Commonwealth of Virginia
July 6, 2020

Report to the Governor and the General Assembly of Virginia

Virginia529 Oversight Report

2020

COMMISSION DRAFT

JLARC
JOINT LEGISLATIVE AUDIT AND REVIEW COMMISSION

Joint Legislative Audit and Review Commission

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Commission draft

This Commission draft of JLARC's *Virginia529 Oversight Report* has been assembled for discussion, verification, and review. Do not quote, publish, or release any of the material contained in this draft until it has been received by the Commission and posted on the JLARC website.

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July 6, 2020

Overview

The Virginia College Savings Plan (Virginia529) administers the state's tax-advantaged savings programs. The programs are authorized by Sections 529 and 529A of the Internal Revenue Code and sponsored in 49 states and the District of Columbia. Virginia529 administers a legacy prepaid tuition program, two education savings programs, and two disability savings programs.

Virginia529's Legacy Prepaid529 program allowed participants to purchase contracts that cover the future cost of college tuition and fees. The Legacy Prepaid529 program was closed to new participants in 2019, but existing accounts will continue to pay benefits in the future. Virginia529 intends to offer a new defined benefit program starting in early 2021.

The education savings programs—Invest529 and CollegeAmerica—provide participants with options to save for educational expenses. Funds from the savings programs can be used to pay for qualified educational expenses. The programs offer federal and state tax advantages on contributions and investment earnings.

The disability savings programs—ABLEnow and ABLEAmercia—provide tax-advantaged savings accounts for eligible individuals with disabilities. Funds from the programs can be used to pay for qualified disability expenses, such as education, medical care, housing, and transportation. ABLEnow opened to customers in 2016, and ABLEAmerica opened to customers in 2018. Like Virginia529's education savings programs, ABLEnow and ABLEAmerica offer federal and state tax advantages on contributions and investment earnings.

Virginia529 is the largest 529 plan in the country, with $68.6 billion in assets and a 22 percent share of the national market as of March 31, 2020. Assets of $61 billion are held in the CollegeAmerica program, managed by a third-party program manager under contract with Virginia529. Approximately 7 percent of CollegeAmerica's accounts are held by Virginia residents.

As of 2017, all college savings plans can be used at elementary and secondary public, private, and religious schools. This change was enacted by the U.S. Congress and allows college savings plans to be used for a broad range of educational programs.

TABLE 1
Virginia529 programs

	Type of program	Accounts	Assets ($)
Prepaid tuition			
Legacy Prepaid529	Contracts for future tuition & fees	59,410	$2.5B
Education savings			
CollegeAmerica	Adviser-sold investments	2,396,416	$61B
Invest529	Direct-sold investments	352,272	$5.0B
Disability savings			
ABLEnow	Direct-sold investments	7,882	$33.5M
ABLEAmerica	Adviser-sold investments	658	$6.4M

SOURCE: Virginia529 program data as of March 31, 2020.

1. Virginia529 defined benefit programs

Virginia529 has two defined benefit college savings plans—Legacy Prepaid529, which was closed to new participants in 2019, and a new defined benefit program currently under development. Legacy Prepaid529 is a defined benefit program that offered prepaid tuition contracts to Virginia residents. Legacy Prepaid529 benefits pay for tuition and fees at public colleges and universities in Virginia, under specific terms that are defined in the contracts (sidebar). Legacy Prepaid529 benefits can be used at private and out-of-state institutions but are not guaranteed to cover the full cost of tuition and fees at those institutions. The Legacy Prepaid529 program paid $125 million in benefits in FY19. Existing accounts will continue to pay benefits into the future even though the program is now closed to new participants.

Legacy Prepaid529 contracts cover tuition and fees for a set period, typically ranging from one to eight semesters at a university or college.

The Legacy Prepaid529 contract defines tuition and fees as the normal, full-time, in-state, undergraduate, mandatory fees assessed to all students. Contracts do not cover additional tuition, fees, or charges associated with a specific program, course, or major.

Payouts for students attending private institutions in Virginia or out-of-state institutions are calculated using contract payments plus a rate-of-return as defined by program policy.

New defined benefit college savings program will replace Legacy Prepaid529 program

Virginia529 is in the process of replacing its Legacy Prepaid529 program with a new defined benefit program because of concerns identified by Virginia529 about the sustainability of Prepaid529. Concerns included the lack of flexibility for purchasing contracts; the growing disparity in payouts depending on the institution attended; changes in tuition and fee policies at institutions; declining program participation; and the actuarial complexity of the program. A 2016 sustainability study performed by Virginia529 examined several options for the future of the Legacy Prepaid529 program and recommended that the board explore the possibility of replacing it with a weighted average tuition (WAT) model, which would provide the same payout regardless of the institution the student attended. A 2018 JLARC study examined the proposed WAT model and found that if Virginia529 were to maintain a defined benefit college savings program, a WAT model would address several concerns about the Legacy Prepaid529 program. In 2019, the General Assembly enacted legislation to replace the Legacy Prepaid529 program with a WAT model.

In 2018, JLARC published the report, *Proposed Change to Payout Model of Virginia's Prepaid529 Program*, in response to a directive in the 2018 Appropriation Act. Legislation was proposed in the 2018 General Assembly session to replace the Legacy Prepaid529 program with a WAT model. However, the legislation was carried over until the following session, and JLARC staff were directed to review Virginia529's proposed WAT model in the meantime.

Virginia529 is currently designing the new WAT defined benefit program

Virginia529 is currently designing a new defined benefit program scheduled to open in the first quarter of 2021. According to Virginia529 staff, the new program will pay the enrollment-weighted average tuition (WAT) at Virginia public universities as the basic contract benefit. The WAT payout will be the same for all students, regardless of where they attend college (in-state, out-of-state, public, or private). The WAT payout may be more or less than the actual cost of tuition and fees, depending on where a student attends college. Students who attend more expensive institutions will have to cover the difference between the WAT payout and actual tuition and fee costs, and students who attend less expensive institutions may have funds left over, which could be used for other expenses such as room and board.

Virginia529 staff are developing guidance to help customers determine how much they would need to save through the new defined benefit program to attend their preferred college. The guidance will also help customers determine whether it or other Invest529 options would best fit their needs. JLARC recommended that Virginia529 provide this guidance in its 2018 report. Accounts for the new defined benefit program will be sold in smaller "units" that represent a percentage of WAT, rather than the semester units that were sold under the Legacy Prepaid529 program. Virginia529's guidance will include a web-based calculator to help customers estimate how many WAT units would be needed to fully cover tuition and fees at different colleges. Providing such guidance will be important since determining the number of WAT units needed for the target institution may be challenging for customers because colleges' tuition and fees vary widely.

