Saving and Investing to Meet the Expenses of Your Child's Education

By Maria Crawford Scott

The biggest single expense facing any parent is most likely to be the child's college education. And if you are starting with little existing savings, those expenses may seem totally unattainable.

However, implementing a plan early allows the effects of compounding to work heavily in your favor, and the longer time horizon provides you with the flexibility to invest in more volatile higher-return investments, giving your savings a further boost toward your goal.

How do you build savings from scratch and invest to meet educational needs? A case study will illustrate the process.

A New Family

Susan and Tom Wilson are expecting their first child in several months. They are, needless to say, overjoyed at the prospect. At the same time, they both recognize that their greater financial responsibilities mean that they need to sit down and do some serious planning.

After examining short-term contingencies—the need for more life and disability insurance, for instance—the Wilsons decide they had better start taking a long look at what will probably be their biggest single expense—paying for their child's college education.

How Much Should They Save?

Like most parents, Tom and Susan want the best education for their child and hope to save enough to pay for a private college education.

Current private college costs are estimated to be around $21,000, including tuition payments plus room and board, or roughly $81,000 for four years. Assuming these rates increase annually at about 6% (the current rate of inflation for educational expenses), the Wilsons need to save around $231,000 by the time their child enters college in 18 years. If they start saving now from scratch, putting money in a savings account each year with an aftertax rate of return of 5%, they calculate that they would have to save over $8,000 annually to accumulate that sum alone. [For more on calculating future college costs, see "How Much Do You Need to Save to Meet Your Child's College Costs?" in the July 1995 *AAII Journal*.] And the Wilsons also hope to have several other children . . .

After recovering from their initial shock, Tom and Susan realize that they can't possibly save at that rate as things stand right now, particularly if Susan does not go back to work. But the wide availability of financial aid can help make up any difference. And sending their child to a public college would result in a halving of expenses.

The Wilsons decide to simply do the best they can, and that means starting early. They also realize that a more informed investment approach, earning higher rates of return than a savings account, can help them get closer to their goal.

How Should They Save?

The Wilsons do have some financial resources, primarily in the form of retirement savings. Currently, Tom has about $12,000 accumulated in his plan, while Susan has $15,000 in hers. They also have a savings account with about $2,000, their other taxable savings having gone toward the purchase of a house two years ago.

For the past several years, both Tom and Susan have been able to make additional contributions to their retirement plans—Tom contributes about $3,500 annually, while Susan has contributed about $2,000.

However, if they save for their child's college education, Tom and Susan won't be able to save for their retirement, particularly since Susan does not plan on returning to work, at least while their child, or children, are young.

On the other hand, assets can accumulate more quickly in

Maria Crawford Scott is editor of the AAII Journal.

a tax-deferred retirement plan, and they estimate they can set aside about $3,000 (pretax) each year. Should they continue to make contributions to Tom's retirement plan, and use that money to fund their child's education, paying the early withdrawal penalty (assuming Tom's employer permits early "hardship" withdrawals for this purpose)? There are legislative proposals to drop the early withdrawal penalty for withdrawals for educational expenses, which would make this approach even more attractive. Or should they set up a taxable account for their child's education and contribute to that?

Although saving outside of the tax-deferred retirement plan will not be quite as advantageous, the tax consequences can be reduced by investing in assets with little in the way of annual income. Thus, most of the returns would be unrealized until the investment is sold, with taxes capped at the capital gains rate. While there are other ways to reduce taxes—such as transfers under the Uniform Gifts to Minors Act and Uniform Transfers to Minors Act, or the establishment of a trust—the Wilsons would prefer to retain control over the investment assets themselves and decide against these methods.

Table 1 presents a rough comparison of the two options, based on two different rates of return. It assumes annual pretax contributions of $3,000 (which would amount to $2,160 after taxes annually for the taxable account). The taxable account option assumes annual taxes on distributions are avoided; the final amount would be lower, however, to the extent that any annual income is produced. The tax-deferred retirement account option assumes that the final amount is taxed at the couple's current 28% marginal rate; however, large withdrawals could push the couple into a higher marginal bracket, resulting in a larger tax bill. The final amounts are close, slightly higher for the tax-deferred account at the highest assumed rate of return, almost identical at an 8% rate of return, and slightly higher for the taxable account at the lower rate of return. Of course, if the early withdrawal penalty were to be dropped, the tax-deferred approach would be far superior.

The Wilsons decide they would prefer to save in a taxable account: They would have more flexibility in their investment choices and they are uncertain of the tax implications of a large withdrawal. In addition, although they plan on using their savings for their child's education, they have no other taxable savings, and so the access to some savings without penalty is a benefit. If they need to withdraw money any sooner than 18 years, they would be worse off in a tax-deferred account because the early withdrawal penalty would outweigh the benefits of tax deferral. Lastly, they are somewhat skeptical of the proposals regarding early withdrawal penalties, and they can always change their approach if the proposal actually comes to pass.

