourly "pay" to attend class.

The message had a definite impact on the student who told me the story 20 years after she attended this class. And it has impacted her desire to ensure that her children also have the opportunity to get "paid" for attending college.

The investment philosophy for a child or grandchild's education doesn't differ much from investing for retirement: start early to make the most of compounding and invest regularly, more aggressively in the early years and reallocating to more conservative vehicles to protect funds as college nears. You do your child a disservice by setting up an account at birth and putting it on autopilot for 18 years.

The difference is that you can postpone retirement and work a few more years to increase your nest egg. With college, the student needs funds at a specific time and on a specific payment schedule.

Some investments aren't appropriate for a college fund, either because they expose you to too much risk or because they provide too modest a return. These include:

1. Investments that don't pay interest higher than the inflation rate, such as money market mutual funds, money market bank accounts, regular savings accounts, short-term bond funds and certificates of deposit. These may have a place in the last year or two before college, when preservation of funds becomes more important than growth.

2. Zero coupon bonds are particularly volatile in the secondary market, so choose maturity dates during the years when you're paying college expenses.

3. Investments such as real estate, unit investment trusts and limited partnerships that can't be easily liquidated.

4. Derivatives, such as futures contracts, whose value is linked to the value of an underlying commodity, or unregulated investments, such as hedge funds.

5. Investments that carry surrender fees and potential penalties if liquidated before a specified time.

Some college savings vehicles allow earnings to accumulate free of federal and sometimes state income taxes. Some states also allow tax deductions for contributions to certain plans - sorry not California. These include Section 529 savings plans, Section 529 prepaid tuition plans, education savings accounts and U.S. savings bonds.

Each of these carries some restrictions, which may include limitations on who can contribute penalties for not using the funds for education and deadlines by which the funds must be used. We will consider 529 savings plans for this article.

Each of the 50 states sponsors at least one plan but they farm out the money management to a professional investment manager. You're free to choose any plan, but it pays to be choosy. Each firm that manages a 529 plan has its own investment approach but performance has varied so you must do your homework.

Once you've picked a plan — or even multiple plans — it is just a matter of making regular contributions to your account. Many employers make that easier by offering automatic paycheck deductions straight into 529 accounts.

What if you've already been saving money in custodial accounts for the kids' college bills?

Some 529 programs accept cash from custodial accounts that were set up earlier in your child's name under the Uniform Gift Transfer to Minors Acts. But you'll have to liquidate any securities in the accounts — and pay taxes, if any, on the gains — before doing so.

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When the tuition bills eventually arrive, all money withdrawn from 529 accounts to pay for qualified higher education expenses is tax-exempt.

If your child gets a scholarship, the government rewards your family by letting you withdraw an equivalent sum, also tax-free, which you can use however you'd like.

And, if your family needs to use the education savings for another purpose, you can always withdraw it and pay capital gains tax — and, in some states, a penalty — on the dividend, if any. The hope is that the funds are used for college.

Don't overlook sources of financial aid such as loans, grants and scholarships. The rising price of tuition has raised the threshold for financial aid eligibility. Some families with incomes of \$150,000 or more may now qualify for some form of financial aid, particularly if they're sending several children to college.

And third, don't shortchange retirement planning. Remember to keep your savings plans in perspective. The total bill from the most expensive private college won't come close to the amount of money you'll need to ensure a comfortable retirement income.

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Investors should consider many factors before deciding which 529 plan is most appropriate. Investors should consult with their financial and tax advisor before investing in any 529 plan.-

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