MISSOURI'S 529 COLLEGE SAVINGS PLAN

CLINT ZWEIFEL
MISSOURI STATE TREASURER

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FROM: Bruce A. Ring, Jr.
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RE: 2012 Annual Program Review

Section 166.450 of the Revised Statutes of Missouri (RSMo) requires an annual review of the Missouri Higher Education Savings Program ("MOST") by the Director of Investments of Treasurer Zweifel's Office and the reporting of the findings to the Missouri Higher Education Savings Program Board ("Board"). The statute requires a review of five areas:

- Board administration
- Financial status
- Investment policy
- Participation rate
- Continued viability

Therefore, in accordance with these requirements, I am pleased to present the following findings from my review for calendar year 2012.

I. Board Administration

Upromise Investments Inc., a subsidiary of Upromise, Inc., ("Upromise") assumed responsibility as program manager for both the Direct and Advisor Plans on June 3, 2006. On February 7, 2011, the Board entered into another contract with Upromise, following a Request for Proposal ("RFP") process. The new contract extends to June of 2016. The Board and Treasurer Zweifel's Office continue to work closely with Upromise and monitor its management of the programs. In addition, the Board met quarterly during 2012, as required by law.

II. Financial Status

Following is a review of the financial status of our major partners and a summary of the investment performance of the most popular investment options within the MOST Plan.

A. Financial Status of MOST Partners

Financial markets in 2012 performed fairly well across sectors and continued to recover from the 2008-2009 market crisis. While the economy is still struggling to recover, in general, the feeling is that there has been slow and steady progress in both economic and financial areas. Only time will tell when and if the economy returns to what is considered "normal" unemployment and inflation levels.

On May 29, 2013, Sallie Mae, the parent company of Upromise Investments, Inc., announced that its Board of Directors had authorized management to pursue separation of the company's existing businesses into two, separate, publicly traded entities -- an education loan management business and a consumer banking business -- to unlock value and enhance long-term growth potential.

Sallie Mae will form an education loan management business comprised of the company's portfolios of federally guaranteed (FFELP) and private education loans, as well as most related servicing and collection activities. The education loan management business is likely to consist of approximately $118.1 billion in FFELP Loans, $31.6 billion in private education loans, $7.9 billion of other interest-earning assets; and a leading education loan servicing platform that services loans for approximately 10 million federal education loan customers, including 4.8 million customer accounts serviced under the company's contract with the U.S. Department of Education. In aggregate, this company will own approximately 95 percent of Sallie Mae's existing assets and remain obligated for the company's senior indebtedness. Upromise Investments, Inc. will be a part of this organization. Sallie Mae's private education loan origination and servicing businesses, including Sallie Mae Bank and the private education loans it currently holds, will operate separately under the Sallie Mae brand.

The distributor for the Advisor Plan in 2012 is Deutsche Asset & Wealth Management, part of Deutsche Bank. Deutsche Bank is one of the world's largest global universal banks with total assets of $2.65 trillion and is active in 72 countries with 2,984 DB branches serving more than 31 million clients by over 98,000 employees. Deutsche is one of the world's leading investment organizations with $1.24 trillion of invested assets as of the end of 2012. Investment strategies include passive and active across equity, fixed income, liquidity, and alternatives. In addition, Deutsche has a large US distribution group to advisors across the US.

The investment manager for the Direct Plan in 2012, The Vanguard Group, remained a strong franchise. Vanguard is the world's largest mutual fund company and one of the world's largest investment management companies. Vanguard manages more than $2.5 trillion in global assets, including $281 billion in global ETF assets. The firm offers more than 160 funds to U.S. investors and more than 80 additional funds in non-U.S. markets. Within the 529 market, Vanguard is the largest provider of investments with $47.1B representing approximately 25% of the market.

B. Performance of MOST Underlying Funds

Overall, 2012 was a much more solid year for returns than was 2011. Broad market equity indices showed 15% to 17% returns for the year and fixed income had another good year showing 4% to 8% returns as well.

The return for investment options in MOST, both Direct and Advisor, was positive in all plan funds and underlying portfolios. The one-year returns of the funds in the Direct Plan, excluding the Interest Accumulation Portfolio ranged from +3.51% (Vanguard Conservative Income Portfolio) to +19.90% (Vanguard International Growth Portfolio). The returns for all options in the Advisor Plan were similar with a range of +1.57% for the lowest one year return and +21.50% for the best performer. Underlying fund performance was similar in that all funds showed similar positive returns for the year. Funds with an international component generally outperformed those with only a domestic exposure.

Treasurer Zweifel's Office is responsible for monitoring the relative performance of each of the underlying investment alternatives versus an established benchmark. This effectively measures the contribution that the investment manager's expertise has on participants' returns. Despite good absolute returns for the calendar year, relative performance for most of the funds (5 Direct and 10 Advisor) can best be described as at or below benchmark for the period. To summarize, the investment managers' overall contribution to participants' returns was negative, albeit modestly. As of year-end, one advisor fund was on the Watch List for negative short-term performance results and three advisor funds were on Watch List for intermediate term performance. All passive (index tracking) funds performed satisfactorily, and experienced low tracking error of returns versus their relevant indices.