Where Should They Invest?

The Wilsons' next question is: Where should they invest the money?

Up until now, the Wilsons have been fairly aggressive investors in their retirement accounts. Aside from the $2,000 in the taxable savings account, their remaining assets are invested exclusively in stocks, with a "core" 60% in larger capitalization funds, 15% in international stock funds and 25% in aggressive growth funds.

In their taxable savings fund, the Wilsons still have a fairly long-term investment horizon, although it is partially shortened by the need for tuition money in 18 years. Thus, several years before that money is needed, they will need to start building up funds in a money market fund or short-term bond fund. But for now, they can afford to invest in higher-risk, higher-return assets such as stocks

However, the Wilsons also need to limit their choice to an investment with low annual distributions, and one in which they can control the realization of gains. The stock investment option that best fits this bill is investment in individual stocks. However, the Wilsons do not have the time horizon or the savings ability to build up an amount that would allow

Table 1.
Retirement Savings vs. Taxable Savings:
Accumulations in 18 Years
(Annual investment: $3,000 pretax; $2,160 aftertax)

	Retirement Account*			Taxable Account**		
	6% Return	8% Return	10% Return	6% Return	8% Return	10% Return
Accumulation:	$92,717	$112,351	$136,797	$66,756	$80,892	$98,494
Less Penalty:	– 9,272	– 11,235	– 13,680	—	—	—
Less Taxes:	– 25,961	– 31,458	– 38,303	– 7,805	– 11,763	– 16,692
Ending Amount	$57,484	$69,658	$84,814	$58,951	$69,129	$81,802

**Assumes income tax rate of 28%; taxes would be higher and ending amount less if withdrawals cause marginal tax rate to rise.*
***Assumes investment in fund with no annual distributions, a basis of $38,880 and a capital gains tax rate of 28%; ending amount would be less if there are annual distributions that are taxed.*

Table 2.
Investing for a Child's Education
(How a savings portfolio may change over time as you first build savings, and then prepare to withdraw.)

Early Years	• Large-Cap Stocks	Initial investments (as minimums permit) to serve as a "core"
Middle Years	• Large-Cap Stocks	Keep as your core (at least 50% holding)
	• Aggressive Growth Stocks • International Stocks	Additional investments (as minimums permit) to add diversification and growth; percentage depends on risk tolerance
Approaching College Age	• Large-Cap Stocks	Core (at least 50%)
	• Aggressive Growth Stocks	Varies
	• International Stocks	Varies
	• Short-Term Bond Fund or Money Market Fund	Used to dollar cost average (quarterly withdrawals over several years) tuition amount out of stock investments, and from which you will eventually make tuition payments

the purchase of a diversified portfolio of individual stocks, and the purchase of just one or two stocks would be taking on too much risk. Thus, they decide that they should limit their selection to low distribution mutual funds.

In addition, minimum account sizes at most mutual fund companies mean that the Wilsons will have to limit their college savings account to a single fund for several years as they build up their savings.

For that reason, the Wilsons decide that the best choice to start out with is a tax-managed index fund, which offers broad diversification among larger capitalization stocks, low distributions, a fairly high market rate of return and fulfills their "core" stock investment criterion of their overall asset allocation strategy.

Could they move to more aggressive investments as they build up this savings pool? As their savings build-up allows them to meet minimum investments, they could add more aggressive growth funds that meet the low distribution requirements; international funds could be added, although they tend to have high levels of distributions, a disadvantage in a taxable account.

However, the Wilsons must keep their time horizon in view. As they move closer to the time that money will be needed for tuition—around five years prior—the Wilsons will want to start dollar cost averaging down into short-term investments. If the Wilsons waited to withdraw a large amount from the stock market at one particular time, they may be withdrawing at a particularly inopportune time; dollar cost averaging spreads withdrawals across market environments.

Table 2 shows how the taxable portfolio may change over time, as the Wilsons first build up their savings, and then as they prepare to withdraw.

Building Up Savings

Here are some thoughts to keep in mind when saving for your child's education:

- College costs may seem out of reach when you try to plan ahead and calculate your future needs. But many options exist to ease the costs. Starting early and investing well will help you meet your goal.
- Since you will most likely need the assets before retirement, make sure you take taxes into consideration when determining the best method of saving. Investments with little or no annual distributions offer the benefits of tax deferral.
- If you are building up an amount from scratch, limit yourself to low-cost mutual funds rather than individual stocks. Minimum initial investments at most mutual funds will most likely limit you to one or two funds, so make sure the funds you do choose are broadly diversified.
- If you are investing in stocks, start with a "core" holding of larger-cap stocks; you can then add more aggressive holdings as you build up your savings portfolio.
- On the other hand, keep in mind that your time horizon is long, but not unlimited. You will need to start dollar cost averaging out of any stock funds into a stable, low-risk investment such as a short-term bond fund or money market fund starting several years before you need to pay tuition bills.