Plan participation and pricing should be assessed after implementation

Virginia529 expects the new WAT-based defined benefit program to attract more participation than the Legacy Prepaid program, but there is no guarantee that will happen. Participation in the Legacy Prepaid529 program declined by 12 percent over the last decade, and the number of semester units sold declined by 35 percent. Virginia529 expects the new defined benefit program to attract more participation because of its greater flexibility, simplicity, and lower cost barrier, but there is risk that it will not. To address this possibility, the 2018 JLARC report recommended that Virginia529 should assess the demand for a WAT-based defined benefit program after the program has operated for a trial period of three years to determine its long-term viability.

The **pricing reserve** on a defined benefit contract is a portion of the contract price that exceeds the estimated amount needed to pay future contract benefits.

Pricing reserves are commonly used for prepaid college tuition contracts and other financial products.

The pricing reserve generates surplus revenue to protect the fund against risk.

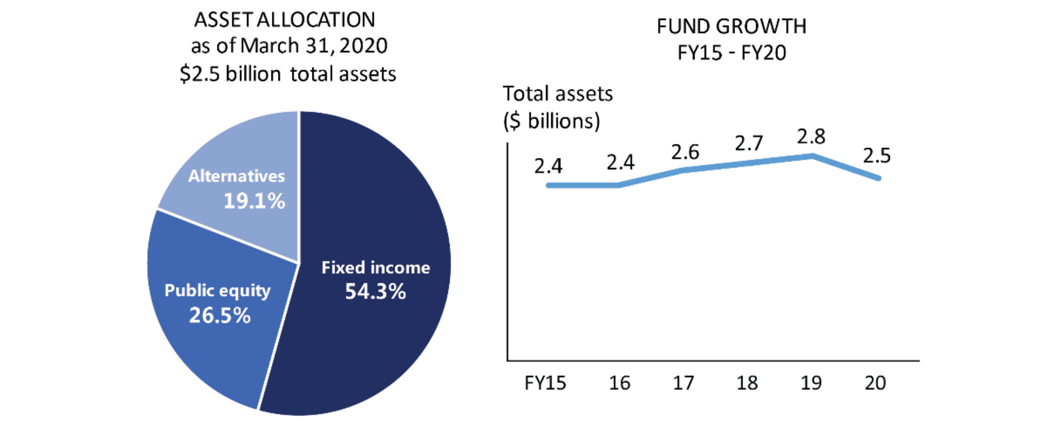
Virginia529 will also need to carefully consider whether a pricing reserve (sidebar) needs to be added to contracts in the new defined benefit program. WAT units sold through the new defined benefit program initially may not include a pricing reserve because there is less actuarial risk than the Legacy Prepaid529 program, according to Virginia529 staff. (Contracts sold in the Legacy Prepaid529 program included a pricing reserve.) Virginia529 has more certainty about future payouts in a WAT model because students receive the same funding regardless of where they attend college. However, there is still actuarial uncertainty associated with a WAT defined benefit program because of the need to predict future tuition and fees. Virginia529 staff said a reserve could be charged in the future if needed. Virginia529 should carefully consider whether a pricing reserve is needed when it assesses the demand for the new program after a 3-year trial period. Such an examination should consider the overall health of the new program's fund as well as the Legacy Prepaid fund, which has been very strong in recent years.

Legacy Prepaid529 fund declined more than 10 percent in 2020, largely because of COVID-19 pandemic

The Legacy Prepaid529 program held $2.5 billion in assets as of March 31, 2020. Fund assets are managed within a single enterprise fund and are divided into three asset classes: fixed income, public equity, and alternatives (Figure 1). Assets in the Legacy Prepaid529 fund have increased by 3.4 percent ($83 million) over the past five years, but assets have declined more than 10 percent ($294 million) since the beginning of

FY20. This decline reflects the significant volatility in the markets since the outbreak of COVID-19. Virginia529 staff said there is sufficient cash on hand to meet short-term liquidity needs and normal seasonal payouts, and staff do not anticipate any exceptional needs to liquidate assets to raise additional cash. Over the past five years, net additions from investment returns, contract sales (prior to May 2019), and net operating revenues have generally exceeded benefit payouts and other deductions.

FIGURE 1
Legacy Prepaid529 fund asset allocation and growth



SOURCE: Virginia529 program data.
NOTE: Total fund assets as of March 31, 2020. All other fiscal years are reported as of June 30.

The Virginia529 board and its investment advisory committee (sidebar) oversee the Legacy Prepaid529 fund. The board determines the fund's overall asset allocation. The investment advisory committee determines the investment strategies for each asset class and selects and retains private investment management firms to implement those strategies. Virginia529 staff and a consulting firm oversee these external managers, monitor their performance, and make recommendations to the board and investment advisory committee.

The **Virginia529 investment advisory committee** is composed of the board chairman, chief executive officer, and at least four investment professionals appointed by the board chairman. All members have voting privileges.

Legacy Prepaid529 fund underperformed most benchmarks

The Legacy Prepaid529 fund's investment returns underperformed relative to most of its benchmarks and the long-term return assumption. Reflecting the volatility in the markets since the outbreak of the COVID-19 pandemic, the Legacy Prepaid529 fund's investments achieved a return of -5.2 percent for the one-year period ending March 31, 2020. The total fund underperformed its benchmarks in the one-, three-, five-, and 10-year periods, but outperformed its "since inception" benchmark. The fund's one-year return (-5.2 percent) and since-inception return (5.6 percent) were less than the 5.75 percent long-term rate of return that has been assumed by the Virginia529 board for its investments (Table 2).

TABLE 2
Legacy Prepaid529 fund performance

FUND INVESTMENT PERFORMANCE
for the period ending March 31, 2020

	CY to date	1 year	3 years	5 years	10 years	Since inception
Total fund	-11.7%	-5.2%	1.6%	2.5%	4.8%	5.6%
Benchmark	-9.8	-2.1	3.3	3.8	5.4	5.2
Fixed income	-8.7	-3.2	0.9	2.0	3.6	5.0
Benchmark	-8.3	-2.4	1.9	2.5	3.9	4.9
Public equity	-24.0	-15.7	-1.7	0.5	5.2	5.6
Benchmark	-21.9	-12.3	1.3	2.8	6.0	4.8
Alternatives	2.6	7.5	9.6	7.7	6.8	5.6
Benchmark	3.9	11.4	8.5	7.5	7.4	5.8

SOURCE: Virginia529 program data.
NOTE: Performance as of March 31, 2020 and reported relative to custom benchmarks and net of fees. Total fund, fixed income, and public equity have inception date of October 1997; alternatives inception was May 2005.

