



Annual Evaluation of the
CONNECTICUT HIGHER EDUCATION TRUST

For the Period Ending December 31, 2017

Submitted to:

The Committees on Education and Finance, Revenue &
Bonding
Of the Connecticut General Assembly

June 29, 2018

Statutory Requirements

This *Annual Evaluation of the Connecticut Higher Education Trust* (“CHET” or “Trust”) is jointly submitted by the Connecticut State Treasurer’s Office and the Executive Director of the Office of Higher Education to the Committees on Education and Finance, Revenue and Bonding of the Connecticut General Assembly, pursuant to Section 3-22e(b) of the Connecticut General Statutes.

Pursuant to Section 3-22k of the general statutes, the annual audited financial statements for CHET are included in the Annual Report of the Treasurer, which is transmitted to the Governor and members of the General Assembly on December 31st of each year. The audited financial statements also are transmitted to the CHET Advisory Committee pursuant to Section 3-22e of the general statutes.

The members of the CHET Advisory Committee as of the 2017 annual meeting, held on March 30, 2017, were:

Denise L. Nappier, State Treasurer
Gayle Slossberg, Senate Co-Chair, Education Committee
Andrew M. Fleischmann, House Chair, Education Committee
Antonietta “Toni” Boucher, Senate Co-Chair, Education Committee
Gail Lavielle, House Ranking Member, Education Committee
John Fonfara, Senate Co-Chair, Finance, Revenue, and Bonding Committee
Jason Rojas, House Chair, Finance, Revenue, and Bonding Committee
L. Scott Frantz, Senate Co-Chair, Finance, Revenue, and Bonding Committee
Christopher Davis, House Ranking Member, Finance, Revenue, and Bonding Committee
Benjamin Barnes, Secretary, Office of Policy and Management
Keith M. Norton, Acting Executive Director, Connecticut Office of Higher Education
Rose Ellis, Dean of Administration, Norwalk Community College
Margaret Malaspina, Director of Financial Aid, Capital Community College
Patrick Torre, Vice President of Finance, University of New Haven
Julie Savino, Executive Director of University Financial Assistance, Sacred Heart University

Background and Program Management

CHET is a qualified state tuition program established pursuant to Section 529 of the Internal Revenue Code. Connecticut’s authorizing statute was unanimously approved by the Connecticut General Assembly and signed into law by the Governor in 1997 (Public Act No. 97-224, the “Act”). The program began operating on January 1, 1998. While the Trust is considered an instrumentality of the State, the assets of the Trust do not constitute property of the State and the Trust is not construed to be a department, institution or agency of the State.

The Act designates the State Treasurer as the Trustee of CHET. The assets of CHET are privately managed by professional money managers under the supervision of the State Treasurer. TIAA-CREF Tuition Financing Inc. (“TFI”) serves as program manager for CHET Direct pursuant to a contract that expires in March of 2020.

In August of 2010, Treasurer Nappier entered into a management agreement with The Hartford Financial Services Group, Inc. to offer an advisor-sold plan. The contract for CHET Advisor runs through August of 2019.

CHET DIRECT

As of December 31, 2017, CHET Direct had 118,979 unique accounts with \$3.0 billion in assets. This compares to 111,698 accounts and \$2.58 billion in assets on December 31, 2016, representing increases of 6.5 percent and 16.3 percent for accounts and assets respectively, and reflects account redemptions as account owners withdrew funds to pay college costs for beneficiaries. Since inception, more than \$1.67 billion has been withdrawn for 44,987 beneficiaries.

Investment Options

CHET Direct gives investors the opportunity to invest in age-band portfolios that rebalance automatically as child ages. Investors can select from conservative, moderate or aggressive age bands, depending on their investment risk tolerances. These options are designed for investors who wish to make deposits and leave the investment decisions to investment managers. For those investors who wish to be more active in their asset management, CHET Direct also offers individual options covering different asset classes.

Age-Based Options

On August 8, 2017, the three CHET Direct age-based options shifted from six age-band portfolios to nine, allowing for a smoother glide path for the investor as the child grows.

The previous age bands for the conservative, moderate and aggressive options were:

- 0-3 years
- 4-7 years
- 8-11 years
- 12-14 years
- 15-17 years
- 18 years and over

The current/new age bands for the conservative, moderate and aggressive options are:

- 0-4 years
- 5-8 years
- 9-10 years
- 11-12 years
- 13-14 years
- 15 years
- 16 years
- 17 years
- 18 years and over

Individual Options

There are 11 individual options that are either actively or passively managed across different asset classes.

