College Savings Plans
CollegeInvest
Department of Higher Education

Performance Evaluation
October 2010

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Office of the State Auditor

Sally Symanski, CPA
State Auditor

October 22, 2010

Members of the Legislative Audit Committee:

This report contains the results of a performance evaluation of the College Savings Plans administered by CollegeInvest. The evaluation was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. The report presents our findings, conclusions, and recommendations, and the responses of CollegeInvest and the Department of Higher Education.

Sally Symanski

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Glossary of Terms and Abbreviations

Board – CollegeInvest Board. A nine-member board appointed by the Governor to oversee the activities of CollegeInvest, including its college savings plans.

Department – Department of Higher Education. A principal department in Colorado state government whose mission is to improve the quality of, ensure the affordability of, and promote access to postsecondary education for the people of Colorado.

Section 529 – Internal Revenue Code Section 529. The section of the Internal Revenue Code that authorizes states, the District of Columbia, and certain educational institutions to establish tax-favored college savings plans to pay for qualified higher education expenses, such as tuition, fees, books, and room and board.

STATE OF COLORADO
OFFICE OF THE STATE AUDITOR REPORT SUMMARY

SALLY SYMANSKI, CPA
State Auditor

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Purpose and Scope

The purpose of this evaluation was to review CollegeInvest's management of its college savings plans established under Internal Revenue Code Section 529 (Section 529). The evaluation focused on whether CollegeInvest and the CollegeInvest Board (Board) are meeting their fiduciary duty in overseeing the plans. The Office of the State Auditor retained two contractors, Buck Consultants and The Bonadio Group, to perform the evaluation from December 2009 to October 2010. Buck Consultants evaluated the performance and fee structure of the college savings plans, while The Bonadio Group reviewed the internal controls over the plans. The Office of the State Auditor analyzed the state income tax treatment of the plans. We gratefully acknowledge the assistance and cooperation extended by management and staff at CollegeInvest and the Department of Higher Education.

Overview

Section 529 programs, which include prepaid tuition and college savings plans, allow families to invest on a tax-favored basis toward "qualified" higher education expenses, such as tuition, fees, and room and board. In a college savings plan, individuals make contributions into an investment account with a designated owner and beneficiary, and the beneficiary uses contributions and related investment earnings to pay for qualified higher education expenses. In 1999, the General Assembly designated CollegeInvest to administer the State's college savings plans.

CollegeInvest currently offers four college savings plan options, which offer a range of fixed-income (e.g., bonds) and equity (e.g., stocks) investment options. While CollegeInvest oversees each of these plans, it contracts with third-party administrators to manage the plans on a daily basis. At the end of Fiscal Year 2010, the fiduciary net assets in CollegeInvest's four plans totaled about $3.3 billion.

Statute allows both residents and non-residents of Colorado to participate in the State's college savings plans as owners or beneficiaries. CollegeInvest reported that as of June 2010, about 57 percent of all of its account holders were non-residents of Colorado. Similarly, Coloradans may also invest in other states' college savings plans. Based on a survey commissioned by CollegeInvest in 2010, about 29 percent of the families in Colorado that had opened college savings plans invested in plans not offered by CollegeInvest.

Key Findings

Plan Administration

Statute designates CollegeInvest as the fiduciary for the State's college savings plans and requires that CollegeInvest ensure that plan investments are "made with judgment and care [that persons] of prudence, discretion, and intelligence exercise in the management of the property of another." Statute also authorizes CollegeInvest to contract with financial institutions to manage the plans' investments.

Our contractors evaluated CollegeInvest's college savings plans to determine how the plans' performance and fees compared to other states' plans and to recognized benchmarks, whether the plans comply with applicable federal and state requirements, and whether CollegeInvest has sufficient internal controls over plan operations. Overall, our contractors concluded that CollegeInvest has adequate controls in place over management of the plans in the areas we reviewed. However, the contractors identified improvements that CollegeInvest could make in the following areas:

- **Plan Performance.** CollegeInvest's investment policies generally provide reasonable approaches for prudently managing the plans' investments. In addition, CollegeInvest generally conformed to the investment policies established for each plan except for the Stable Value Plus plan. Specifically, CollegeInvest has not been monitoring the financial health of its Stable Value Plus third-party administrator in accordance with its investment policy. Our contractor also found that the investment returns of the Scholars Choice plan were generally above the returns of plan benchmarks in the most recent one-year period and below the benchmark returns for the three- and five-year period, while the investment returns for Direct Portfolio were generally above the returns of plan benchmarks. The returns for the underlying mutual funds in CollegeInvest's plans and for CollegeInvest's plans overall were in line with the returns of peer mutual funds and other states' plans. Finally, our contractor identified a gap in CollegeInvest's investment options, as CollegeInvest does not offer a plan that allows participants to invest in low-cost, actively managed mutual funds.

- **Plan Fees.** While CollegeInvest's asset management and administrative fees, most of which are retained by CollegeInvest's third-party administrators, are competitive with fees charged by programs in other states, CollegeInvest's administrative fee may be set too high. For example, CollegeInvest's excess administrative expense reserve balance (i.e., the amount of administrative fees collected above the amount expended) reached $4.2 million at the end of Fiscal Year 2010, an increase of 740 percent since Fiscal Year 2006.

- **State Income Tax Treatment of Plan Contributions.** Statute allows Colorado residents a state income tax deduction only for contributions made to CollegeInvest or to Section 529 programs sponsored by Colorado education institutions. This limit creates a powerful incentive for Colorado residents to invest in CollegeInvest's plans even though residents could possibly earn better returns in other states' Section 529 programs. In addition, this "home state" bias could possibly lead to higher fees and less competition, according to a United States Department of the Treasury report.

- **Stable Value Plus Contributions.** The Plan Disclosure Statements for CollegeInvest's Stable Value Plus plan allows CollegeInvest to take up to 30 days before depositing a participant's contribution with the plan's third-party administrator, which would be an unreasonable delay. In addition, CollegeInvest retains any interest earned before the contribution is deposited. CollegeInvest reported that it currently transfers Stable Value Plus contributions to the third-party administrator on a weekly basis. As of June 30, 2010, CollegeInvest held about $306,000 in untransferred contributions.

- **Controls over Account Contributions and Withdrawals.** CollegeInvest is generally in compliance with applicable federal and state laws governing the establishment and administration of Section 529 programs and accounts. However, the Participation Agreements for the Scholars Choice and Direct Portfolio plans do not contain a participation certification related to maximum account balances as mandated by state law. In addition, CollegeInvest does not have procedures for ensuring that its third-party administrators for Scholars Choice and Direct Portfolio are filing required federal tax forms on time. Our contractor confirmed with the third-party administrators that the forms have been filed appropriately.

- **Information Technology (IT) Controls.** Our contractor noted improvements that CollegeInvest could make in the areas of (1) change management, (2) user access, (3) monitoring, (4) physical security and disaster recovery, and (5) process documentation. Although our contractor identified control weaknesses in each of above areas, no existing data problems were discovered related to these weaknesses.

Our recommendations and the responses of CollegeInvest and the Department of Higher Education can be found in the Recommendation Locator and in the body of this report.

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
1	20	Strengthen fiduciary oversight of its college savings plans by (a) defining in the Stable Value Plus investment policy what factors should be considered when monitoring the financial health of the Stable Value Plus investment provider and hiring an investment consultant to annually monitor the provider's financial health and to complete an annual, independent review of the provider and (b) continuing to evaluate its investment approaches for Scholars Choice and Direct Portfolio to allow the addition of actively or passively managed mutual funds to either plan.	CollegeInvest	Agree	a. December 2010 b. Ongoing
2	26	Minimize the administrative fees it collects on its college savings plans by (a) recommending action to the CollegeInvest Board every year that administrative fees exceed expenses, in compliance with its administrative fees policy, and (b) revising its administrative fees policy to establish an excess administrative fee balance threshold that would trigger a reduction in fees on an annual basis.	CollegeInvest	Agree	December 2010
3	28	Enhance the options for individuals to invest in Section 529 programs by (a) analyzing the effects of allowing Colorado residents to receive a state income tax deduction for making contributions to any Section 529 program nationwide and (b) determining, based on the analysis in part "a," whether it will work with the General Assembly on revising statute to allow state income tax deductions for contributions made to any Section 529 program nationwide.	Department of Higher Education	Disagree	--
4	30	Ensure that contributions to the Stable Value Plus plan are deposited timely with the manager of the plan by revising its policy to require deposits into accounts within a period not to exceed seven business days.	CollegeInvest	Agree	November 2010

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
5	32	Ensure that account contributions and withdrawals meet applicable state and federal requirements by (a) revising its Participation Agreement for both the Scholars Choice and Direct Portfolio plans to include a contributor certification regarding compliance with maximum account balance limits and (b) implementing a process for confirming that its third-party administrators file Form 1099-Q for all accounts in accordance with federal law.	CollegeInvest	Agree	a. September 2010 b. January 2011
6	36	Strengthen controls over its information technology (IT) controls by (a) instituting a system development life cycle and change management process covering software development and implementation; (b) creating strong passwords for access to its IT system at the Banner application and database levels; (c) routinely reviewing user access for appropriateness and ensuring that segregation of duties is maintained when granting user access; (d) documenting routine reviews of audit logs and employing intrusion detection software to determine if any anomalous events have occurred in the IT system; (e) formally monitoring data backup processes and following up on backup failures; (f) maintaining a fire suppression system in its IT data center, keeping its servers and other IT equipment in locked cabinets, testing its battery backup system, securing removable storage media, and changing the access to its data center routinely; (g) testing its disaster recovery plan on a routine basis and implementing a formal process for monitoring backup activity; and (h) ensuring that procedures for granting and disabling user access and training new employees on its policies and procedures are adequately documented.	CollegeInvest	Agree	November 2010

Overview of Colorado's College Savings Plans

Chapter 1

To make higher education more affordable, Internal Revenue Code Section 529 (Section 529) established programs that allow families to invest on a tax-favored basis toward "qualified" higher education expenses (e.g., tuition, fees, books, and room and board). Section 529 programs include prepaid tuition plans and college savings plans. In a prepaid tuition plan, individuals purchase tuition credits for a beneficiary that entitles the beneficiary to a specified number of credit hours of future attendance at designated educational institutions. In a college savings plan, individuals make contributions into an investment account with a designated owner and beneficiary, and the beneficiary uses contributions and related investment earnings to pay for qualified higher educational expenses at institutions throughout the United States.