Virginia529 staff attribute the Legacy Prepaid529 fund's underperformance relative to its benchmarks to two primary factors. First, because of a 2019 change in asset allocation policies, the fund is overweight in public equities, which have substantially underperformed their benchmark. The fund is also underweight in alternative assets, which have the potential to outperform public equities and provide more steady returns amid market volatility. Based on an attribution analysis (sidebar) conducted by Virginia529, this overweighting in public equities and underweighting in alternatives reduced the fund's overall performance by 80 basis points during the first quarter of 2020. According to Virginia529 staff, the fund has underperformed longer-term because of investment decisions that favored small and mid-cap value equities compared to the benchmark. Over the past decade, markets have favored large-cap, growth-oriented companies.

An **attribution analysis** decomposes a fund's returns into three components: asset allocation, asset class structure, and manager selection. Attribution analysis helps determine what is responsible for the growth or decline of a fund's overall value.

The Legacy Prepaid529 total fund has generally underperformed its benchmarks for several years. This underperformance has occurred in both strong market conditions and down markets, which is concerning. JLARC staff will continue to closely monitor investment advisory committee and Virginia529 staff actions related to Legacy Prepaid529 investments over the coming year.

Fixed income. The fixed income program is the largest Legacy Prepaid529 asset class, with $1.3 billion in assets. The program primarily consists of U.S. dollar-denominated securities that pay a specific interest rate (government bonds, corporate bonds, and U.S. treasury bills), high yield bonds, convertible bonds, and emerging market debt. Fixed income investments typically exhibit lower volatility relative to most other asset classes and are expected to generate steady returns even in down equity markets. The fixed income portfolio underperformed its benchmarks for all periods with the exception of the "since its inception" benchmark. Nearly all managers underperformed most of their individual benchmarks. According to Virginia529 staff, market turmoil due to the COVID-19 pandemic severely impacted all high-quality liquid assets.

Virginia529 staff attribute the underperformance of the fund's fixed income assets to managing the portfolio with a defensive posture, which is intended to guard against rising inflation and interest rates. This approach results in relatively lower returns during periods of level or declining Federal funds rates, as in recent years.

Public equity. Public equity is the Legacy Prepaid529 fund's second-largest asset class, with $663 million in assets. The program consists of stocks and other equity securities for publicly traded companies in the U.S. and abroad. Public equity investments are typically higher volatility than bonds but offer potential for greater long-term growth. The public equity portfolio underperformed its benchmarks for the one-, three-, five-, and 10-year period, and outperformed the "since inception" benchmark.

The public equity asset class has hampered the total fund's performance over the last 10 years. Virginia529's investment advisory committee has adopted a defensive posture for public equity, which is intended to protect fund assets in down markets and periods of market volatility. Prepaid529's domestic equities consist primarily of small and mid-cap equities, which have lagged the broader Russell 3000 Index benchmark for domestic equity during the market's growth over the past decade. According to Virginia529 staff, underperformance of public equities relative to benchmarks in the near term was expected because, until recently, the markets have experienced a period of high market growth and lower volatility. However, in the recent down markets that have occurred since the COVID-19 pandemic, the defensive positioning did not protect the fund as much as intended. Small to mid-sized companies considered to be value-oriented have declined more than the broader market.

Alternatives. Alternative assets are the fund's smallest asset class with $478 million in assets under management. Alternatives include investments in real estate, private equity (investments in privately held companies), and hedge funds (unique strategies to provide higher returns, more consistent returns, or lower risk than standard market investments). Alternative investments have potential to provide greater returns than public equity markets and steady returns during periods of high market volatility. The alternative asset class underperformed its benchmark for the one-, 10-, and "since inception" periods, but outperformed benchmarks for the three- and five-year periods.

According to Virginia529 staff, two factors account for the underperformance in the alternatives asset class. First, many of the Legacy Prepaid529 private equity funds are relatively new funds. Nearly 30 percent of the fund's alternative assets are less than four years old. Private equity funds typically take four to five years to mature, and performance typically improves over time. Second, the alternative portfolio's performance was hindered by the fund's largest private real estate manager, which has underperformed its benchmark since inception by more than 240 basis points.

Legacy Prepaid529 asset allocation revised

In 2019, the Virginia529 board approved a revised target asset allocation policy intended to reduce the overall risk to the fund while maintaining the current assumed rate of return. The fund's asset allocation is based on the overall levels of risk and return assumed by the board, given market and economic conditions. The previous asset allocation strategy was developed in 2009 when the Legacy Prepaid529 plan was underfunded, and the US was emerging from the 2008 financial crisis. By 2019, Legacy Prepaid529 was overfunded, with a funded status of 152 percent. Virginia529's investment consultant also advised that economic conditions in 2019 suggested lower future return expectations for all asset classes.

When fully implemented, the new asset allocation will reduce the target allocation of assets to public equities from 32.5 percent to 22.5 percent (Table 3). The target allocation of assets to alternative investments will increase from 15 percent to 25.5 percent. Within the alternative asset class, funds allocated to real estate will increase from 2 to 7.5 percent, and funds allocated to private equity will increase from 9.5 to 13 percent. The target allocation of assets in the fixed income program will remain at approximately 53 percent, but within this asset class Virginia529 is moving more assets to multi-asset credit (0 to 10 percent) and private debt (1 to 5 percent).

Funded status is the actuarially determined ratio of assets to obligations for the Legacy Prepaid529 program.

The Legacy Prepaid529 fund's **actuarial reserve** is the best estimate of the present value of the surplus (or deficit) that will result once all currently held obligations are paid, over time, using the assets currently held in the fund.

TABLE 3
Virginia529 strategic asset allocation policy for Legacy Prepaid program

Asset class	Previous policy target	New policy target	Change
Fixed income	52.5%	52.5%	None
Public equity	32.5	22.5	↓ 10.0
Alternatives	15.0	25.5	↑ 10.5

SOURCE: Virginia529 board meeting documents.

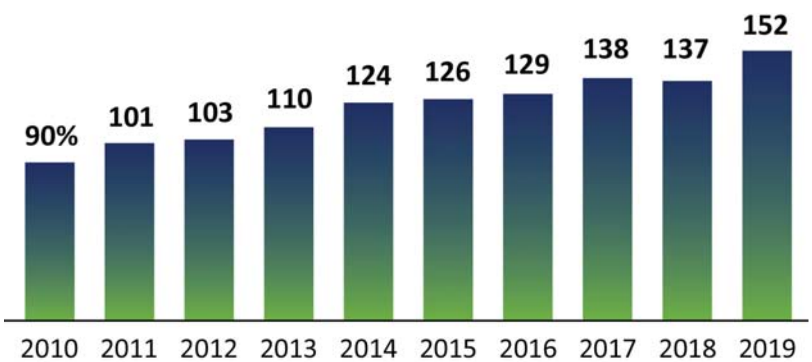
Virginia529 staff are in the process of implementing the revised asset allocation strategy and anticipate reaching the target allocations by 2022–2024. The new allocation strategy is being implemented over several years so that Virginia529 can take advantage of opportunities to sell and buy assets.

