INVESTMENT INSIGHTS

WHAT TO LOOK FOR IN A 529 PLAN

Evaluating 529 plan investment portfolios

FOUR KEY DIFFERENCES IN 529 PLAN INVESTMENT PORTFOLIOS

1. Asset class diversification

Some portfolios hold only traditional stocks and bonds, while others diversify into extended and alternative assets.

2. Glide path design

Age-based portfolios may differ in how they pursue growth and manage volatility from the early years to the later years.

3. Portfolio construction

Key considerations include the universe of potential investments and the process for deciding which to include.

4. Tactical asset allocation

Most managers don't tactically adjust portfolio positions as market conditions change over the short term.

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Not all 529 college savings plans are created equal. Besides differences in state tax benefits, fees and contribution limits, each plan takes a unique approach to the age-based and risk-based portfolios typically favored by participants.

Four key considerations in evaluating 529 portfolios

All 529 portfolios offer a professionally managed mix of assets that either remains the same over time (asset allocation) or automatically becomes more conservative as college approaches (age-based). However, there can be vast differences in how each portfolio is allocated, assembled and adjusted. Which is right for your clients? This paper examines four factors to consider when choosing a 529 portfolio.

1. Asset class diversification

Differences in diversification are likely to have a dramatic impact on college savings outcomes and 529 participant experiences. Comparing and analyzing asset class exposure can help you align each client's needs with the appropriate solution.

- **Which asset classes are included in a portfolio?** Some portfolios hold only core stocks and bonds. Others include a broader range of extended and alternative assets, such as high yield bonds, emerging markets and real estate.

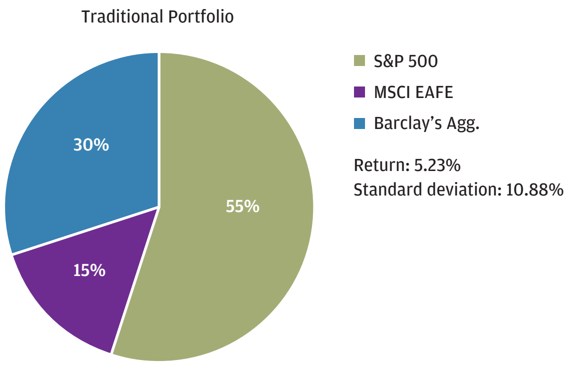
  Our research shows that a broader, more sophisticated level of diversification has the potential to increase expected returns while lowering risk (see **Exhibit 1** on next page). Given today's rapidly rising tuition costs, every basis point of performance can be critical in meeting a client's college savings goals without taking on undue risk.

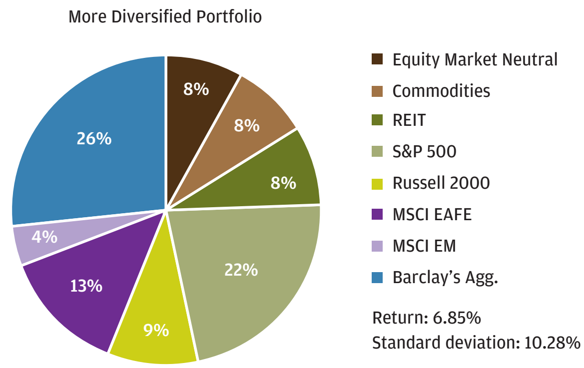
- **How does the manager decide which asset classes to include?** When it comes to diversification, the objective isn't simply more holdings but rather less correlation. Managers should be adept at analyzing both historical and forward-looking risks/returns in order to manage volatility.

- **How diverse is the fixed income allocation?** Some 529 plan portfolios are limited to one core bond strategy tracking the Barclays U.S. Aggregate Index. With yields currently low and core bonds highly sensitive to rising rates, a broader approach may make sense for clients seeking to mitigate duration risk or generate more income.

J.P.Morgan Asset Management

EXHIBIT 1: BROADER DIVERSIFICATION PRODUCED HIGHER RETURNS WITH LOWER RISK, 1999–2013





Indexes and weights of the less diverse portfolio are as follows: U.S. stocks: 55% S&P 500, U.S. bonds: 30% Barclays Capital Aggregate, International stocks: 15% MSCI EAFE. Portfolio with 25% in alternatives is as follows: U.S. stocks: 22.2% S&P 500, 8.8% Russell 2000; International stocks: 4.4% MSCI EM, 13.2% MSCI EAFE; U.S. Bonds: 26.5% Barclays Capital Aggregate; Alternatives: 8.3% CS/Tremont Equity Market Neutral: 8.3%, DJ/UBS Commodities: 8.3% NAREIT Equity REIT Index. Return and standard deviation calculated using Morningstar Direct.

Charts are shown for illustrative purposes only. Past returns are no guarantee of future results. Data as of December 31, 2013.

2. Glide path design

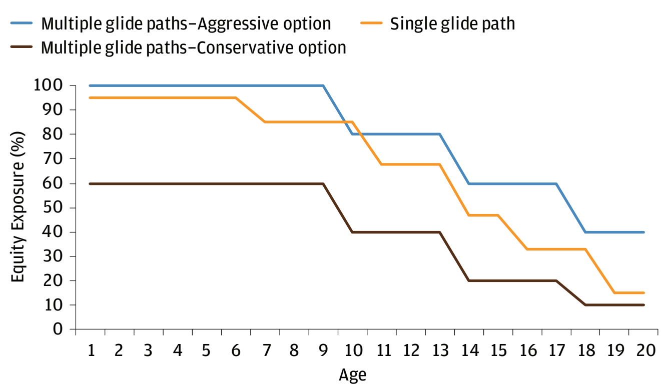
An age-based portfolio's glide path design and sequencing of returns are crucial aspects to examine given a time horizon of 18 years or less until college. Understanding the different methodologies is one of the keys to making informed decisions with your clients.