Federal law allows states, the District of Columbia, and certain educational institutions to administer Section 529 programs. In Colorado, CollegeInvest operates the State's prepaid tuition and college savings plans. CollegeInvest, a division of the Colorado Department of Higher Education (Department), is a self-supporting state enterprise established by the General Assembly to provide several functions related to higher education financing, including administering Colorado's Section 529 programs. Our evaluation focused only on CollegeInvest's college savings plans, as CollegeInvest's prepaid tuition plan has been closed to new investors since 2002.

Plan Administration and Funding

The General Assembly established the State's college savings plans in 1999 and designated CollegeInvest to administer them. Both the Department and the CollegeInvest Board (Board) provide oversight of CollegeInvest's activities, including its administration of the State's college savings plans. The Board consists of nine members appointed by the Governor for four-year terms.

CollegeInvest currently offers four college savings plan options: Direct Portfolio, Scholars Choice, Smart Choice, and Stable Value Plus. Each of these plans will be described in more detail in Chapter 2 of this report. These plans offer a range of fixed-income (e.g., bonds) and equity (e.g., stocks) investment options for families, which investors may change once every 12 months. While

CollegeInvest is the trustee and administrator for each plan, it also contracts with third-party administrators to manage specific parts of each plan.

CollegeInvest does not receive an appropriation from the General Assembly related to its college savings plans. It finances its college savings plan operations through administrative fees received from investors for administering the plans. CollegeInvest passes through the revenue from most of the fees it charges to its third-party administrators. CollegeInvest maintains each college savings plan in a separate fiduciary fund. As the table below shows, at the end of Fiscal Year 2010 the fiduciary net assets in the College Savings Program Funds totaled about $3.3 billion. The Smart Choice plan option was added in Fiscal Year 2010.

CollegeInvest College Savings Plans
Fiduciary Net Assets and Number of Plan Accounts
Fiscal Years Ending June 30, 2006 Through 2010
(Dollars in Millions)

Fund	2006	2007	2008	2009	2010	Percentage Change, FY06-10
Fiduciary Net Assets						
Scholars Choice	$1,964.0	$2,524.1	$2,345.4	$1,954.3	$2,251.1	15%
Direct Portfolio	477.2	710.5	829.2	812.2	1,013.9	112
Stable Value Plus	22.9	23.5	25.7	29.2	33.4	46
Smart Choice	N/A	N/A	N/A	N/A	3.3	N/A
Total Net Assets	**$2,464.1**	**$3,258.1**	**$3,200.3**	**$2,795.7**	**$3,301.7**	**34%**
Number of Plan Accounts						
Scholars Choice	117,000	123,000	192,000	186,000	184,000	57%
Direct Portfolio	49,000	33,000	75,000	83,000	91,000	86
Stable Value Plus	2,600	2,600	2,600	4,600	5,400	108
Smart Choice	N/A	N/A	N/A	N/A	1,200	N/A
Total Plan Accounts	**168,600**	**158,600**	**269,600**	**273,600**	**281,600**	**67%**

Source: For fiduciary net assets for Fiscal Years 2006 – 2009 and for plan accounts for Fiscal Years 2006 – 2008: CollegeInvest audited financial statements. For fiduciary net assets for Fiscal Year 2010 and plan accounts for Fiscal Years 2009 – 2010: reported by CollegeInvest.

As the table shows, fiduciary net assets increased by 34 percent and the total number of accounts managed by CollegeInvest increased by 67 percent from Fiscal Years 2006 through 2010. Statute [Section 23-3.1-308, C.R.S.] allows both residents and non-residents of Colorado to participate in the State's college savings plans as owners or designated beneficiaries. CollegeInvest reported that as of June 2010, about 57 percent of all its plan account holders were non-residents of Colorado. The table below shows the percentage of non-resident account holders for each of CollegeInvest's plans as of June 2010.

CollegeInvest College Saving Plans Percentage of Non-Resident Account Ownership As of June 2010	
Plan	**Non-Resident Account Holders**
Direct Portfolio	16%
Scholars Choice	80%
Smart Choice	4%
Stable Value Plus	4%
Overall	**57%**
Source: CollegeInvest.	

Coloradans may also invest in college savings plans offered by entities (e.g., states) other than CollegeInvest. The number of Coloradans owning college savings plans not offered by CollegeInvest is not readily available. However, a 2010 survey commissioned by CollegeInvest found that of the families in Colorado with children 19 years of age or younger who had opened college savings plans, 29 percent owned plans that were not offered by CollegeInvest.

CollegeInvest allocates direct and indirect administrative costs to its college savings plans. Direct administrative costs reflect expenses that solely benefit the college savings plans, while indirect administrative costs reflect the college savings plans' portion of expenses that benefit CollegeInvest as a whole or multiple programs within CollegeInvest. We reviewed CollegeInvest's administrative expenses, including those charged to the college savings plans, in our August 2009 *CollegeInvest Scholarship and Loan Forgiveness Programs Performance Audit.* As of July 2010, CollegeInvest reported it had 11.9 FTE dedicated to administering its college savings plans. The General Assembly does not appropriate FTE to CollegeInvest.

Scope and Methodology

Our evaluation focused on whether CollegeInvest and the Board are meeting their fiduciary duty with respect to overseeing the college savings plans and generally covered the period September 2004 through September 2009. Our evaluation did not include the Smart Choice plan, which opened to investors during the evaluation. The Office of the State Auditor retained two contractors, Buck Consultants and The Bonadio Group, to perform most of the evaluation. Buck Consultants' work centered on CollegeInvest's and the Board's management of investments in the college savings plans. Specifically, Buck Consultants reviewed (1) processes for determining specific investment options offered to participants in the college savings plans, (2) plan fees charged by CollegeInvest and its third-party administrators, and (3) overall fiduciary oversight. The Bonadio Group's work focused on compliance with applicable federal and state requirements and controls over the management of participant accounts.

As part of the evaluation, Buck Consultants and The Bonadio Group interviewed staff and Board members and reviewed and analyzed various documents and related data pertaining to the college savings plans. In addition to the work performed by our contractors, Office of the State Auditor staff also compiled performance data and fee information related to CollegeInvest's college savings plans and analyzed the state income tax treatment of the plans.

Plan Administration

Chapter 2

As noted in Chapter 1, statute [Section 23-3.1-304(1)(a), C.R.S.] gives CollegeInvest the authority to develop and implement college savings plans qualified under Internal Revenue Code Section 529 in Colorado. In establishing the college savings plans, statute [Section 23-3.1-304(2), C.R.S.] designates CollegeInvest as the plans' fiduciary and requires that CollegeInvest ensure that plan investments are "made with judgment and care [that persons] of prudence, discretion, and intelligence exercise in the management of the property of another." Statute also authorizes CollegeInvest to contract with financial institutions to manage the plans' investments.

As discussed in Chapter 1, CollegeInvest currently offers four different college savings plans, as described below.

Scholars Choice. CollegeInvest established Scholars Choice in 1999 and currently operates it as an advisor-sold plan, meaning that individuals may only enroll in and contribute to the plan through their financial advisors. CollegeInvest has contracted with Legg Mason, Inc., to manage the plan through December 2022. When establishing their accounts, investors must select one of nine investment portfolio options. The nine options are listed in Appendix A and represent varying levels of risk depending on the asset allocation, or mix of equities, bonds, and other investments in the portfolio.

Direct Portfolio. CollegeInvest began Direct Portfolio in 2004 as a direct plan, meaning that individuals open their accounts directly with CollegeInvest and not through an investment advisor. CollegeInvest has contracted with Upromise Investments, Inc., and The Vanguard Group, Inc. (Vanguard), to manage the plan through December 2014. Individuals must select one of 11 investment portfolio options. The 11 options are listed in Appendix A and represent varying levels of risk depending on the asset allocation.

Stable Value Plus. Stable Value Plus opened in 2003 as a fixed-rate investment, meaning that it provides a fixed rate of return that is determined on an annual basis. CollegeInvest has contracted with Metropolitan Life Insurance Company of Connecticut (MetLife) to serve as the manager of the plan through December 2011 but CollegeInvest retains administrative and marketing responsibilities over the plan. The guaranteed annual rate of return (net of fees) was 3 percent as of September 2010. MetLife solely guarantees the investments (including returns) in Stable Value Plus.

Smart Choice. Smart Choice opened in 2009 and offers money market and certificate-of-deposit saving options. CollegeInvest has contracted with FirstBank Holding Corporation to serve as the manager of the plan through September 2019. Investments are guaranteed by the Federal Deposit Insurance Corporation up to $250,000.

Our contractors evaluated CollegeInvest's college savings plans to determine how the plans' performance and fees compared to other states' plans and to recognized benchmarks, whether the plans comply with applicable federal and state requirements, and whether CollegeInvest has sufficient internal controls over plan operations. The period of review generally covered September 2004 through September 2009 and did not include the Smart Choice plan, which began operations as our evaluation started. Overall, our contractors concluded that CollegeInvest has adequate controls in place over management of the plans in the areas reviewed. However, the contractors identified improvements that CollegeInvest could make to strengthen the plans' performance, fee structure, and controls over plan contributions, withdrawals, and information technology, which we discuss in this chapter.

Plan Performance

In establishing the State's college savings plans, the General Assembly declared that such a college savings program was intended to "enhance the availability of postsecondary educational opportunities for [Colorado] residents." Performance is a key factor in determining whether investments in CollegeInvest's college savings plans will help make higher education more attainable. Performance is measured by the returns that investments generate each year. Long-term returns may be especially important, as investors in Section 529 programs often start saving for their child's education when the child is young. No matter when Section 529 program accounts are opened, higher returns are more likely to allow investors to reach their goals for financing higher education.