Legacy Prepaid529 funded status

Virginia529 must maintain sufficient assets in the Legacy Prepaid529 fund to pay the program's current and future obligations. The fund receives three categories of revenue: Legacy Prepaid529 contract payments, fund investment returns, and net operating revenue, mostly composed of fees from other Virginia529 programs. Assets must be sufficient to cover future benefit payments, refunds, and other payouts.

The Legacy Prepaid529 fund currently has sufficient assets to cover its estimated obligations. Legacy Prepaid529's funded status was 152 percent as of June 30, 2019. This funded status is the highest in the program's 23-year history. Over the past 10 years, Legacy Prepaid529's funded status has not been lower than 90 percent (Figure 2). This low point occurred in 2010, one year after the 2007–2009 recession, when there were major declines in the domestic and international equity and credit markets that affected many of the program's investments. The fund recovered to a funded status of over 100 percent the following year. The recent decline in the fund's assets as a result of the COVID-19 pandemic will have a negative impact on Legacy Prepaid529's funded status, but Virginia529 staff expect that the program will remain overfunded.

FIGURE 2
Legacy Prepaid529 percent funded status (as of June 30)



SOURCE: Virginia529 actuarial data.

The Legacy Prepaid529's funded status indicates it is highly likely to cover future obligations. Virginia529's plan actuary estimates that, at a funded status of 152 percent, the plan had an actuarial reserve of a little more than $1 billion. At this level, the Legacy Prepaid529 fund has a 99 percent chance of meeting or exceeding future obligations, as estimated by the plan actuary in the 2019 fund valuation using current actuarial assumptions.

Pursuant to statute, net operating revenue generated by other Virginia529 programs is allocated to the Legacy Prepaid529 fund at the end of each fiscal year, where it is invested along with other assets and contributes to the program's funded status (sidebar). A total of $117.5 million in net operating revenue has been allocated to the Legacy Prepaid529 fund over the last five years. Given Legacy Prepaid529's favorable funded status, it would be appropriate in the future to reexamine how that fee revenue can best be used to support college affordability goals in Virginia.

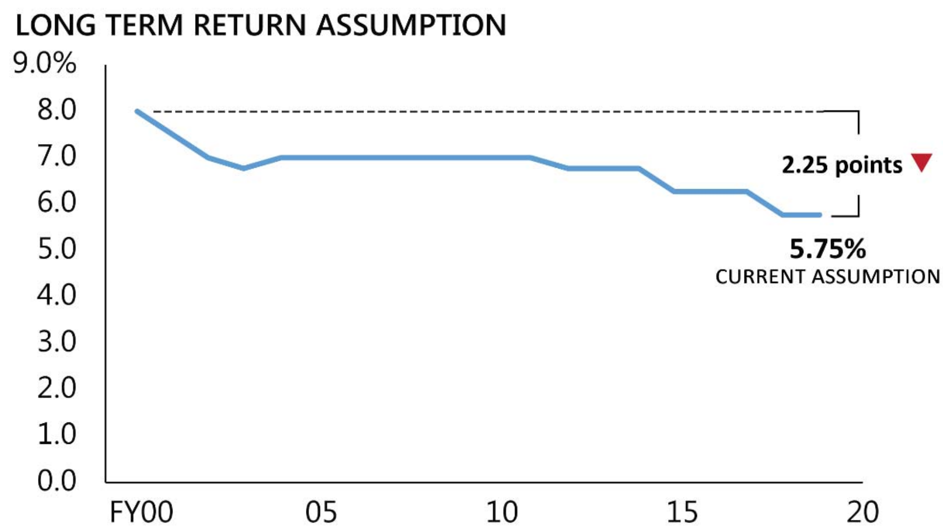
Virginia529's **operating revenue** is generated by administrative fees (mainly from CollegeAmerica and Invest529) and used to pay operating expenses.

The **net operating revenue**—any revenue that remains—is allocated to the Legacy Prepaid529 fund at the end of each fiscal year.

Key actuarial assumptions changed

The Virginia529 board made changes to two key actuarial assumptions for the Legacy Prepaid529 fund—the expected rate of return and expected tuition growth. In 2018, the board reduced the long-term rate of return assumption from 6.25 percent to 5.75 percent. The long-term rate of return assumption is an annualized percentage return on investments expected in the future based on a 20-year forecast and has important implications for the program's funded status. The board's decision to reduce the assumed rate of return, which was made with input from its investment consultant, anticipates declines in future returns for both the public and private equity markets. On several prior occasions since 2000, the board has reduced the long-term rate of return for the Legacy Prepaid program in response to changing market conditions (Figure 3).

FIGURE 3
Legacy Prepaid529 long-term investment return assumptions



SOURCE: Virginia529 actuarial data.

In 2019, the Virginia529 board reduced its long-term tuition growth assumption to 4 percent for the 2020–21 and 2012–22 academic years and 6 percent thereafter. The previous assumption was 5 percent for the 2018–19 academic year and 6.5 percent thereafter. The board's decision to reduce the tuition growth assumption was based on recent and historical trends in tuition growth at Virginia's higher education institutions. Tuition and mandatory E&G fees did not increase in the 2019–20 academic year for most in-state undergraduates, and average tuition and total mandatory fees increased just 1.2 percent, the lowest increase since 2000. This was the result of additional funding provided by the General Assembly for higher education institutions, which were required to maintain in-state undergraduate tuition and mandatory E&G fees at FY19 levels. The long-term tuition growth assumption is an important factor Virginia529 uses to price contracts for its defined benefit programs.

Legislation limited pricing reserve based on funded status

The 2019 General Assembly enacted legislation limiting the pricing reserve Virginia529 can add to Legacy Prepaid529 contracts when the program's funded status exceeds a certain amount. This legislation will also apply to the defined benefit program currently under development by Virginia529. HB1611 capped the pricing reserve at 5 percent when the funded status is 105 percent or higher. In addition, the pricing reserve cannot exceed 10 percent when the funded status is below 105 percent.

The legislation was in response to a recommendation in JLARC's 2018 biennial oversight report on Virginia529. That report found that Legacy Prepaid529's relatively high funded status and actuarial soundness provided the opportunity to better balance program affordability and protection against risk. At the time, Legacy Prepaid529 had a funded status of 138 percent. JLARC recommended that Virginia529 develop guidelines for reducing the pricing reserve when the funded status exceeded 130 percent.