- **How do portfolio allocations change as college approaches?** Is the overall glide path consistent with your client's risk profile? What is the level of equity exposure in early years versus later years? Is risk managed by reducing equity allocations or by broadening diversification into uncorrelated assets with similar return potential?

- **Does the 529 plan offer a single glide path or multiple glide paths?** Some managers may offer multiple glide paths—for example, one more aggressive and one more conservative. In these cases, how does each glide path optimize the risk/return trade-off throughout the investment experience? Does one forego too much upside potential at the beginning? Does the other assume too much downside risk at the end (**Exhibit 2**)?

- **What information is used to make asset allocation decisions?** Are long-term capital market assumptions used? How are those assumptions formed? Do the portfolio allocations account for 529 plan participant behavior? Has the manager factored cash flow volatility resulting from participant contributions and withdrawals into the glide path design?

EXHIBIT 2: EQUITY EXPOSURE BY AGE, SINGLE GLIDE PATH VS. MULTIPLE GLIDE PATHS



For illustrative purposes only.

- **Does the glide path go up to college or through all the enrollment years?** What is the time horizon? A "through college" portfolio, as opposed to a "to enrollment" portfolio, may take on more risk in the college years, when preservation of capital is most important and cash volatility is higher due to distributions.

- **What is the manager's experience with glide path design?** When 529 plan portfolios have fairly short performance histories, does the manager offer a longer track record with similar multi-asset portfolios.

Diversification does not guarantee investment returns and does not eliminate risk of loss.

3. Portfolio construction

Because most 529 participants choose age-based or asset allocation options, the responsibility for portfolio construction lies with the plan's investment manager. It's important that their approach be compatible with yours and your client's.

- **How does the manager screen, select and monitor underlying investments?** Criteria can include the investment process, performance history, risk characteristics, style consistency, correlations, management and fees. A 529 plan manager should demonstrate a clear process for adding or replacing strategies as well as a track record of successful investment selection.

- **How diverse is the opportunity set?** How deep is a manager's pool of potential investments? Does it cover the full spectrum of asset classes and sub-classes? Is it limited to proprietary strategies or are external managers also included?

- **Are underlying investments actively or passively managed?** Active strategies may add incremental return potential and access to asset classes not readily available through indexing. Passive strategies can help lower plan fees and facilitate tactical shifts in portfolio allocations.

- **What is the approach to risk management?** An effective manager will develop a risk budget indicating how much active risk to take in each asset class and how to "spend" that risk within underlying holdings. The goal is to create a mix of uncorrelated investments with the potential to amplify overall performance and diversify strategy-specific risks.

4. Tactical asset allocation

Most 529 plan portfolios are not tactically managed. In these cases, portfolio weightings generally change only when: (1) assets are rebalanced back to target allocations, (2) a predetermined shift takes place along an age-based portfolio's glide path, or (3) participants make their once per year investment exchange.

- **How important is tactical management?** The ability to tactically adjust an allocation based on a short-term outlook is particularly important in 529 plans because Section 529 rules allow participants to change investments only once per calendar year. A tactical manager adds a level of flexibility that would otherwise be lacking, especially during rapidly changing markets.

- **How does the manager make tactical adjustments?** What process does a tactical manager follow? Are they seeking to increase upside potential? Limit downside risk? What guidelines govern their tactical tilts? For example, are there ranges for each asset class to prevent the portfolio from straying too far from its strategic long-term allocations?

- **Is the manager experienced and skilled in tactical asset allocation?** Tactical management involves complex decisions about when to reallocate, which assets to shift and by how much. To gauge a manager's skill, ask for specific examples of how they adjusted portfolios in the past. How was the decision made? Which portfolio positions increased? Which decreased? What were the results?

WHO IS IM SOLUTIONS—GLOBAL MULTI-ASSET GROUP?

Part of J.P. Morgan's IM Solutions group, GMAG (our Global Multi-Asset Group) includes some of J.P. Morgan's most senior investment professionals. They offer decades of combined experience and a deep understanding of today's global markets. This dedicated team of asset allocation specialists blend multiple assets into single investments to maximize diversification, return potential and manager flexibility.

- Over 100 investment professionals, averaging 11 years of experience (as of 6/30/2014)
- Over $168 billion in global assets under supervision (as of 6/30/2014)
- Nearly 40-year track record of advising pension plans
- Offices in New York, London and Hong Kong

The **S&P 500 Index** is widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. An investor cannot invest directly in an index.

The **Barclays Capital U.S. Aggregate Index** represents securities that are SEC-registered, taxable and dollar denominated. The index covers the U.S. investment-grade fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities. These major sectors are subdivided into more specific indexes that are calculated and reported on a regular basis.

The **MSCI® EAFE** (Europe, Australia, Far East) Net Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises 21 MSCI country indexes, representing the developed markets outside of North America.

The **Russell 2000 Index®** measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

The MSCI **Emerging Markets Index℠** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of June 2007, the MSCI Emerging Markets Index consisted of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey.

The **Barclays U.S. Corporate High Yield Bond Index** covers the U.S. dollar-denominated. non-investment grade, fixed-rate, taxable corporate bond market.

The **J.P. Morgan EMBI Global Index** includes U.S. dollar denominated Brady bonds, Eurobonds, traded loans and local market debt instruments issued by sovereign and quasi-sovereign entities.

The **NAREIT EQUITY REIT Index** is designed to provide the most comprehensive assessment of overall industry performance, and includes all tax-qualified real estate investment trusts (REITs) that are listed on the NYSE, the American Stock Exchange or the NASDAQ National Market List.

J.P. Morgan is the investment manager and distributor for New York's 529 Advisor-Guided College Savings Program.

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