529 plans for K–12 savings: unique time horizons and objectives

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- Recent changes to federal tax law extended 529 plans' tax benefits to include saving for kindergarten through Grade 12.
- K–12 savers have different objectives, time horizons, and spending patterns.
- Vanguard suggests an investment strategy customized to K–12 savers' unique circumstances.

Introduction

529 savings plans were originally designed to help investors save for the primary goal of college funding. The benefits included tax-advantaged growth, tax-free withdrawals, gift tax incentives, and, in some cases, state tax deductions or credits. Recent changes in federal tax law extended these benefits to education savings for kindergarten through Grade 12. Specifically, the new code permits federally tax-free distributions for private school tuition expenses of up to $10,000 per year. More than 30 states offer a tax credit or deduction for 529 plan contributions, but nonqualified withdrawals can be subject to state tax recapture. As of March 2018, some states have conformed to the federal law, and taxpayers in these states will not be subject to recapture. The remaining states are in the process of deciding whether or not to expand their benefits to include these expenses.

Investment strategy

As with college savings, Vanguard approaches the construction of investment options for K–12 savers with an eye toward best practices. These include the principles of asset allocation, diversification, transparency, and a balance between risk, return, and cost.[1]

However, K–12 savers will have shorter and more varied time horizons than college savers. Even those starting when their child is born will likely start withdrawing in five or six years for elementary education. Many will have an extended drawdown period during which they will continue to contribute, such as those who start saving when a child is born, begin withdrawals when the child reaches kindergarten, then continue to contribute and withdraw for the next 12 years until the child finishes high school. Others may be saving only for private high school expenses and therefore, if they begin early, have a longer time horizon. There will likely be many variations of these hypothetical examples.

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1 For a complete analysis of Vanguard's 529 investment methodology, see *When Age Meets Risk Tolerance: Best Practices for 529 Investing,* Vanguard, September 2016.

Because of such varied time horizons and enrollment dates, Vanguard does not view an age-based or years-to-enrollment glide path as an applicable solution. Instead, we suggest a set of global risk-based portfolios linked to appropriate time horizons specifically for K–12 savers. This could serve the needs of those not wishing to build their own portfolios from the options already in the 529 plan and looking for more of a turnkey solution. **Figure 1** shows one such set of portfolios at the asset class level. The time horizons and allocations are linked to Vanguard's suggested moderate college savings glide path. Portfolios are never more aggressive but in some cases are slightly more conservative than the moderate glide path because of the varying accumulation and drawdown periods. Investors with dynamic time horizons could reallocate as their horizon changes.

Figure 1. K–12 risk- and time horizon-based portfolios

Years to expense	Target allocation	Risk (1–5)	Description
0–2	100% short-term reserves	1	• Could be a good fit for investors with a short-term savings goal whose main priority is preserving principal. • Investors should be comfortable with unit prices that are expected to remain stable or that fluctuate only slightly.
3–4	75% bonds/ 25% short-term reserves	2	• Subject to low to moderate fluctuations in unit prices. • Could be a good fit for investors with a short- to medium-term savings goal. • Investors should be comfortable with the risks that come with investing in the bond market.
5–8	25% stocks/ 75% bonds	2	• Subject to low to moderate fluctuations in unit prices. • Could be a good fit for investors with a short- to medium-term savings goal. • Investors should be comfortable with the ups and downs that come with investing in the bond and stock markets.
9–12	50% stocks/ 50% bonds	3	• Subject to a moderate degree of fluctuation in unit prices. • Could be a good fit for investors with a long-term savings goal. • Investors should be comfortable with the ups and downs that come with investing in the bond and stock markets.
13+	75% stocks/ 25% bonds	4	• Subject to wide fluctuations in unit prices because they hold the majority of their assets in common stocks. • Could be a good fit for investors with a long-term savings goal. • Investors should be comfortable with the ups and downs that come with investing in the bond and stock markets.

Source: Vanguard.

Notes on risk

All investing is subject to risk, including the possible loss of the money you invest. Past performance is no guarantee of future results. Diversification does not ensure a profit or protect against a loss. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income. Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments. Investments in stocks or bonds issued by non-U.S. companies are subject to risks including country/regional risk and currency risk.

Suggested underlying portfolios for K–12 savers are shown in **Figure 2**. These market-cap-weighted index portfolios are taken directly from Vanguard's suggested moderate college savings glide path and therefore reflect our recommended methodology for sub-asset allocation, non-U.S. allocation, inflation, and principal protection. Each portfolio is supported by research into the appropriate risk and reward balance for an investor with moderate risk tolerance.

Vanguard also recommends including guidance on the plan website to help account owners choose the appropriate portfolio(s) and to highlight the importance of spending patterns. As with college saving, risk tolerance and time horizon are key considerations. But because many K–12 savers' accumulation and spending phases will be concurrent, time horizon can be nebulous. Therefore, spending frequency and magnitude are more important considerations, because both are potentially high. The total saving time horizon may be ten years or longer, but if spending is frequent and each drawdown involves a significant percentage, spending should be the portfolio selection driver. For such investors, regardless of risk tolerance, an aggressive portfolio would not be appropriate. For any investors spending within two years, an interest accumulation portfolio is likely most appropriate.

Conclusion

Investors can now save for primary and secondary education in a 529 plan. Because these savers have varying objectives, time horizons, and spending patterns, we do not believe age-based or years-to-enrollment glide paths are applicable to the majority of K–12 savers. Instead, we suggest a set of portfolios customized to their unique needs.

Reference

Stockton, Kimberly A., Scott Donaldson, Harshdeep Ahluwalia, Matthew Tufano, and David Walker, 2016. *When Age Meets Risk Tolerance: Best Practices for 529 Investing.* Valley Forge, Pa.: The Vanguard Group.

Figure 2. Funds underlying moderate glide-path portfolios

	Growth	Moderate growth	Conservative growth	Income	Interest accumulation
Vanguard Total Stock Market Index Fund	45.00%	30.00%	15.00%	–	–
Vanguard Total International Stock Index Fund	30.00%	20.00%	10.00%	–	–
Vanguard Total Bond Market II Index Fund	17.50%	35.00%	52.50%	34.50%	–
Vanguard Total International Bond Index Fund	7.50%	15.00%	22.50%	22.50%	–
Vanguard Short-Term Inflation-Protected Securities Index Fund	–	–	–	18.00%	–
Vanguard stable value securities	–	–	–	25.00%	100.00%

Source: Vanguard.

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For more information about any 529 college savings plan, contact the plan provider to obtain a program description, which includes investment objectives, risks, charges, expenses, and other information; read and consider it carefully before investing. If you are not a taxpayer of the state offering the plan, consider before investing whether your or the designated beneficiary's home state offers any state tax or other benefits that are only available for investments in such state's qualified tuition program. Vanguard Marketing Corporation serves as distributor and underwriter for some 529 plans.

For more information about Vanguard funds, visit vanguard.com or call 866-734-4524 to obtain a prospectus or, if available, a summary prospectus. Investment objectives, risks, charges, expenses, and other important information about a fund are contained in the prospectus; read and consider it carefully before investing.

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