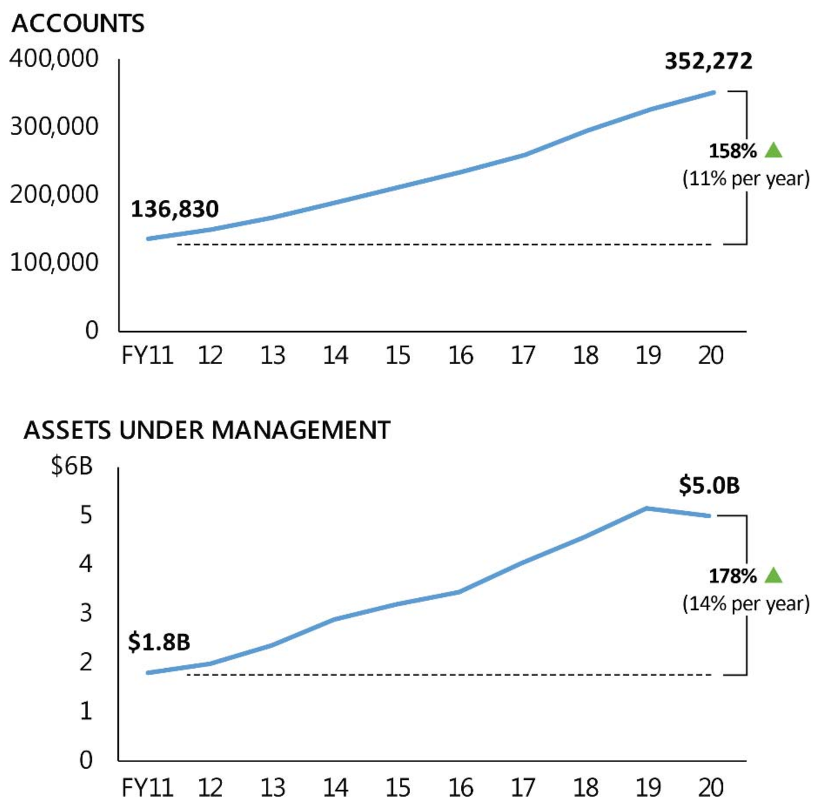
2. Invest529 program

Invest529 is a college savings program sold directly by Virginia529 to program participants. Participants contribute to their individual accounts and have several investment options. Investment earnings are exempt from federal taxes if they are used to pay for qualified education expenses, such as tuition, books, housing, and student loan repayment. For state residents, Virginia also exempts earnings from state taxes and offers an income tax deduction for contributions made to this and other Virginia529 savings programs. Funds from Invest529 accounts can be used at institutions in Virginia and other states. The program distributed $378 million to participants in FY19.

Invest529 participation

The Invest529 program has increased substantially over the past 10 years in both program participation and total assets under management (Figure 4). The number of

FIGURE 4
Invest529 account and asset growth



SOURCE: Virginia529 program data.
NOTE: Figures reported are as of the June 30 end of the fiscal year except for 2020, which is as of March 31.

Invest529 accounts more than doubled in the 10 years from FY11 to FY20, increasing by an average of 11 percent per year. The value of assets under management grew from $1.8 billion to approximately $5 billion, although declined somewhat in FY20 because of the volatility in the markets resulting from the COVID-19 pandemic. The overall growth is attributable to both new contributions and investment returns. The increase in Invest529 participation follows a national trend for college savings programs, which have steadily grown over the past decade.

Invest529 underperformed nearly all investment benchmarks

The Invest529 program held an aggregate of $5 billion in assets as of March 31, 2020. Assets are owned by program participants, who have their own individual accounts. Individual participants determine how to invest by choosing from options offered by the program.

Program participants may choose any combination of 22 investment options. Investment options include traditional investments, such as stock and bond investments, and target-date portfolios that automatically adjust over time as the participant approaches college age. Thirteen options are actively managed, with the goal of providing better returns or lower volatility than the overall market. The remaining nine options are passively managed and track market indices.

Invest529 offers two new options that were approved by the Virginia529 board—the Global Equity Fund, which became available on February 1, 2019, and the 2039 age-based portfolio, which became available on January 1, 2020. (Two additional investment options are now closed to new participants.) The Global Equity Fund is an actively managed investment option that includes a mix of domestic and international equities. The 2039 portfolio is a target-date portfolio that adjusts over time as the participant approaches college age. A new target-date portfolio is added every three years as an existing target-date portfolio reaches its end point and closes.

The Invest529 investment options generally underperformed both long-term and near-term benchmarks (Table 4). Among the actively managed investment options that underperformed their benchmarks, all but four underperformed by 20 or more basis points. Compared with actively managed investment options, a few more passively managed options outperformed their benchmarks. A majority of the passively managed investment options underperformed their benchmarks by less than 20 basis points (adjusted for fees).

TABLE 4
Invest529 program investment performance

for the period ending March 31, 2020

	1 year	3 years	5 years	10 years
Actively managed options				
Met or exceeded benchmark	1	1	1	3
Total number of options	13	12	8	6
Passively managed options				
Met or exceeded adjusted benchmark	3	2	1	3
Total number of options	9	9	8	8

SOURCE: Virginia529 program data.
NOTE: The total number of investment options in each period can differ because longer-term performance data is not available for newer options. Performance is reported net of investment fees. Passively managed options are expected to provide returns equal to their benchmark index, less any fees charged to participants. Benchmarks were adjusted to account for the estimated impact of fees. Some passively managed options continued to trail the benchmark after this adjustment was made.

Invest529 received gold rating from Morningstar

The Invest529 program received the gold Morningstar rating in 2019—the fourth year in a row the program has received Morningstar's highest rating. Morningstar cited the program's strong managers and state oversight, the addition of a dedicated investment director in 2018, and an asset allocation for the age-based portfolios that includes a mix of passive and active strategies. Only four of the more than 60 college savings programs evaluated by Morningstar received a gold rating in 2019.

3. CollegeAmerica program

CollegeAmerica is an education savings program offered under a partnership between Virginia529 and Capital Group, a private mutual fund company. CollegeAmerica accounts are sold through private financial advisers and invested in a suite of American Funds mutual funds. Program participants contribute to individual accounts and work with their adviser to determine how money is invested. Investment earnings are exempt from federal taxes as long as they are used to pay for qualified education expenses, such as tuition, books, and housing. For state residents, Virginia also exempts earnings from state taxes and offers an income tax deduction for contributions made to this and other Virginia529 college savings programs. Funds from CollegeAmerica accounts can be used at institutions in Virginia and other states. The program distributed $4.8 billion to participants in FY19.

