



CLINT ZWEIFEL
MISSOURI STATE TREASURER

August 24, 2011

FROM: Bruce A. Ring, Jr.
Director of Investments

RE: 2010 Annual Program Review

Section 166.450 of the Revised Statutes of Missouri (RSMo) requires an annual review of the Missouri Higher Education Savings Program (or "MOST") by the Director of Investments of Treasurer Zweifel's Office and the reporting of findings to the 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 2010.

I. Board Administration

Upromise Investments Inc., a division of Upromise, Inc. assumed responsibility as program manager for the MOST Plans on June 3, 2006. The Board and Treasurer Zweifel's Office worked closely with Upromise and monitored their management of the program. The Board met quarterly during 2010, as required by law.

II. Financial Status

In this section of the report, we review the financial status of our major partners and summarize the investment performance of the most popular investment options within the MOST Plan.

A. Financial Status of MOST Partners

Financial markets recovered significantly in 2009 and continued their recovery in 2010. The financial performance of fee-based financial institutions is heavily influenced by assets under management and therefore, valuation of assets is a primary factor. The recovery of global financial markets in 2009 and 2010 has led to an earnings recovery for most financial institutions, coming off low levels experienced in 2008. Although 2010 was somewhat volatile, corporate earnings industry-wide, were fairly strong.

As a result of reductions to the federal government's subsidies to student lenders and dislocations in the student loan industry, Moody's downgraded SLM Corporation, the parent

company of Upromise, in early 2009 from “Baa2” to “Ba1”, which is below investment grade. Standard & Poor’s and Fitch continue to maintain investment-grade ratings for SLM although Fitch has SLM on negative credit watch. Since the downgrade, ratings have stabilized and come off of negative watch status which is a positive signal. SLM’s credit rating is less of an issue for the MOST plan because none of the investments of the new MOST plan are secured by SLM; however, further downgrades to SLM Corporation’s rating would be an indicator that there continues to be concerns regarding the company’s profitability.

The two investment managers for the Direct Plan in 2010, The Vanguard Group and American Century Companies Inc., remain strong franchises. Although neither company is publicly traded and thus do not publish financial statements we can examine, our research of their funds indicates that both companies managed to avoid issues related to subprime mortgages or SIV’s that other mutual fund firms had to face in 2008. Vanguard is the top U.S. mutual fund manager as measured by assets under management.

B. Performance of MOST Underlying Funds

Overall, 2010 can be described as a period of continuing recovery. Absolute returns for equity indices were good for the most part, continuing to recover some of the losses experienced during the crisis year of 2008.

The absolute return for all investment options in MOST, both Direct and Advisor, was positive in 2010. The returns of the funds in the Direct Plan ranged from +0.62% for the most conservative option to +28.51% for the most aggressive. The returns for all options in the Advisor Plan were similar with a range of +25.71 for the highest return and +4.36% for the worst performer (the cash equivalent money market fund yielded 0%). Generally speaking, the magnitude of the return for each individual fund was positively correlated with the amount of equity exposure in each alternative. For the most part, Growth Funds and Small to Mid-Cap Funds performed better than Income or Value Funds during 2010.

Treasurer Zweifel’s Office is also 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 strong absolute returns for the calendar year, relative performance can best be described as weak for the period. To summarize, the investment managers’ overall contribution to participants’ returns was negative, albeit modestly. As of yearend, three funds in total were on the Watch List for negative short-term performance results and one fund was on the Watch List for negative intermediate-term performance results. All passive (index tracking) funds performed well overall, and experienced low tracking error of returns versus their relevant indices.

III. Investment Policy

The Missouri Higher Education Savings Program adopted a formal investment policy governing its investments in mid-2007. The policy establishes objectives for the 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 plan 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 place the decision to place or release a fund to/from “WATCH” status under the Director of Investments rather than at the board level.

IV. Participation Rate

In this section, we examine the participation rate of the MOST program. By examining the participation rate for the program, one can attempt to gauge the relative success the state's 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 2010

The MOST plan experienced growth in both assets and accounts during the year 2010. The asset growth in 2010 is predictable due to the market strength resulting in higher asset valuations, but the positive change in number of accounts can only be explained by increased awareness and popularity of the program.

Plan assets grew by a rate of 16.4% ending the year at approximately \$1.6 billion. Growth was experienced in both Advisor and Direct Plans although the majority of the growth was accounted for in the Direct Plan. While the plan experienced an increase of 26% in plan assets during the previous year 2009, last year was still demonstrably stronger than the 13% from 2008. For the past three years, including the down year of 2008, the net plan increase in assets has been 29.4% and the average plan increase for the past three years has been 9.8%.

Contributions during the period outpaced withdrawals, also contributing to the positive asset growth. Total combined contributions for both plans equaled \$221.7 million, while withdrawals were \$137 million. Contributions increased by \$11.7 million versus \$210 million in 2009 and \$199 million in 2008. A general increase in contributions should be expected as the economy continues to recover.

The number of accounts grew by a rate of 3%, down 1% from a year earlier, resulting in a total of 125,345 combined accounts at year end. The rate of growth was similar for both Advisor and Direct Plans. Roughly 88% of account holders are Missouri residents.

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.

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. As many states are having their plans re-bid for the first time, 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 was rebid at the end of 2010 and a selection was made in February 2011. The impact of the decision will be discussed in the 2011 report.

V. Continued Viability

The MOST program remains a viable college savings program. In Upromise's 4½ years of operation in Missouri, we have experienced strong trends in assets and accounts 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.

The performance of the Plan throughout the economic downturn has been surprisingly resilient. The fact that participants weren't required to make non-qualified withdrawals on a large scale during this period is comforting. Furthermore, as a result, the majority of participants should have experienced almost full recovery of their college savings account balances. The economic environment remains uncertain, but the view in regards 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 plan continue. However, the increased competition in the 529 marketplace will require even greater efforts on behalf of all parties involved to ensure these goals are met.

Missouri's MOST 529 Plan remains not only viable, but well positioned for growth. The implementation of the new Program Manager contract is critical to future growth – growth that has a very positive outlook.