The Board has adopted investment policy statements for each of its college savings plans and requires that each statement be reviewed at least annually. The purpose of the investment policy statements is to articulate the objectives that CollegeInvest is trying to meet in selecting the investments offered by the plans and the methods that CollegeInvest will use to monitor and evaluate such investments. In addition, CollegeInvest's investment policy statements provide specific guidelines that the Board will use to select and modify the investment options to be used in each plan's portfolio(s). These guidelines include (a) defining the investment options for consumers and the permitted underlying investments (i.e., the equity, bond, and/or other investments that comprise each option) for each plan; (b) establishing benchmarks that the Board will use to evaluate the performance of each plan, its investment options, and the permitted underlying investments; and (c) setting performance criteria that will trigger

Board action to consider adding or removing investment options or permitted underlying investments from each plan. These guidelines thus provide controls that the Board should use to ensure that each college savings plan is meeting its investment objectives.

Buck Consultants evaluated the investment policy statements for the plans. The evaluation included reviewing CollegeInvest's processes for determining the specific investment options in each plan, as outlined in each plan's respective investment policy, and determining whether CollegeInvest is complying with its investment policies. Our contractor found that CollegeInvest's investment policies generally provide reasonable approaches for prudently managing the plans' investments. For example, CollegeInvest's investment policies define each plan's investment objectives, define the types of investments each plan can make, and provide criteria for making changes in the plans' investments. Our contractor also found that CollegeInvest conformed to its investment policies in all plans with the exception of Stable Value Plus. Finally, our contractor identified an improvement that could be made to the Scholars Choice and Direct Portfolio investment approaches.

In addition, our contractor evaluated the performance of the college savings plans, which included comparing the performance of the plans to plan benchmarks and other states' plans. Overall, our contractor found that the investment returns for Scholars Choice were generally above the returns of plan benchmarks in the most recent one-year period and below the benchmark returns for the three- and five-year periods, while the investment returns for Direct Portfolio were generally above the returns of plan benchmarks. The returns for the underlying mutual funds in CollegeInvest's plans and for CollegeInvest's plans overall were in line with the returns of peer mutual funds and other states' plans. We discuss our contractor's findings on performance in the next two sections, starting first with the plans' investment returns and then continuing with the plans' investment policy statements.

Investment Returns

One way to determine the strength of a particular investment's returns is to compare its returns to those of other, similar investment options. For Scholars Choice and Direct Portfolio, which both provide multiple investment portfolio options, the investment returns for CollegeInvest's college savings plans were compared in three ways. First, we compiled information available from CollegeInvest's third-party administrators that compares the investment returns of the plans with the benchmarks established in each plan's investment policy. Second, the investment returns of the underlying mutual funds in CollegeInvest's plan options were compared to the returns of similar funds. Finally, national rankings were used to rate and compare Section 529 programs nationwide with Scholars Choice and Direct Portfolio. As discussed below, these comparisons show that the investment returns for Scholars Choice exceed the returns of plan benchmarks for the most recent one-year period and trail the returns of the plan benchmarks for the three- and five-year periods, while the investment returns for Direct Portfolio generally exceed the returns of the plan benchmarks. In addition, the returns for Scholars Choice and Direct Portfolio overall and for their underlying mutual funds are neither consistently higher nor lower than the returns of other states' plans or of peer funds.

Comparison to plan benchmarks. As noted, the investment policies for Scholars Choice and Direct Portfolio include benchmarks against which the Board can evaluate the performance of each plan option. For most of the options in both plans, the "benchmark" is a weighted average of multiple benchmarks that reflect the asset allocation mix of a particular option. Tables 1 and 2 below show how the investment returns of each plan option in Direct Portfolio and Scholars Choice, respectively, compare against its benchmark for recent one-, three-, and five-year periods. The shaded cells indicate that the plan option's returns fell below the returns of its benchmark.

Table 1
Performance[1] of Direct Portfolio Portfolios
Compared to Designated Benchmarks
As of June 2010

Portfolio	1 Year	3 Years	5 Years
Aggressive Growth	14.01%	-10.14%	-0.41%
Benchmark	***14.17%***	***-10.32%***	***-0.49%***
Stock Index	15.37%	-9.73%	-0.82%
Benchmark	***15.36%***	***-9.91%***	***-0.91%***
Growth	13.19%	-5.32%	0.94%
Benchmark	***13.15%***	***-5.68%***	***0.72%***
Moderate Growth	12.07%	-1.18%	2.65%
Benchmark	***11.92%***	***-1.57%***	***2.39%***
Bond Index	8.90%	6.92%	4.88%
Benchmark	***8.87%***	***6.83%***	***4.82%***
Conservative Growth	10.66%	2.73%	4.10%
Benchmark	***10.49%***	***2.42%***	***3.89%***
Income	6.54%	5.53%	4.16%
Benchmark	***6.48%***	***5.35%***	***3.99%***
Money Market	0.00%	1.56%	2.57%
Benchmark	***-0.74%***	***0.69%***	***1.91%***

Source: CollegeInvest.
[1]Shaded cells indicate that the portfolio's performance fell below the performance of the benchmark. Portfolio performance is net of fees. Benchmark results have been reduced by the equivalent annualized fee.

Table 2
Performance[1] of Scholars Choice Portfolios Compared to Designated Benchmarks
As of June 2010

Portfolio	1 Year	3 Years	5 Years
All Equity	12.42%	-13.92%	-3.61%
Benchmark	***13.74%***	***-10.99%***	***-1.49%***
Equity 80%	14.71%	-9.43%	-1.10%
Benchmark	***13.63%***	***-7.60%***	***0.11%***
Balanced 50/50	17.10%	-4.09%	0.64%
Benchmark	***12.03%***	***-2.13%***	***1.97%***
Fixed Income 80%	11.71%	-0.20%	1.70%
Benchmark	***6.45%***	***1.54%***	***2.96%***
All Fixed Income	23.11%	6.86%	4.78%
Benchmark	***10.39%***	***6.71%***	***4.81%***
Cash Reserve	0.01%	1.45%	N/A
Benchmark	***-0.97%***	***0.31%***	***N/A***
Age-Based 0-3 Years Old	14.71%	-9.43%	-1.10%
Benchmark	***13.63%***	***-7.60%***	***0.11%***
Age-Based 4-6 Years Old	15.88%	-7.60%	-0.62%
Benchmark	***13.31%***	***-5.68%***	***0.66%***
Age-Based 7-9 Years Old/Years to Enrollment 10-12 Years	17.02%	-5.43%	0.44%
Benchmark	***12.84%***	***-3.88%***	***1.41%***
Age-Based 10-12 Years Old/Years to Enrollment 7-9 Years	17.10%	-4.09%	0.64%
Benchmark	***12.03%***	***-2.13%***	***1.97%***
Age-Based 13-16 Years Old/Years to Enrollment 4-6 Years	15.12%	-2.62%	1.28%
Benchmark	***10.33%***	***-0.97%***	***2.34%***
Age-Based 16-18 Years Old/Years to Enrollment 1-3 Years	11.71%	-0.20%	1.70%
Benchmark	***6.45%***	***1.54%***	***2.96%***
Age Based 19+ Years Old/Years to Enrollment < 1 Year	8.26%	-0.23%	1.47%
Benchmark	***4.27%***	***2.54%***	***3.21%***

Source: CollegeInvest.
[1]Shaded cells indicate that the portfolio's performance fell below the performance of the benchmark. Portfolio performance is net of fees. Benchmark results have been reduced by the equivalent annualized fee. Table does not include Scholars Choice's U.S. Treasury Zero-Coupon Bond portfolios because those portfolios were introduced in September 2009 and, therefore, one-year performance records are not available.

As the tables show, the investment returns for Direct Portfolio's options are generally slightly better than the returns of their benchmarks, while the returns for Scholars Choice's options generally exceed the returns for their benchmarks in the most recent one-year period but trail the benchmark's returns for the three- and five-year periods. As noted previously, our contractor determined that the Board has complied with its investment policies for Scholars Choice and Direct Portfolio, meaning that the Board has taken appropriate steps to identify and implement changes in the plan's underlying investments when the investments' returns are not meeting the performance criteria established in the investment policies (e.g., trailing the benchmark's performance by a certain percentage over the most recent 24-month rolling period).

Fund rankings. Most investment options in Scholars Choice and Direct Portfolio consist of a varying mix of underlying mutual funds. The mix varies in accordance with the risk and return potential of each option. For example, higher risk and return options typically include a greater percentage of equity mutual funds, while lower risk and return options typically have more bond or fixed-income mutual funds. Our contractor compiled how the investment returns of the underlying mutual funds in Scholars Choice and Direct Portfolio compared to their peers in the same fund category (e.g., the short-term bond mutual fund in CollegeInvest's portfolio was compared to all other short-term bond mutual funds) for the one-, three-, five-, and 10-year periods ending in September 2010, as shown in Table 3 below. The peer rankings are expressed as percentiles with 1 representing the best fund in the peer group and 100 the worst fund in the peer group. The shaded cells in the table represent instances in which the fund's returns fell in the bottom half of its peer group (i.e., 51st to 100th percentile).