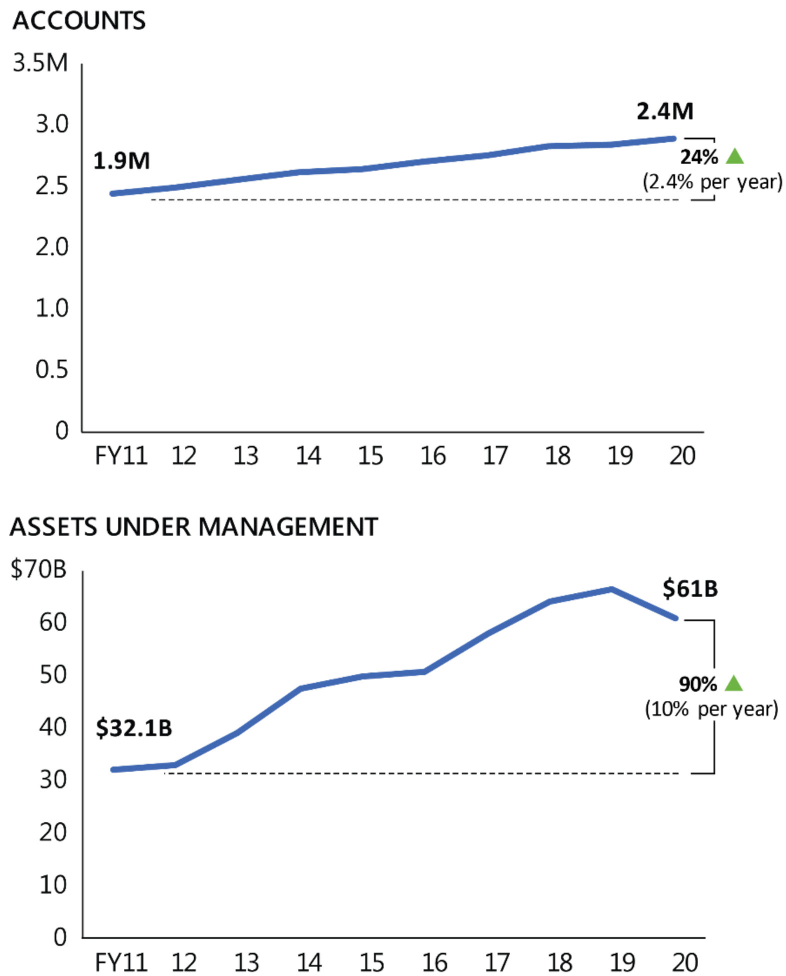
CollegeAmerica participation

The CollegeAmerica program has increased over the past 10 years in both the number of participant accounts and the total assets under management (Figure 5). The number of CollegeAmerica accounts increased by an average of 2.4 percent per year from FY11 to FY20. The value of assets under management increased 90 percent, from $32.1 billion to $61 billion. This growth is attributable to both new contributions and investment returns. The increase in CollegeAmerica participation follows a nationwide trend for college savings programs, which have grown steadily over the past decade.

CollegeAmerica investment performance

The CollegeAmerica program held an aggregate of $61 billion in assets as of March 31, 2020. Assets are owned by program participants, who have their own individual accounts. In consultation with their adviser, program participants have 45 investment options from Capital Group's American Funds mutual funds. Investment options include traditional individual investment options, such as stock and bond investments, target-date portfolios that automatically adjust over time as the beneficiary approaches college age, and diversified portfolios ("Portfolio Series") based on different investment strategies, such as growth or capital preservation. All of the CollegeAmerica options are actively managed, with the goal of providing better returns or lower risk than the overall market.

FIGURE 5
CollegeAmerica account and asset growth



SOURCE: Virginia529 program data.
NOTE: Figures are reported as of the June 30 end of the fiscal year except for 2020, which is reported as of March 31.

The CollegeAmerica investment options generally outperformed their benchmarks as of March 31, 2020 (Table 5). All of the college target-date options outperformed their benchmarks in the one-, three-, and five-year periods. A majority of the individual and portfolio series options outperformed their benchmarks for nearly all periods.

TABLE 5
CollegeAmerica program investment performance

for the period ending March 31, 2020

	1 year	3 years	5 years	10 years
Individual options				
Met or exceeded benchmark	21	20	18	14
Total number of options	30	30	28	23
College Target-Date options				
Met or exceeded benchmark	7	6	6	n/a
Total number of options	7	6	6	
Portfolio Series options				
Met or exceeded benchmark	4	3	4	n/a
Total number of options	6	6	6	

SOURCE: Virginia529 program data.
NOTE: The number of investment options can change because longer-term performance data is not available for newer options. Three- and five-year data is not yet available for one recently established college target-date option. All college target-date and portfolio series options have inception dates of 2012 or later and therefore do not have 10-year performance to report. Performance is reported net of investment fees. Investment performance comparisons are for the "A" share class; 79 percent of CollegeAmerica assets are invested in A shares. Individual options and portfolio series options are benchmarked against the Lipper Funds Index. College target-date options are benchmarked against the Lipper Funds Average.

CollegeAmerica offers two new investment options that were approved by the Virginia529 board in 2019: the Global Insight Fund and the International Vantage Fund. Investment performance data are not yet available for these funds.

4. ABLE programs

The Achieving a Better Life Experience (ABLE) program is intended to offer tax-advantaged 529A savings accounts for individuals with disabilities. Account funds can be used to pay for qualified disability expenses such as education, training, medical care, housing, and transportation. State-run ABLE programs were authorized under a 2014 federal law, and Virginia became the first state to enact ABLE legislation in March 2015.

Under Virginia's ABLE act, Virginia529 was vested with responsibility for establishing and managing programs for ABLE savings accounts. Virginia529's two ABLE programs are modeled on its two education savings programs. Both Virginia529 ABLE programs are national programs, open to enrollment by residents of Virginia and other states. Virginia529's ABLEnow direct-sold program opened in 2016, and the ABLEAmerica adviser-sold program opened in 2018.

ABLEnow direct-sold program

The ABLEnow program is a "direct-sold" investment program similar to Invest529. Under this program, participants establish investment accounts directly with Virginia529. Virginia529 is responsible for customer service, investment oversight, and marketing. As with Invest529, Virginia529 offers ABLEnow participants several investment options through external investment management firms. Virginia529 has retained PNC Financial Services to be the program's administrator. The company handles all aspects of account management, including program enrollment, contributions, and disbursements.

ABLEnow participation and investment performance

The ABLEnow program is relatively small compared with Virginia529's education savings programs. This is for two main reasons: (1) ABLEnow is relatively new and (2) the potential customer base is diverse (in terms of age and other factors) and more difficult to reach than the customer base for education savings. Furthermore, ABLE programs have requirements set by federal statute—such as annual contribution limits and that the beneficiary must also be the account holder—that may make the programs less appealing, according to Virginia529 staff. The ABLEnow program had 7,882 accounts and $33.5 million in assets as of March 31, 2020.