III. Investment Policy

The Missouri Higher Education Savings Program Board adopted a formal investment policy governing program investments in mid-2007. The policy establishes objectives for structuring the investment options in the Direct and Advisor Plan, formulates policies for selecting appropriate investment managers and the use of specific investment vehicles, and establishes an investment performance process for underlying funds in the Plan. The policy is an important statement by the Board in terms of defining its fiduciary responsibilities and standards for Treasurer Zweifel's office staff and MOST partners. The policy was modified in 2008 to allow the Director of Investments, rather than the Board, to make the decision to place or release a fund to/from "WATCH" status. The Board again modified the investment policy in August 2011 to provide that the formal review period for a fund would be three consecutive quarters (as opposed to two consecutive quarters) when looking at benchmark performance evaluation for the Watch List. "Beta" and "Alpha" measures were also added to the review process for funds when determining Watch List eligibility and quarterly performance, as well as the elimination of the "value of active management" measurement criteria.

IV. Participation Rate

Following is an examination of the participation rate of the MOST program. By examining the participation rate for the program, we can attempt to gauge the relative success the program has had in reaching the state's residents and encouraging them to increase college savings—the original goal of the IRS section authorizing these programs. The relative success or failure of states' various 529 programs rests on many different factors including the effectiveness of marketing efforts, demographic and economic conditions, cost structure and the abilities and resources of states' partners to attract and retain assets. However, one facet that has remained a constant is the competition for assets among states' program managers. As the field of firms in the 529 industry has shrunk, this competition for assets remains fierce as evidenced by the decline in fees among plans issuing new RFP's in recent years.

A. Growth of Plan in 2012

The MOST Plans experienced growth in both assets and accounts during the year 2012. The asset growth in 2012 is due to both investment returns and increased contributions, while the positive change in number of accounts is primarily the result of increased awareness and popularity of the program.

Combined Plan assets grew by a rate of 15.2% ending the year at approximately $1.941 billion as compared to year-end 2011 at $1.685 billion. Growth was experienced in both the Advisor (19.9%) and the Direct Plans (14.8%) although the majority of the absolute dollar growth was again accounted for in the Direct Plan. Both plans grew at a significantly higher rate than the year before which saw Advisor Plan growth at 7% and Direct Plan growth at 5.2%. In the two previous years, the plans experienced a combined increase of 16% in assets during 2010 and a more modest increase of 5.4% in 2011. For the past three years, plan growth in MOST has been approximately 37%, due in large part to the recovery in the markets after a very poor 2008, and the average plan increase for MOST over the past three years has been 12.2%.

Contributions during the period once again outpaced withdrawals, also contributing to the positive asset growth. Total combined contributions for both plans equaled $254.2 million, while withdrawals were $173.3 million. Contributions increased by $26.2 million in 2012 versus $7 million in 2011 and $11 million in 2010. A general increase in contributions should be expected as the economy continues to recover and the cost of higher education increases.

The number of accounts grew by a rate of 3.3%, the rate of growth decreasing slightly from a year earlier (3.99%), resulting in a total of 136,419 combined accounts at year-end. The rate of growth for the Advisor Plan was 2% and the Direct Plan was 5.2%. Roughly 88% of account holders are Missouri residents, an amount relatively unchanged in 2012.

B. Comparison of MOST Participation to National Trends

Nationally, assets in 529 Plans on average have grown significantly over the past decade, but at a decreasing rate. Similar to Missouri, levels plummeted in 2008 due primarily to the financial market performance, but accounts have continued to grow signaling that popularity and awareness across the country is on the rise. Overall, the growth trends for Missouri's MOST Plan, both in respect to assets and accounts, have consistently mirrored the national rates over the past several years, with a slightly better result in 2012 (10% rather than 9% nationally).

The 529 Plan landscape is a maturing marketplace and several trends are emerging. Most noticeably is the rise in competition and its impact on program fees. Many states are re-bidding their plans and this is accelerating the fee reduction impact. As a result, some program managers are even voluntarily reducing fees in a pro-active effort to improve client retention. Innovative and cost-effective market initiatives, as well as more conservative investment options such as CDs, are also prominent trends in the 529 market. Remaining at the forefront of these market trends will be critical to the success and competitiveness of Missouri's MOST program in coming years.

MOST's program management contract with Upromise was renewed in 2011. Some fairly significant changes to the Advisor Plan were put into place in 2011. These changes included the elimination of some poor performing funds and the addition of DWS as a partner in the Advisor Plan. DWS brings with it a broad family of plans as well as a significant relationship with the Broker-Dealer community which should continue to improve our visibility with this all important aspect of the Advisor Plan.

V. Continued Viability

The MOST program remains a viable college savings program. In Upromise's six and one-half years of program management we have experienced strong trends in asset and account growth despite the market turmoil that plagued much of this period. We also saw an upswing in the number of new beneficiaries enrolled in the plan, which shows growth of new customers, and much better participation in the Advisor Plan among Missouri-based brokers over the past year.

The performance of the Plan throughout the economic downturn and subsequent recovery has been resilient. The fact that participants weren't required to make non-qualified withdrawals on a large scale during this period is promising. As a result, the majority of participants should have experienced almost full recovery of their college savings account balances. The economic environment remains challenging, but the view in regard to a sustainable recovery and financial markets stability is one of optimism. With this outlook, we should expect to see growth in all aspects of the plans continue. Increased competition in the 529 marketplace requires innovation and a commitment to excellence to ensure MOST continues to grow.

Missouri's MOST 529 Plan remains not only viable, but well positioned for growth as one of the premiere plans in the Country.