Table 3
Performance Rankings[1] of Scholars Choice Funds Relative to Similar Funds
As of September 2010

Fund Category[2]	Fund Name	Ranking (1 = Best) 1 Year	3 Years	5 Years	10 Years
Short-Term Bond	Legg Mason Western Asset Short-Term Bond I	6	79	84	70
Intermediate-Term Bond	Western Asset Core Plus Bond	2	13	14	4
High-Yield Bond	Legg Mason WA Global High-Yield Bond	26	53	58	9
Large Value	John Hancock Classic Value A	69	94	97	13
Large Blend	Legg Mason Batterymarch US Large Cap Equity	51	N/A[3]	N/A[3]	N/A[3]
Large Blend	Legg Mason Cap Management Value I	96	99	99	89
Large Blend	Legg Mason ClearBridge Appreciation	52	9	13	18
Large Growth	Legg Mason ClearBridge Aggressive Growth	24	63	89	28
Small Blend	Royce Pennsylvania Mutual Investment	67	30	23	12
Small Growth	Legg Mason ClearBridge Small Cap Growth	25	15	29	37
Foreign Large Blend	Legg Mason Batterymarch Institutional Equity	79	93	92	46

Performance Rankings of Direct Portfolio Funds Relative to Similar Funds
As of September 2010

Fund Name	Fund Category	Ranking (1 = Best) 1 Year	3 Years	5 Years	10 Years
Intermediate-Term Bond	Vanguard Total Bond Market Index Institutional	78	39	28	32
Inflation-Protected Bond	Vanguard Inflation-Protected Securities Institutional	29	37	22	34
Large Blend	Vanguard Institutional Index Institutional Plus	26	45	42	49
Foreign Large Blend	Vanguard Total Institutional Stock Index	34	30	23	19

Source: Buck Consultants analysis of historical mutual fund investment returns.
[1] Shaded cells indicate that the fund's performance fell in the bottom half of its peer group (i.e., 51st to 100th percentile).
[2] See Appendix B for a description of these fund categories.
[3] N/A indicates that the fund has not existed long enough to compare performance for this period.

As the table shows, some funds have consistently provided above-average returns relative to their peers throughout the last 10 years (e.g., Western Asset Core Plus Bond) while others have not (e.g., Legg Mason Cap Management Value I). In addition, the strength of the returns of some funds (e.g., John Hancock Classic Value A) varies based on the time period being evaluated.

National rankings. The website savingforcollege.com provides comprehensive national rankings of the performance of Section 529 programs. Savingforcollege.com is a commercial website which provides information on college savings issues generally and Section 529 programs specifically. The website also ranks the past performance of both advisor-sold (e.g., Scholars Choice) and directly purchased (e.g., Direct Portfolio) Section 529 programs. The rankings are composite and based on the plans' average investment returns in seven unique asset allocation categories: 100 percent equities, 80 percent equity, 60 percent equity, 40 percent equity, 20 percent equity, 100 percent fixed-income, and 100 percent short-term (i.e., money-market or cash reserve accounts). Table 4 below shows how Scholars Choice and Direct Portfolio ranked against other states' plans in the website's rankings as of June 2010 for the most recent one-, three-, and five-year periods. The shaded cells in the table represent instances in which the plan's ranking fell in the bottom half of all plans reviewed.

Table 4
National Performance Rankings[1] for Scholars Choice and Direct Portfolio
As of June 2010

Plan	1 Year	3 Years	5 Years
Scholars Choice[2]	1st of 32 plans[3]	22nd of 27 plans	22nd of 23 plans
Direct Portfolio	33rd of 51 plans[3]	19th of 45 plans	28th of 38 plans

Source: Savingforcollege.com.
[1] Rankings are composite and based on the average investment return for seven different asset allocation options available within the plans. Shaded cells indicate that the plan's performance fell in the bottom half of all plans reviewed.
[2] Rankings based on Class A shares, which charge upfront sales commissions. Rankings reflect the maximum sales charges that can be deducted from the account.
[3] "Plans" refer to other Section 529 programs nationwide that are considered similar to Scholars Choice or Direct Portfolio by savingforcollege.com.

As the table shows, the composite ranking of CollegeInvest's plans varies by plan and by the time period observed. For example, Scholars Choice received the highest composite ranking in the country among advisor-sold plans for the most recent one-year period but ranked near the bottom in both the three-year and five-year periods.

The aforementioned website also gives "cap" ratings to Section 529 programs, with the highest rated programs receiving five caps. The cap ratings are broader than the performance rankings described above, including factors such as the availability of a state income tax deduction for plan contributors and the plan's flexibility in areas such as changing beneficiaries and rolling over funds to other Section 529 programs. For each state's plan, the website offers ratings for both residents and nonresidents to reflect that the plan may offer different benefits to contributors depending on whether they live in that state. As of September 2010, Scholars Choice, Direct Portfolio, and Stable Value Plus all received a 4½-cap "resident" rating. At that time, seven states had at least one Section 529 program option that received a 5-cap resident rating, and 26 other states had at least one option that received a 4½-cap resident rating. For non-resident ratings, Scholars Choice and Stable Value Plus received 3½ caps, while Direct Portfolio received 2½ caps as of September 2009. At that time, 39 other states had at least one Section 529 program option that received at least a 3½-cap nonresident ranking. Thus, these cap ratings appear to indicate that Scholars Choice and Direct Portfolio are comparable to options in other states' Section 529 programs.

Stable Value Plus performance. As noted previously, Stable Value Plus provides a fixed return to investors that is adjusted annually. Our contractor found that few states include stable value funds in their Section 529 program offerings, which is why we excluded this plan from the discussions above. For those that exist, the returns for CollegeInvest's Stable Value Plus were similar. For example, Stable Value Plus returned 3.32 percent per year over the five years ending September 2009, compared to 3.59 percent for a similar plan in North Carolina and 3.43 percent for state plans provided by the Teachers Insurance and Annuity Association, College Retirement Equities Fund (TIAA-CREF). Furthermore, TIAA-CREF's guaranteed return for 2010 is 2.5 percent, compared to 3 percent for Stable Value Plus.

Investment Policies

As noted previously, the Board has adopted investment policies that govern each of CollegeInvest's college savings plans. Our contractor reviewed these policies and found that CollegeInvest is complying with the policies for Scholars Choice and Direct Portfolio but is not complying with one of the provisions in the policy for Stable Value Plus. Our contractor did identify a potential improvement to the Scholars Choice and Direct Portfolio investment approaches.

Stable Value Plus. The Stable Value Plus investment policy requires that CollegeInvest have an investment consultant monitor the financial health of the Stable Value Plus investment provider (currently MetLife) and provide CollegeInvest with an annual, independent review of the provider. Stable Value Plus' policy also requires that the provider annually affirm that its current rating from at least two nationally recognized credit rating agencies, such as Moody's or Standard & Poor, is at least "A," which represents a low credit risk. Our contractor found that CollegeInvest is ensuring annually that its Stable Value Plus provider maintains at least an "A" rating. However, CollegeInvest has not had an independent financial health review completed on the provider since the investment policy went into effect in 2003.

It is important that CollegeInvest ensure that the financial health of its Stable Value Plus provider is sound because the provider is the sole guarantor of the fixed investment return offered by the plan. Therefore, CollegeInvest should take steps to comply with the provision of its investment policy requiring the annual, independent review of the provider. In addition, the Board needs to define what factors the independent reviewer should consider to adequately monitor the provider's financial health, as the current Stable Value Plus investment policy does not define this term.

Scholars Choice and Direct Portfolio. Our contractor identified a possible improvement in the Scholars Choice and Direct Portfolio investment approaches related to actively and passively managed mutual funds. In actively managed funds, an investment manager is picking stocks to include in the fund, while passively managed funds typically invest in a basket of stocks that mirror a pre-determined index (e.g., Standard & Poor's 500) and do not involve a manager picking individual stocks for inclusion. One advantage of actively managed funds is the possibility of higher-than-market returns, but a disadvantage is the risk of below-market returns and higher fees. Our contractor found that although the Scholars Choice and Direct Portfolio investment policies allow both plans to invest in actively and passively managed mutual funds, CollegeInvest management and the Board have traditionally maintained an active/passive dichotomy between the two plans. Specifically, only actively managed mutual funds are included in Scholars Choice portfolios, and only passively managed mutual funds are included in Direct Choice portfolios.

The separation between actively and passively managed funds prevents CollegeInvest from considering low-cost, actively managed funds for Direct Portfolio, which could benefit the plan. For example, Vanguard recommended adding one of its highly rated (top 3 percent of its fund category) low-cost, actively managed funds to Direct Portfolio, but CollegeInvest did not consider the fund for inclusion into Direct Portfolio in part because the fund is actively managed and because the Vanguard fund would have required a different fee structure.

CollegeInvest indicated that the divide between actively and passively managed funds benefits consumers. For example, management said that restricting actively managed funds to Scholars Choice requires consumers to access the funds through a financial advisor who can more fully explain the risks involved in investing in actively managed funds. However, risks exist with every investment option. Further, CollegeInvest does not provide a plan option for consumers who are knowledgeable about investing, feel they understand the risks of active management without needing to pay a financial advisor, and desire high-quality active management at a low cost. The lack of this type of low-cost, actively managed option is an omission in CollegeInvest's investment line-up. For example, our contractor found that 36 of 52 (69 percent) direct-sold plans available nationally in September 2010 offered actively managed funds in their plans, and 33 (63 percent) offered participants a choice in their plans between investing in actively and passively managed funds. Therefore, the Board should consider revising the investment approaches for Scholars Choice and Direct Portfolio so that CollegeInvest has the option of adding actively or passively managed mutual funds to either plan if the funds can help the plan achieve its investment objectives.

Recommendation No. 1:

CollegeInvest should strengthen fiduciary oversight of its college savings plans by:

a. Defining in the Stable Value Plus investment policy statement what factors should be considered when monitoring the financial health of the Stable Value Plus investment provider and hiring an investment consultant to annually monitor the provider's financial health and to complete an annual, independent review of the provider.

b. Continuing to evaluate revisions to its investment approaches for Scholars Choice and Direct Portfolio to allow the addition of actively or passively managed mutual funds to either plan if the funds can help the plans achieve investment objectives.

CollegeInvest Response:

a. Agree. Implementation date: December 2010.

   The financial health of our plan manager for Stable Value Plus is critical. We will revise our Investment Policy Statement and review the provider annually as recommended.

b. Agree. Implementation date: Ongoing.