ABLEnow offers four investment portfolios that vary in asset allocation and investment return potential. They include the aggressive growth, moderate growth, and conservative income portfolios, which are composed of different proportions of equity (stocks) and fixed income (bond) investments. All three of these options are passively managed and track market indices. The fourth option is a money market portfolio that invests entirely in cash and cash equivalents. Because ABLEnow is new, the program intentionally offers fewer and less expensive (passively managed) investment options. The investment advisory committee and board will consider additional options as the program grows.

All four ABLEnow investment portfolios underperformed their benchmarks (adjusted for fees) for the one-, three-, and since-inception periods as of March 31, 2020 (Table 6). The aggressive growth, moderate growth, and conservative income portfolios—which contain varying portions of public equities—underperformed their benchmarks for the one-, three-year, and since-inception periods by an average of 47 basis points. The money market portfolio, which consists of safer cash and cash equivalent funds, underperformed its benchmark by an average of 13 basis points for all periods. According to Virginia529 staff, rising short-term interest rates since inception in 2016 have hindered performance relative to the benchmark.

TABLE 6
ABLEnow program investment performance
for the period ending March 31, 2020

	1 year	3 years	5 years	10 years	Since inception
Portfolio options					
Met or exceeded adjusted benchmark / Total number of options	0/4	0/4	n/a	n/a	0/4

SOURCE: Virginia529 program data.
NOTE: Inception of all investment options was December 2016. Passively managed options are expected to provide returns equal to their benchmark index, less any fees charged to participants. Benchmarks were adjusted to account for the estimated impact of fees.

ABLEAmerica adviser-sold program

The ABLEAmerica program is an "adviser-sold" investment program similar to the CollegeAmerica education savings program. Under this program, participants establish investment accounts through private financial advisers. Virginia529 partners with Capital Group, its CollegeAmerica partner, to manage the program. Capital Group handles most administration and investment management duties. Virginia529 retains the authority to approve investment options and other aspects of the program's operations. A total of 337 ABLEAmerica accounts were opened in FY19, and the number of accounts nearly doubled to 658 through March 31, 2020. Over this period, the value of total assets under management increased from $3.4 million to $6.4 million.

Similar to ABLEnow, the ABLEAmerica program offers seven investment portfolios that vary in their asset allocation and investment return potential. Five of these seven portfolios outperformed their benchmarks for the one-year period. Longer-term investment performance data are not available because the ABLEAmerica program became operational in 2018.

5. Agency and program management

Virginia529 agency and program operations are funded entirely through fees charged under its college savings programs. The Virginia529 board approves the agency's budget and all changes to programs, including the fees charged to participants. Like all state agencies, Virginia529's operating funding must be appropriated by the General Assembly through the appropriation act.

Operating expenses increased primarily because of increases in personnel, marketing, and professional services expenses

Virginia529's operating expenses increased by $9.2 million over the five-year period from FY15 to FY19 (Table 7). This represents a 46 percent increase, with an average annual increase of 10.1 percent. Much of this increase occurred in FY17, when Virginia529 began implementing the ABLEnow program, which accounted for $1.3 million in additional spending that year. Total operating expenses increased an additional 10 percent in FY18 and 8 percent in FY19.

TABLE 7
Trends in Virginia529 operating expenses

	FY15 ($M)	FY19 ($M)	Change ($M)	Change (%)
Personal services	9.7	12.6	3.0	31%
Marketing & communications	3.9	6.3	2.4	62
Professional services	2.8	4.4	1.5	55
Information technology	1.2	1.4	0.3	24
Facilities and leases	1.2	1.3	.06	5
Other [a]	1.1	1.1	-.09	-8
SOAR Virginia [b]	0	2.0	2.0	--
Total	**19.9**	**29.1**	**9.2**	**46**

SOURCE: Virginia529 program data: budget vs. actual reports.
NOTE: Numbers may not sum due to rounding.
[a] Other expenses include administrative services; meetings, conferences, and training; supplies and materials; and professional development, memberships, and subscriptions. [b] No funds were appropriated for SOAR Virginia in FY15 or FY16.

SOAR Virginia is a scholarship program for high school students from low- and moderate-income households. Through SOAR, Virginia529 partners with nonprofit organizations to provide individual advising to students, such as assistance with the college admissions process and with financial aid applications, and grants a scholarship contribution of up to $2,000 to a Virginia529 account. SOAR is an early commitment program; recipients enter the program in 10th grade and must adhere to program criteria to receive their scholarship.

Spending growth was primarily driven by increases in Virginia529's three largest spending categories: personal services (staff), marketing and communications, and professional services (consulting, outside fiscal services, etc.). Virginia529's personal services costs increased by nearly $3 million over the past five years. The increase was primarily due to growth in the number of staff. As of the end of FY19, Virginia529 had 103 full-time equivalent positions, an increase of 11 percent from 93 positions in FY15. Spending growth also increased because Virginia529 received a $1 million appropriation in FY19 for its SOAR Virginia scholarship program and was also permitted to provide another $1 million for the program from its operating budget if certain conditions were met (sidebar).

Virginia529 reduced fees for the Invest529 and CollegeAmerica programs

Virginia529 recently reduced administrative fees for the Invest529 and CollegeAmerica savings programs to reduce costs for participants and in response to fee reductions in the 529 industry. Virginia529 reduced the annual administrative fee for Invest529 accounts 10 percent in 2019, from 0.10 percent to 0.09 percent; for an account with assets totaling $20,000, the annual administrative fee declined from $20 to $18. For CollegeAmerica accounts, the first breakpoint (sidebar) for administrative fees was also reduced by 10 percent, from 0.10 to 0.09 percent. The fee decrease was an effective reduction of 4.6 percent for CollegeAmerica accounts. Both fee reductions took effect on January 1, 2020.

Breakpoints are commonly used in mutual funds, including 529 accounts, to offer investors discounted fees for larger investments. For example, an investor may pay a lower percentage fee on each additional $10,000 invested.

Expected growth in the Invest529 and CollegeAmerica programs over time is anticipated to more than offset any decline in program revenue due to the fee reductions. Virginia529's revised revenue forecast for FY21 projects that overall revenue will be 2 percent higher than originally forecast. Fee revenue from the two programs has consistently exceeded Virginia529 operating costs.