   A report by the United States Department of Treasury on Section 529 programs (which the auditors discuss later in the report) recommends that states provide a plan invested in index funds and notes, "Index funds . . . are well suited to investors who do not wish to spend time acquiring information and evaluating the investment philosophy and track records of the various actively managed funds that are offered." The Direct Portfolio Plan is offered to investors who are not required to use an advisor or broker and have a wide variety of investment knowledge and sophistication. The plan is structured using index funds to provide conservative and diverse investment options while reducing volatility and complexity. We also believe that costs matter and adding actively managed funds will increase the cost of the plan and result in a complex and a less transparent fee structure. Vanguard was engaged to manage the plan, as they are a leader in low-cost index funds. We will continue to evaluate our options and the plan managers we utilize.

Plan Fees

Fees are also an important consideration when opening any investment account with a Section 529 program. Because fees are deducted from investor account balances, they directly affect the returns that investors receive on their investments. Accordingly, the higher the fees charged by Section 529 programs, the better the plan performance must be to compensate for the negative effects of the fees. For example, if two plans have the same investment returns but one plan charges fees that are higher than the other plan's fees, the investor in the higher-cost plan will have a lower account balance at the end of the year than the investor in the lower-cost plan (assuming equal investments are made at the beginning of the year). This disparity in returns will continue to grow the longer the two investors remain in these plans. Therefore, it is important for Section 529 programs like CollegeInvest's to minimize fees as a way of maximizing investment returns so that families will have more financial resources to pay for college.

CollegeInvest account holders pay varying fees depending upon the plan in which they have enrolled. For Scholars Choice and Direct Portfolio, account holders pay asset management fees, charged annually as a percentage of their account balances, to these plans' third-party administrators and an administrative fee to CollegeInvest, also charged as a percentage of their account balances. For Stable Value Plus, account holders pay an administrative fee annually based on a percentage of their account balances to CollegeInvest.

CollegeInvest's account holders may also be subject to sales charges and account maintenance fees depending on the plan option they select and other factors. Sales charges are one-time, upfront fees that account holders pay whenever making contributions to their college savings plans. Sales charges are calculated on a percentage of the contribution and deducted from the contribution before it is credited to the account. Account plans with sales charges generally have lower asset management fees. In addition, accounts may be subject to annual maintenance fees if the account holder or beneficiary is not a resident of Colorado, the account holder does not maintain a minimum account balance, or the account holder elects to receive paper account statements. CollegeInvest's plans, like most plans nationally, do not have an enrollment fee when investors initially sign up. Table 5 below summarizes CollegeInvest's current fees for the three plans included in our scope: Scholars Choice, Direct Portfolio, and Stable Value Plus.

Table 5
Fees[1] Charged by CollegeInvest College Savings Plans
As of September 2010

Plan	Asset Management Fee	CollegeInvest Administrative Fee[2]	Sales Charge	Account Maintenance Fee[3]
Scholars Choice	0.61% to 1.83%	0.10%	0% to 3.5%	$20
Direct Portfolio	0.42%	0.10%	None	$20
Stable Value Plus	None	0.75%	None	None

Source: Office of the State Auditor analysis of CollegeInvest plan disclosure documents.
[1]Asset management fees and the CollegeInvest administrative fees are charged annually as a percentage of the account balance. Sales charges are one-time, upfront fees charged when an account holder makes a contribution.
[2]CollegeInvest is waiving this fee for Scholars Choice and Direct Portfolio investors from September 2010 to August 2011. CollegeInvest is reducing the Stable Value Plus fee from 0.75 percent to 0.65 percent from September 2010 to August 2011.
[3]Depending on the plan, account holders can avoid account maintenance fees by being a resident of Colorado, by maintaining a minimum account balance set by the plan, or by signing up for electronic delivery of account statements.

Our contractor compared the fees for CollegeInvest's Scholars Choice, Direct Portfolio, and Stable Value Plus plans to the fees of similar Section 529 programs nationwide to determine whether CollegeInvest's fees were reasonable. Overall, our contractor found that CollegeInvest's asset management and administrative fees are competitive with fees charged by programs in other states. However, our contractor also found evidence that CollegeInvest's administrative fee may be set too high. We discuss fees in the next two sections.

Fee Comparison

Section 529 programs typically offer age-based investing options, which base investment portfolios on the age of the child, since investors may want more conservative options as the child grows closer to college age. Because different age-based options contain different mixes of equities, bonds, and other investments, these options usually have different fee structures. To ensure an appropriate comparison, our contractor evaluated CollegeInvest's plan fees (i.e., the plan's asset management fee plus CollegeInvest's administrative fee) against fees nationwide using an age-based portfolio designed for an 11-year-old child from each plan. In addition, our contractor evaluated similar types of plans against each other (e.g., Scholars Choice was compared against other advisor-sold plans). Our contractor's fee comparison did not include sales charges or account maintenance fees.

Our contractor found that, based on fees charged as of September 2009, CollegeInvest's fees are comparable with fees for other states' plans and, in some cases, are lower than most states, as shown in Table 6 below.

Table 6
Comparison of Fees Charged by CollegeInvest Plans to Other State Plans For an Age-Based Portfolio Designed for an 11-Year Old Child As of September 2009

Plan	Type of Plan	CollegeInvest Plan Fee[1]	Range of Fee[2] Nationally	Rank of CollegeInvest Plan Fee Nationally
Scholars Choice	Advisor-Sold	1.01%	0.63% - 1.50%	6th of 39
Direct Portfolio	Direct Purchase	0.52%	0.21% - 0.65%	18th of 31
Stable Value Plus	Stable Value	0.75%	0.65% - 1.50%	6th of 35

Source: Buck Consultants analysis of Section 529 program fees nationwide.
[1]Fee represents the combination of the asset management fee and CollegeInvest administrative fee shown in Table 5.
[2]For other states' plans the fee represents the combination of the asset management fee and the state's administrative fee.

As the table shows, the fees for Scholars Choice and Stable Value Plus rank among the lowest fees in their category, while the fee for Direct Portfolio ranks more in the middle. The table also shows that the fee for Stable Value Plus (0.75 percent) is close to the lowest fee in its category nationally (0.65 percent), while the fee for Direct Portfolio (0.52 percent) is close to the highest fee in its category nationally (0.65 percent).

CollegeInvest has made efforts to lower its fees and should continue to do so. For example, CollegeInvest negotiated a 35 percent decrease in the Direct Portfolio asset management fee (from 0.65 percent to 0.42 percent) when it renewed its contract with Vanguard in 2009. The decrease in the Direct Portfolio fee is part of a national trend in which states are negotiating lower fees for their Section 529 programs as contracts for these programs come up for renewal. Therefore, although CollegeInvest's fees for its college savings plans are currently competitive, management will need to keep informed on national trends in Section 529 program fees and ensure that CollegeInvest's fees remain in line with those of other plans nationwide as it negotiates new third-party administrator contracts in the future.

CollegeInvest Administrative Fees

As noted previously, CollegeInvest collects an administrative fee of 0.10 percent of the asset balance for the Scholars Choice and Direct Portfolio plans and 0.75 percent of the asset balance for the Stable Value Plus fund. Statute [Section 23-3.1-304(1)(h), C.R.S.] authorizes CollegeInvest to charge administrative fees "in amounts not exceeding the cost of establishing and administering the program, including the funding of scholarships and other grants." For Fiscal Year 2010, CollegeInvest collected about $3.5 million in administrative fees from account holders.

As part of our August 2009 *CollegeInvest Scholarships and Loan Forgiveness Programs Performance Audit*, we reviewed CollegeInvest's administrative expenses for all its programs, including its college savings plans, and identified several concerns related to the appropriateness of the expenditures and the allocation of direct and indirect costs to its programs. We made recommendations to CollegeInvest to address these problems and, as of May 2010, management reported taking action to implement all of these recommendations.

For the current evaluation, our contractor analyzed whether CollegeInvest is charging administrative fees in line with the costs of administering the program and found that since Fiscal Year 2006 CollegeInvest has routinely collected more in administrative fees from account holders than it has spent on its administrative expenses. As a result, CollegeInvest has steadily built a reserve of excess administrative fees, as shown in Table 7 below.

Table 7
CollegeInvest Administrative Fees
Amount of Fee Revenue in Excess of Administrative Expenses
Fiscal Years 2006 through 2010
(Dollars in Millions)

	2006	**2007**	**2008**	**2009**	**2010**	**Percent Change, 2006-2010**
Beginning Balance	$0.1	$0.5	$1.4	$2.6	$3.3	3,200%
Administrative Fee Revenue	2.4	3.0	3.4	2.9	3.5	46
Administrative Fee Expenses	2.0	2.1	2.2	2.2	2.6	30
Revenue in Excess of Expenses	0.4	0.9	1.2	0.7	0.9	125
Ending Balance	$0.5	$1.4	$2.6	$3.3	$4.2	740%

Source: Office of the State Auditor analysis of CollegeInvest audited financial statements for Fiscal Years 2006 through 2009 and unaudited financial statements for Fiscal Year 2010.

As the table shows, CollegeInvest's reserve from excess administrative fees has increased from $500,000 at the end of Fiscal Year 2006 to $4.2 million at the end of Fiscal Year 2010, or about 740 percent. According to a legal opinion CollegeInvest obtained from its private legal counsel, this excess administrative fee reserve does not violate the statutory provision that CollegeInvest not charge administrative fees in excess of its administrative expenses as long as CollegeInvest can reasonably expect to have administrative expenses in the future to use up the reserve.

Although the increase in the administrative fee reserve may not violate statute, it appears to indicate that CollegeInvest is charging too high of a rate for administrative fees. CollegeInvest management recognized that its excess fees had grown too large and recommended to the Board in June 2010 that CollegeInvest waive its 0.10 percent fee for Scholars Choice and Direct Portfolio and reduce the Stable Value Plus fee from 0.75 percent to 0.65 percent. The Board approved this recommendation, and fee waivers and reductions will be in effect from September 2010 to August 2011.

Although the Board recently addressed the issue of excess fees collected by CollegeInvest, it appears that the Board's action was overdue, as the excess fee balance surpassed $1 million in Fiscal Year 2007 and continued to grow. As a result, stronger policies are needed to minimize future excess administrative fees. CollegeInvest's administrative fees policy states that if administrative fees exceed expenses, CollegeInvest shall (a) determine if such revenues are required to fund subsequent years' expenses, (b) determine if such revenues are required to fund prior years' unfunded expenses, or (c) reduce future fees for program participants the next year. According to the policy, if administrative revenue exceeds expenses at the end of the year, management will recommend one of these options to be approved by the Board. The policy also states that "in no event shall 'excess' fees be carried over for more than one year unless there are extenuating circumstances and such carryover is approved by the Board."

Our contractor's review of Board minutes from Fiscal Years 2006 through 2009 found no evidence that management recommended or that the Board approved one of the options for the excess administrative fees or identified extenuating circumstances necessitating the carryover of the fee balance, which allowed the excess administrative fee balance to continue to grow. By the end of Fiscal Year 2009 the balance reached $3.3 million, which equaled 150 percent of that year's administrative expenses. By comparison, statute [Section 24-75-402, C.R.S.] limits most cash funds to a reserve of not more than 16.5 percent of annual expenses. CollegeInvest is not subject to this statute, but it provides a reasonable best practice for fee management. For Fiscal Year 2010, the excess fee balance reached $4.2 million and management recommended, and the Board approved, the aforementioned reduction in fees.

CollegeInvest should follow the stated policy and continue to make formal recommendations to the Board about how to handle its excess administrative fee balance, when such a balance exists at the end of the fiscal year. To facilitate these recommendations, CollegeInvest should establish a specific excess administrative fee balance threshold, similar to the threshold in effect for the State's cash funds, that would trigger a reduction in fees on an annual basis. As mentioned, CollegeInvest current policy states that "excess" fees will not be carried over for more than one year without Board approval. However, the policy does not define what "excess" means, so it is unclear how large CollegeInvest's administrative fee balance can become before management and the Board will move to reduce fees. Reducing fees when possible is important because fees have a direct impact on investment performance.

Recommendation No. 2:

CollegeInvest should minimize the administrative fees it collects on its college savings plans by:

a. Recommending action to the CollegeInvest Board every year that administrative fees exceed expenses, in compliance with its administrative fees policy.

b. Revising its administrative fees policy to establish an excess administrative fee balance threshold that would trigger a reduction in fees on an annual basis.

CollegeInvest Response:

Agree. Implementation date: December 2010.

The CollegeInvest Board discussed the excess fee situation in 2008 and 2009 and felt there were extenuating circumstances necessitating the carryover of the fee balance due to the significant equity market disruptions and the uncertainty of the future value of the assets in the plans. The Board concluded that retention of the excess fees was necessary to ensure the stability of program management. However, assets values stabilized and withdrawals from the plan remained consistent with prior years such that fee revenues did not drop as significantly as feared, and in fact continued to exceed expenses. As a result, the Board took action in 2010 to reduce fees to zero. The Board will continue to evaluate the fee level every year and take appropriate action. In addition, the fee policy will be revised to require a fee reduction if excess fees exceed a set threshold on an annual basis.

State Income Tax Treatment of Plan Contributions

As mentioned in Chapter 1, Section 529 programs, such as CollegeInvest's college savings plans, provide a tax-favored method for saving for college expenses. For example, for Colorado residents at both the federal level and in Colorado, the investment returns on Section 529 program contributions grow taxdeferred, and the distributions to pay for the beneficiary's college costs are tax-free. These contributions are not deductible on a taxpayer's federal tax return but are deductible from a taxpayer's federal taxable income on his or her Colorado tax return. As of September 2009, most states offer taxpayers a deduction on their state tax return, which ranged (when filing as a single taxpayer) from $250 to $12,000 for states that cap contributions on a per-beneficiary basis and from $500 to $10,000 for states that cap total contributions. Colorado, along with New Mexico, South Carolina, and West Virginia, places no limit on the amount of the deduction for Section 529 program contributions. However, in Colorado this deduction cannot exceed the taxpayer's federal taxable income. In addition, statute [Section 39-22-104(4)(i)(II), C.R.S.] limits the state income tax deduction to contributions made to CollegeInvest's college savings programs or to Section 529 programs sponsored by Colorado educational institutions.

In Calendar Year 2007 (the most recent year from which data were available from the Department of Revenue), preliminary data indicate that the State gave up about $10.5 million in tax revenue related to about $226.5 million in Section 529 program contributions from about 28,000 taxpayers (1.5 percent of all taxpayers). The average deduction was about $8,000, resulting in tax savings to the average taxpayer of about $370. About $8.9 million (85 percent) of the tax savings accrued to taxpayers with incomes over $100,000, including about $4.9 million (46 percent) that accrued to taxpayers with incomes over $250,000.

We noted one concern with limiting the state income tax deduction to contributions made to CollegeInvest's college savings plans. This limit creates a powerful incentive for Colorado residents to invest in CollegeInvest's plans even though residents could possibly earn better returns in other states' Section 529 programs. As we discussed earlier, the performance of CollegeInvest plans sometimes exceeds and sometimes falls behind the performance of other states' plans, based on analysis by a national website. Further, a September 2009 report by the United States Department of the Treasury (US Treasury) concluded that this "home state" bias (i.e., state tax policies that promote that state's Section 529 program) could possibly lead to higher fees and less competition. Specifically, the US Treasury report concluded that eliminating home-state bias in state tax policies would provide more investment options for consumers, more intense competition among Section 529 programs nationwide, and very likely lower fees. For example, the report noted that there is a wide variation in fees charged nationwide for essentially the same index funds, which suggests that competition among the states' Section 529 programs is currently imperfect and that more competition would be desirable. The increased competition could also have the effect of ensuring that CollegeInvest continually improves its investment offerings to retain and attract Colorado customers.

Extending the state income tax deduction to contributions made to other states' Section 529 programs appears to have had some consideration. For example, we reviewed committee testimony for House Bill 00-1274, which created the deduction for contributions to CollegeInvest's plans, and found that there was no discussion of extending the deduction to other states' programs. However, several years later House Bill 03-1074 proposed extending the deduction to other states' programs but was postponed indefinitely in the first committee hearing. We reviewed the committee testimony for House Bill 03-1074 and found that it did not include discussions about how extending the tax deduction would benefit consumers or promote competition among Section 529 programs, which might lead to lower costs. The testimony also did not consider the possibility of making the extended tax deduction revenue-neutral to the State by placing limits on the deduction amount, which could compensate for the presumed increase in the number of taxpayers taking advantage of the deduction. As noted previously, Colorado is one of only four states that place no limits on its state income tax deduction for contributions to Section 529 programs.

Given that the current structure of the state income tax deduction limits consumer options and creates strong incentives for consumers to contribute to CollegeInvest's college savings plans even if these plans are not the best options for individual investors, we believe that the limit on the state tax deduction should be reconsidered by the Department of Higher Education (Department), keeping in mind options for making the extension revenue-neutral for the State. The Department is the appropriate agency for initiating the discussion to reconsider this policy, as the General Assembly has granted the Department's executive director authority to oversee CollegeInvest [Section 23-3.1-205.7, C.R.S.].

The Department should research and analyze the effects of extending the state income tax deduction to contributions made to any Section 529 program nationwide. These effects would include, but not be limited to, the benefits consumers would receive by having expanded investment choices, the possible benefits that increased competition could have in terms of lowering the costs of Section 529 programs, and the financial consequences to the State of extending the state income tax deduction to non-CollegeInvest plans. In examining the financial effects of extending the state income tax deduction, the Department should consider the effects of making such an extension revenue-neutral by limiting the amount of the deduction taken by individual contributors. Once the Department completes its analysis, it should determine whether it will work with the General Assembly to revise statute and allow state income tax deductions for contributions made to any Section 529 program nationwide, with consideration given to limitations on individual contributions.

Recommendation No. 3:

The Department of Higher Education should enhance the options for individuals to invest in Section 529 programs by:

a. Analyzing the effects of allowing Colorado residents to receive a state income tax deduction for making contributions to any Section 529 program nationwide. Consideration should be given to ways to make the extension of the deduction revenue-neutral by limiting the amount of the deduction that an individual may claim.

b. Determining, based on the analysis in part “a,” whether it will work with the General Assembly on revising statute to allow state income tax deductions for contributions made to any Section 529 program nationwide.

Department of Higher Education Response:

Disagree. Implementation date: N/A.

One of the main objectives of the CollegeInvest Section 529 program is to encourage Colorado residents to save for college. A primary incentive for Colorado residents to save for college is the unlimited Colorado tax deduction. Broadening the tax deduction to any 529 college savings plan would have a negative impact on statewide tax revenues during a time of precipitously declining state budgets and higher education funds.

The only way to mitigate the negative impact to statewide tax revenues would be through capping or limiting the tax deductions afforded to Colorado residents. The impact of this would be to discourage residents from maximizing savings for college which runs counter to the primary objective and goal of saving for college.

The recommendation is based on the possibility that a Colorado resident could earn a better return or that the current tax policy leads to less competition and higher fees. We believe that the known detrimental impact of reducing statewide tax revenues or capping deductions far outweighs the unknown potential benefit of greater performance or lower fees.

Lastly, the Department does not believe it should devote its limited resources to conduct such an analysis in the midst of the fiscal challenges facing higher education.

Stable Value Plus Contributions

Neither federal nor state law requires that contributions to Section 529 programs be deposited into an individual’s account within a certain time frame. As a result, program administrators like CollegeInvest set their own policies in this area. For

Direct Portfolio, the Plan Disclosure Statements say that account contributions will be credited to the participant's account no later than the next business day after the contribution is received and for Scholars Choice no later than the second business day after the contribution is received. For both of those plans, the third-party administrator accepts the contribution and deposits it into the participant's account. However, for Stable Value Plus, the Plan Disclosure Statements say that CollegeInvest may take up to 30 days before depositing the contribution with MetLife. Further, CollegeInvest states that any interest earned on the Stable Value Plus account holder's contribution during the 30 days before being deposited with the third-party administrators will be retained by CollegeInvest, not the account holder, to offset CollegeInvest's administrative expenses.