Virginia529 implemented changes to Legacy Prepaid plan benchmarks based on JLARC's consultant recommendations

In 2018, JLARC staff worked with a consultant to assess the investment benchmarks used by Virginia529 for its Legacy Prepaid529 program. The assessment's purpose was to determine whether Virginia529 was using appropriate benchmarks to measure the Legacy Prepaid529 fund's performance, given the investment goals, strategies, and risk tolerance adopted by the board.

Callan LLC's assessment, completed in November 2018, recommended several changes to the benchmarks used to assess the Legacy Prepaid program. Callan found Virginia529 used a single set of benchmarks weighted to each investment manager's end-of-period market value. As a result, Virginia529 was attributing all variation in fund performance to the individual investment managers and not measuring the effects of the overall asset allocation or the types of investment strategies pursued by managers. Callan recommended that Virginia529 begin measuring investment performance relative to benchmarks at three different attribution levels—the total fund level, the asset class level, and the investment management level.

Callan recommended that Virginia529 adopt a benchmark at the total fund level that reflects the asset allocation policy approved by the board. At the asset class level, Callan recommended that Virginia529 adopt static benchmarks to show the impact of investment structural and style decisions by managers that differ from the benchmark. Callan agreed with the majority of Virginia529's benchmarks at the manager level.

Virginia529 has implemented all recommendations from the benchmark assessment. With the assistance of its investment consultant, Virginia529 also develops quarterly attribution reports that decompose the performance of the Legacy Prepaid529 fund into the effects of asset allocation, asset class structure, and manager selections.

2020 legislation requires Virginia529 to study a state-sponsored private retirement program

The General Assembly makes changes to Virginia529 programs or directs mandates through legislation and approves Virginia529 spending, including appropriations for administrative spending and payments made under the Prepaid529 program. The 2020 General Assembly enacted legislation requiring Virginia529 to analyze the development of a state-sponsored retirement program and legislation affecting ABLE benefits.

Study of a state-sponsored retirement program

The 2020 General Assembly enacted HB 775 directing Virginia529 to analyze the development of a state-sponsored retirement program open to private-sector employees in Virginia and report its findings and recommendations by December 15, 2020. State-sponsored retirement programs are designed to provide retirement savings options to employees who may not have access to retirement savings programs at their private employers. HB 775 requires Virginia529 to examine several aspects of a state-sponsored retirement program, including

- the level of interest among Virginia's private employers in participating in a voluntary state-sponsored program;
- the likely costs of such a program, estimated time before a program could be fully self-funded, and potential funding options;
- the experience of other states that have implemented similar programs; and
- the appropriate state entity to operate such a program.

The legislation directs Virginia529 to undertake the study in consultation with relevant stakeholders.

The General Assembly has directed two previous studies of state-sponsored retirement programs. In 2017, the Virginia Retirement System published the findings of a working group convened to consider options for encouraging private sector retirement savings. The study found that governments have used three primary ways to help increase retirement plan access and savings for private-sector workers: an auto-IRA plan that requires employers to offer a retirement plan and automatically enroll employees; a state-sponsored plan, such as a plan administered directly by the state; and a marketplace approach in which the state creates a central exchange for individuals to choose among service providers and plans. In 2019, a study by Christopher Newport University estimated the potential market size for a state-sponsored plan, start-up and operating costs for such a plan, and the time for it to become self-funding.

JLARC staff will monitor Virginia529's study of a state-sponsored retirement system as part of its oversight. To provide the most useful information for the General Assembly, the study should include a thorough and objective review of how a state-sponsored retirement program in Virginia could best be implemented. The study should focus particularly on three issues:

- The study should attempt to estimate the number of private employers and employees that would likely participate in such a program. Broad participation by private employers and employees is important for spreading administrative fees across a large number of participants and ensuring that fees for each account holder are reasonable.
- The study should provide an accurate assessment of start-up and operating costs for such a program, as well as when a program would become self-funding through fees paid by account holders. The assessment should estimate the amount of time a program would need to repay any start-up funds from the state. The level of participation by private employers and employees will have important implications for how quickly such a program becomes self-funding.
- The study should carefully examine which state agency could best operate a state-sponsored retirement program in Virginia, or whether a new state entity should be created to operate it. Giving Virginia529 responsibility for operating such a program would significantly expand the agency's mission beyond educational savings programs. As a result, it will be important for the Virginia529 board to review and approve the study's findings and recommendations, particularly if the study determines that Virginia529 is the most appropriate entity to operate such a program.

Virginia529 is undertaking several research activities as part of its study of a state-sponsored retirement program. Virginia529 staff are reaching out to a broad range of stakeholders, including state agencies that may be involved in operating a program, academic centers with expertise in retirement programs, and private-sector stakeholders representing small businesses, independent insurance providers, and securities and financial advisers. To gauge private employer interest in such a program, Virginia529 is collaborating with the Pew Charitable Trust to gather employer feedback through a series of listening sessions. Virginia529 is also compiling information about the design and governance structure of state-sponsored retirement programs in the 10 states that operate them.

ABLE beneficiaries allowed to appoint survivors

The 2020 General Assembly passed legislation shielding ABLE funds from recovery by the state if an account beneficiary dies. HB 887 allows beneficiaries of ABLE savings accounts to appoint a survivor to receive funds in the event of the beneficiary's death. Previously, if an ABLE beneficiary died, the Commonwealth could seek payment from any remaining ABLE funds for Medicaid benefits the beneficiary received while alive. HB 887 applies only to Virginia beneficiaries and does not apply to beneficiaries living outside Virginia.

Board appointments

Lauren Kent Stack was appointed by the governor to the Virginia529 board in August 2019. Her term will expire in 2023. Stack serves as independent trustee for Six Circles Funds, a suite of mutual funds designed exclusively for JPMorgan discretionary portfolios.

Edward H. Bersoff was re-appointed by the governor to the Virginia529 board in June 2018. His term will expire in 2022. Bersoff is chairman of Greenwich Associates, LLC, a business advisory firm located in Bethesda, Maryland.

Reginald D. Samuel was re-appointed by the governor to the Virginia529 board in June 2019. His term will expire in 2023. Samuel is managing partner of The Leumas Group, a real estate brokerage and private equity investment firm he founded in 2009.

Edward H. Bersoff and Reginald D. Samuel were elected by the board to serve as chairman and vice-chairman, respectively, for 2020. The chairman and vice-chairman serve one-year terms.

The Virginia529 board is a supervisory board that is directly vested with authority for managing and overseeing most aspects of Virginia529. The board has 11 members, including four appointed by the governor, three appointed by the General Assembly, and four ex officio members representing the State Council of Higher Education for Virginia, Virginia Community College System, state treasurer, and state comptroller. Board members serve four-year terms. The board appoints a chief executive officer who oversees the day-to-day management of Virginia529 and its programs. The board also appoints an investment director to assist with managing program assets.

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