The potential 30-day delay for contributions to Stable Value Plus to be transferred to MetLife is unreasonable. CollegeInvest stated that the 30-day allowance for transferring contributions to MetLife was a result of standard contractual language required by MetLife. However, account holders should be able to expect that their contributions will be deposited into their accounts as soon as possible and that their contributions will not be used to accrue interest on CollegeInvest's behalf.

CollegeInvest reported that it currently transfers Stable Value Plus contributions on a weekly basis to MetLife and, according to CollegeInvest, it held about $306,000 in untransferred contributions as of June 30, 2010. Although the amount of interest earned by CollegeInvest and foregone by investors is likely small, as the fiduciary for the fund CollegeInvest should revise its Plan Disclosure Statements related to the deposit of Stable Value Plus contributions with MetLife, or any subsequent manager of the Stable Value Plus, to state that deposits will be made within a more reasonable time frame, not to exceed seven business days.

Recommendation No. 4:

CollegeInvest should ensure that contributions to the Stable Value Plus plan are deposited timely to MetLife, or to any subsequent manager of Stable Value Plus, by revising its policy so that Stable Value Plus deposits into participants' accounts occur within a reasonable time frame, not to exceed seven business days.

CollegeInvest Response:

Agree. Implementation date: November 2010.

Our procedures for depositing contributions to the Stable Value Plus program require weekly deposits of all funds received prior to each deposit. However, we will clarify our policy over deposits of contributions to state that amounts are to be deposited within seven business days of receipt of the monies.

Controls over Account Contributions and Withdrawals

Federal and state law both provide basic requirements that CollegeInvest must meet in establishing and administering its Section 529 program and individual accounts. The Bonadio Group reviewed these requirements and found that CollegeInvest was generally in compliance. Our contractor did, however, note one concern each related to account contributions and account withdrawals, as discussed below.

Account contributions. Statute [Section 23-3.1-306(1)(a)(IV), C.R.S.] requires that CollegeInvest's account applications include a certification from the contributor stating that, to the best of the contributor's knowledge, "the account balance for the designated beneficiary in all qualified state tuition programs . . . does not exceed the greater of either a maximum [account balance] established by [CollegeInvest] or the cost in current dollars of qualified higher education expenses that the contributor reasonably anticipates the designated beneficiary will incur." This certification helps to ensure that contributors do not exceed contribution limits for Section 529 programs.

Our contractor found that CollegeInvest includes this contributor certification on its Stable Value Plus and Smart Choice Participation Agreements but not in the Scholars Choice and Direct Portfolio Participation Agreements. Our contractor reviewed CollegeInvest's records and did not identify any accounts that exceeded CollegeInvest's current account balance limit of $280,000. Our contractor also found that CollegeInvest has implemented procedures to prevent an account from accepting additional contributions if the account balance reaches $280,000. Even so, it is important that CollegeInvest comply with statute and ensure that its applications for Scholars Choice and Direct Portfolio contain all required elements.

Account withdrawals. As noted in Chapter 1, the purpose of Section 529 programs is to allow tax-favored saving for qualified higher education expenses. To ensure that account withdrawals are used to pay for qualified expenses, federal law requires Section 529 programs to file Form 1099-Q (Payments from Qualified Education Programs) with the federal government for each account by January 31st each year to reflect the previous year's account withdrawals. A copy of Form 1099-Q is also sent to the account holder. The federal government uses the Form 1099-Q to verify that the account withdrawals were only used by the account holder for qualified expenses; Section 529 programs like CollegeInvest are not responsible for ensuring that account withdrawals are used for qualified expenses.

Our contractor found that CollegeInvest has properly filed Form 1099-Qs for the Stable Value Plus fund, which it directly administers, but CollegeInvest does not have procedures for checking that its third-party administrators for the Scholars Choice and Direct Portfolio plans are filing these forms on time. Our contractor confirmed with the third-party administrators that the Form 1099-Qs have been filed appropriately. CollegeInvest should put a process in place for verifying each year that its third-party administrators are properly filing the Form 1099-Qs.

Recommendation No. 5:

CollegeInvest should help ensure that account contributions and withdrawals meet applicable state and federal requirements by:

a. Revising its Participation Agreement for both the Scholars Choice and Direct Portfolio plans to include a contributor certification regarding compliance with maximum account balance limits.

b. Implementing a process for confirming that its third-party administrators file Form 1099-Q for all accounts in accordance with federal law.

CollegeInvest Response:

a. Agree. Implementation date: September 2010

CollegeInvest and our vendors have established strong controls over receipts of contributions. Any deposit to an account that causes it to exceed $280,000 is immediately identified and the deposit is not allowed. We did add language to the Participation Agreements stating that the account owner represents they will not make a contribution in excess of the maximum account balance limits as of September 1, 2010.

b. Agree. Implementation date: January 2011.

Vendors will be required to annually confirm the filing of all Form 1099-Qs.

Information Technology Controls

CollegeInvest and its third-party administrators maintain significant amounts of sensitive data about account holders, such as names, addresses, Social Security numbers, and account balances. Accordingly, it is critical that CollegeInvest establish and maintain strong controls over its information technology (IT) system and ensure that its third-party administrators have adequate controls to protect this sensitive data. For the plans managed by third-party administrators (Scholars Choice, Direct Portfolio, and Smart Choice), new investors are directed to the websites of the administrators to sign up. CollegeInvest does not collect any individual data for accounts in these plans. The third-party administrators submit aggregated data to CollegeInvest on a daily, monthly, and annual basis. CollegeInvest uses the aggregated data for purposes such as ensuring that account balances do not exceed plan limits and reporting contributions to the Department of Revenue for state tax deduction purposes. For Stable Value Plus, CollegeInvest, as the direct administrator, collects and stores all account data.

Our contractor reviewed IT controls at each of CollegeInvest's third-party administrators and at CollegeInvest's Denver office to determine whether the controls in place were sufficient to protect the sensitive data they collect. For the third-party administrators, our contractor primarily relied on the reviews conducted at each administrator in compliance with the Statement of Auditing Standards, No. 70, *Service Organizations* (SAS 70). The purpose of a SAS 70 review is to report on the safety and integrity of data used by a service organization, such as the third-party administrators, in processing agencies' transactions for other parties, such as CollegeInvest. Based on the review of the SAS 70 reports, our contractor did not identify any issues with IT controls at any of the third-party administrators.

Our contractor performed more detailed testing of IT controls at CollegeInvest's Denver office because CollegeInvest has not undergone a SAS 70 review. As discussed below, our contractor noted improvements that CollegeInvest could make in the areas of (1) change management, (2) user access, (3) monitoring, (4) physical security and disaster recovery, and (5) process documentation. The contractor's findings primarily involve instances in which CollegeInvest can bring its policies more in line with the Colorado Cyber Security Policies, developed by the Office of Information Technology at the Governor's Office. Although statute [Section 24-37.5-402(9), C.R.S.] does not require CollegeInvest, as part of the Department of Higher Education, to comply with these polices, they represent generally accepted IT standards that reduce the risk of breaches in data security and integrity. Although our contractor identified the control weaknesses discussed below, it is important to note that our contractor did not discover any existing data problems related to these control weaknesses at CollegeInvest's Denver office.

Change management. According to Colorado Cyber Security Policies, agencies should develop and regularly review policies that document system development life-cycle and change management processes. These policies help ensure that agencies adequately plan, design, test, and approve initial IT system development and provide reasonable assurance that only authorized and tested changes are made to a system. Our contractor found that CollegeInvest does not have a documented system development life-cycle or change management process and that formalized IT project plans do not exist. In addition, CollegeInvest does not require that changes to its current IT system have documented approvals for the requirements, development, testing, and "go live" implementation of the changes. CollegeInvest also does not require that changes to its current IT system have documented plans for implementation, "back-out" (which occurs if implementation is not successful), or user training.

Without sufficient system development life-cycle and change management policies, the risk increases that inappropriate, unexpected, or detrimental changes (either intended or unintended) could be made to CollegeInvest's IT environment. Further, the lack of these policies may result in IT changes that do not meet the expected or desired business requirements that CollegeInvest needs to fulfill its objectives. Finally, the lack of a documented back-out plan could result in significant costs, both in terms of work effort and financial outlays, if an unsuccessful implementation of a change to the IT system needs to be reversed.

User access. User access refers not only to one's ability to gain initial entry into the IT system but also to the ability to access various parts of the IT system once initial entry into the system occurs. According to Colorado Cyber Security Policies, agencies should develop policies to ensure appropriate user access. For example, agencies should ensure that users create strong passwords for access to IT systems. Strong passwords typically have a minimum length of eight characters, are complex (e.g., alphanumeric and use of capital letters and symbols), must be changed on a regular basis (e.g., every 60 days), and will lock out users after a specified number of invalid attempts to access the system. In addition, agencies should ensure that users only receive the minimum access needed to perform their job duties and that reviews of existing user access for appropriateness occur regularly.

Our contractor found that, due to system limitations, CollegeInvest does not have strong passwords at the Banner application and database levels. Banner is CollegeInvest's record-keeping application for its Stable Value Plus and Prepaid Tuition plans. The current version of Banner does not permit the passwords to be complex in nature, nor does it allow for specific length, meaning that anyone with application or database level access could create a password that consists of a few letters or numbers. Weak passwords increase the risk that inappropriate users could gain access to the CollegeInvest Banner system and the sensitive data it contains. Although the weak Banner passwords are a concern, it is important to note that CollegeInvest's network-level passwords, which all staff use to access the IT system daily, were considered strong.

Our contractor also found that CollegeInvest does not routinely review existing user access for appropriateness. As a result, users could be granted or maintain access to system functions that are not consistent with their job duties. Finally, our contractor found that CollegeInvest's policies for granting new users access do not include controls to prevent conflicts with segregation of duties. For example, CollegeInvest's current policies allow a user with the ability to make a change to the IT system in the testing environment to also have the ability to migrate the change to the live environment. A person with this level of access could perform inappropriate or fraudulent activities in the test system and then implement the changes to the live system without detection.

Monitoring. According to Colorado Cyber Security Policies, an agency should protect the security of its IT system by routinely monitoring the system for evidence of inappropriate access or other security breaches. Our contractor identified two concerns in this area. First, although CollegeInvest has system monitoring software and compiles audit logs of the activities that occur on its IT system, our contractor could not find any evidence that staff monitor these logs for evidence of possible security issues. Staff reported that this monitoring occurs informally, but our contractor could not confirm that this monitoring occurs since it is not documented. Second, CollegeInvest has not implemented any form of intrusion detection software. Without a formal review of the audit logs from its system monitoring software or the implementation of intrusion detection software, the risk increases that security breaches could go unnoticed and that important data or system functions could become compromised without detection.

Physical Security and Disaster Recovery. Physical security refers to the methods that CollegeInvest uses to protect entry into in its data center and to prevent the theft of IT equipment. Disaster recovery refers to the plans that CollegeInvest has put in place to recover data in the event of a disaster (e.g., act of nature). Our contractor identified three concerns in these areas. First, according to Colorado Cyber Security Policies, agencies should establish environmental controls to protect the physical security of its IT data centers. Our contractor found that CollegeInvest's data center was lacking important environmental controls. The missing controls included (1) a fire suppression system, (2) locked server storage cabinets, (3) testing of the battery backup system, (4) unsecured removable storage media (e.g., tapes and disks), and (5) regular changes to the access code to enter the data center. Second, according to Colorado Cyber Security policies, agencies should develop a disaster recovery plan and test it regularly. Our contractor found that CollegeInvest created a disaster recovery plan in January 2010 but has not yet formally tested it to determine whether the plan is workable. Finally, according to Colorado Cyber Security policies, agencies should establish procedures for ensuring that backups of the IT system and its data occur. Our contractor found that CollegeInvest does not maintain evidence of backup completion or backup failure review and resolution. In addition, CollegeInvest does not regularly test the completeness and accuracy of the backup data. Without formal monitoring of backup processes, the risk increases that incomplete backups may occur, which could compromise CollegeInvest's efforts to restore data if the IT system malfunctions.

Process documentation. Our contractor identified three instances in which CollegeInvest did not adequately document that IT-related security procedures had been completed in accordance with its own policies. For example, for one of four new users sampled, CollegeInvest did not set up a tracking ticket to monitor the level of IT access given to the new user. In addition, CollegeInvest could not produce a signed form for one of three new employees sampled showing that the new employee had read the employee manual. Finally, a tracking form for disabling user access was missing for one of three employees sampled who had left employment at CollegeInvest. Our contractor found that user access had been properly set up or disabled in these cases. CollegeInvest should ensure that it properly documents that these procedures have been completed.

Recommendation No. 6:

CollegeInvest should strengthen the controls over its information technology (IT) system by:

a. Instituting a system development life-cycle and change management process covering system and software development and implementation.

b. Creating strong passwords for access to its IT system at the Banner application and database levels.

c. Routinely reviewing user access for appropriateness and ensuring that segregation of duties is maintained when granting user access.

d. Documenting routine reviews of audit logs and employing intrusion detection software to determine if any anomalous events have occurred in the IT system.

e. Formally monitoring data backup processes and following up on backup failures.

f. Maintaining a fire suppression system in its IT data center, keeping its servers and other IT equipment in locked cabinets, testing its battery backup system, securing removable storage media, and changing the access code to its data center routinely.

g. Testing its disaster recovery plan on a routine (e.g., annual) basis and implementing a formal process for monitoring backup activity.

h. Ensuring that procedures for granting and disabling user access and training new employees on its policies and procedures are adequately documented.

CollegeInvest Response:

Agree. Implementation date: November 2010.

CollegeInvest performs regular audits of the information technology systems. The last audit was completed in May 2009 which identified all the issues noted in this recommendation. Implementation of all but two parts of the recommendations was completed in August 2010 as follows:

For part "b," the Banner system will be upgraded to allow for more complex passwords in November 2010.

Part "f" has been substantially implemented. However, the server cabinets we use no longer have replacement doors available and, therefore, we cannot implement this part of the recommendation until new server cabinets are acquired.

Appendices

Appendix A
Investment Portfolio Options for Scholars Choice and Direct Portfolio
As of September 2010

Scholars Choice

Scholars Choice accounts can be opened at any time through an investment advisor. When opening an account, investors must select from nine investment options. Each option consists of a different mix of equity, bond, and/or fixed income investments. The nine Scholars Choice options include:

- **Age-Based Option.** Contributions are invested in a series of up to seven portfolios over time. As the beneficiary gets closer to college age, the fund manager automatically moves investments from higher-risk portfolios to lower-risk portfolios.

- **Balanced 50/50 Option.** Contributions are invested in a portfolio with a median degree of risk, with 50% invested in stocks and 50% invested in bonds.

- **Years-to-Enrollment Option.** Contributions are invested in a series of up to five portfolios depending on the time to account for maturity, similar to the age-based option, but with a more limited, lower-risk, range of portfolios.

- **All Equity Option.** Contributions are invested in equity mutual funds that are shifted to bond and money market funds throughout the life of the account. This option carries the highest potential for risk and return through its focus on equity markets.

- **All Fixed Income Option.** Contributions are invested in bond funds throughout the life of the account. This option seeks stable returns on fixed income investments.

- **Equity 80% Option.** Contributions are invested 80% in equity mutual funds while maintaining 20% in portfolio with exposure to more stable returns of fixed income investments throughout the life of the account.

- **Fixed Income 80% Option.** Contributions are invested 80% in more stable returns of fixed income investments while maintaining 20% in one portfolio with exposure to the long-term capital appreciation potential of equity mutual funds.

- **Cash Reserve Option.** Contributions are invested in the Western Asset money market mutual fund. The investment objective of the Cash Reserve Option is to seek maximum current income and preservation of capital.

- **U.S. Treasury Zero-Coupon Bond Target Maturity Option.** Contributions are invested primarily in zero-coupon U.S. Treasury bonds. Three portfolios are available, each with different bond maturity dates.

Direct Portfolio

When opening an account, investors must select from 11 investment options. The 11 Direct Portfolio Options include three types of age-based options and eight portfolios based on different mixes of equities, bonds, and/or fixed income investments:

Age-Based Options. Contributions are invested in a series of portfolios over time based on the age of the beneficiary. As the beneficiary gets closer to college age, the fund manager automatically moves investments from higher-risk portfolios to lower-risk portfolios. The investor can select a Conservative, Moderate, or Aggressive age-based portfolio, depending upon the risk willing to be assumed.

Blended Portfolios and Individual Portfolio Options. Contributions can be invested in one of the eight portfolio options, which are each invested according to a set asset allocation. The eight portfolios include:

- **Aggressive Growth Portfolio Option.** Contributions are invested in a portfolio with a high degree of risk and most potential for capital appreciation. The portfolio is invested 100% in stock market index funds.

- **Growth Portfolio Option.** Contributions are invested in a portfolio that seeks to provide capital appreciation and low-to-moderate income. The portfolio is invested 75% in stock market index funds and 25% in bond index funds.

- **Moderate Growth Portfolio Option.** Contributions are invested in a portfolio that seeks to provide capital appreciations and current income. The portfolio is invested 50% in stock market index funds and 50% in bond funds.

- **Conservative Growth Portfolio Option.** Contributions are invested in a portfolio that seeks to provide current income and low-to-moderate capital appreciation. The portfolio is invested 25% in stock market index funds and 75% in bond funds.

- **Income Portfolio Option.** Contributions are invested in a portfolio that seeks current income. The portfolio is invested 75% in bond funds and 25% in money market funds.

- **Stock Index Option.** Contributions are invested 100% in the Vanguard Total Stock Market Index Fund that seeks to track the performance of a benchmark index that measures the investment return of the overall stock market.

- **Bond Index Option.** Contributions are invested 100% in the Vanguard Total Bond Market Index Fund that seeks to track the performance of a broad, market-weighted bond index.

- **Money Market Option.** Contributions are invested 100% in the Vanguard Prime Money Market Fund that seeks to provide preservation of principal and current income.

Source: CollegeInvest.org

Appendix B
Description of Mutual Fund Categories
As of September 2010

Category	Description
Foreign Large Blend Fund	Invests in a variety of large international stocks, mostly in developed countries (e.g., Japan and Germany) but also in developing markets (e.g., Brazil and Mexico). Typically have less than 20 percent of assets invested in U.S. stocks.
High-Yield Bond Fund	Concentrates on lower-quality bonds which offer higher yields but also higher risk.
Inflation-Protected Bond Fund	Invests in bonds designed to protect the investor from inflation.
Intermediate-Term Bond Fund	Invests in bonds with maturity dates greater than 3.5 and less than 6 years.
Large Blend Fund	Has portfolios that are fairly representative of the total market in size, growth rates, and price. Tends to invest across the spectrum of U.S industries. Returns tend to mirror the returns of Standard & Poor's 500 Index.
Large Growth Fund	Focuses on large companies whose share prices are projected to grow faster than other large companies. Tends to invest in companies in rapidly expanding industries.
Large Value Fund	Focuses on large companies whose shares are less expensive or growing more slowly than other large-cap stocks. Often features investments in energy, financial, or manufacturing sectors.
Short-Term Bond Fund	Invest in bonds with maturity dates between 1 and 3.5 years.
Small Blend Fund	Favors smaller companies and are flexible in the types of companies they own. May aim to own an array of value and growth stocks or stocks with growth rates similar to the average for smaller companies.
Small Growth Fund	Focuses on smaller companies with fast growth. Tends toward companies in up-and-coming industries or young firms in their early growth phases.
Source: Morningstar.com	

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