Actively managed:

- Active Global Equity Option
- Active Fixed Income Option
- High Equity Balanced Option (a blend of equity and fixed income)
- Social Choice Option (large cap U.S. equities)
- Principal Plus Interest Option (a life insurance funding agreement)
- Global Tactical Asset Allocation Option
- Money Market Option

Passively managed:

- Global Equity Index Option
- U.S. Equity Index Option
- International Equity Index Option
- Index Fixed Income Option

Underlying Funds

Both the age-based and individual options' portfolios have underlying investment funds that span asset classes. There are 23 total underlying funds used in the CHET Direct options. A total of twenty-two institutional mutual funds (from TIAA-CREF/Nuveen, Blackrock, DFA, Harding Loevner, State Street, TCW, T. Rowe Price, Templeton, Vanguard and GMO fund families) underlie the investment options. The Principal Plus Interest Option is invested through a funding agreement with TIAA-CREF Life Insurance Company. Some options use multiple underlying funds.

Administrative and Program Fees

CHET Direct's administrative and program management fees are competitively ranked in the bottom quartile of fees charged by providers in the 529 industry and are currently the lowest in the program's history. The Principal Plus Interest Option is not assessed a program management fee. The total asset-based fees of the other investment options range from 0.18% to 1.12%, depending upon which option is selected. Approximately 97% of CHET Direct assets are subject to an expense ratio of under 0.50% and almost one-quarter of assets are subject to an expense ratio under 0.25%.

Since inception, program management fee reductions for CHET Direct have been negotiated by the Treasurer's Office seven times, from 1.55% to the current fee level of 0.12% on the average daily net assets of the Trust (plus the cost of underlying fund expenses.) As part of 2010 contract renewal negotiations, the Treasurer's Office revised the fee structure from a flat fee (unitary pricing for all options) to a non-unitary structure in line with industry standards. The updated fee structure provides a detailed breakdown of program management fees, state administrative fees, and underlying mutual fund fees. et forth below is a history of program management fee reductions for CHET Direct:

2006: All prices reduced to new all-in cost of 0.70%
2006: All prices reduced to all-in cost of 0.65%
2010: All-in price reduced to 0.60%
2010: New pricing structure, Cost of Funds (COF) + 0.20% (+0.01% State Admin Fee)
2011: Fee reduction to COF + 0.18% (+0.01% State Admin Fee)
2013: Fee reduction to COF + 0.15% (+0.01% State Admin Fee)
2016: Fee reduction to COF + 0.12% (+0.01% State Admin Fee)

There is an annual state administrative fee of 0.01% of the average daily net assets of the Trust to pay for expenses related to oversight of the Trust.

Investment Performance

CHET Direct was one of 20 national 529 plans to earn a Bronze Star rating from Morningstar in 2017. CHET Direct has been a Bronze medalist every year since Morningstar began awarding medals. This award reflects Morningstar's conviction in CHET Direct's ability to outperform its peer group over a full market cycle of at least five years. Five different factors are evaluated for this rating: Process, Performance, People, Parent, and Price.

Performance of Age-Band Options

CHET Direct's age-based portfolios are offered in three risk categories: aggressive, moderate and conservative investment styles. The nine age-based portfolios in the aggressive options earned positive returns of between 2.70% to 6.30% for the period from August 8, 2017 (when the age-based options were restructured from six bands to nine bands) through December 31, 2017. During the same time period, portfolios in the moderate option returned between 1.70% and 5.60%, while the conservative option returns generated between 0.90% and 3.80%.

Performance of Individual Options

The active options, which include global equities, fixed income, and short-term investments, all had positive returns for the year ending December 31, 2017. Returns, net of investment management fees, ranged from 69 basis points for the money market fund to 26.27% for the Active Global Equity Option. The index options had positive annual returns, ranging from 25.18% for the International Equity Index Option to 3.26% for the Index Fixed Income Option. The Global Tactical Asset Allocation portfolio had a return of 12.77% for the period.

CHET-Direct Marketing and Promotion

- The Treasurer's Office worked closely with TFI to develop and execute a robust multi-channel marketing plan to promote CHET, strengthen public awareness, and increase understanding of the importance of saving for a college education. The Treasury and TFI remain committed to promoting the benefits of saving for college early to families of all backgrounds and cultures throughout Connecticut. In addition to broad-based marketing

to the core target market, CHET also incorporated an outreach effort to low- to moderate-income individuals to ensure that all Connecticut residents have the knowledge and access to save with CHET. Further, over the past two years, TFI expanded outreach and marketing to the state's Latino and African-American constituents through targeted events, community influencers and social media.

Key highlights include:

- In May 2017 CHET partnered with GiftofCollege.com to offer individuals a innovative way to gift money to a CHET 529 plan. GiftofCollege.com is a gift registry for college savings 529's that lets friends, family, and employers contribute to a recipient's 529 plan account both online and with gift cards. By the end of 2017, CHET had sold 1,800 gift cards for a total of \$776K.
- TFI partnered with a data-driven marketing agency to execute core direct and digital marketing for CHET. Over the course of 2017, TFI put in the market a six-month onboarding program for all new account owners, followed by monthly communicationsto stay in contact with existing CHET account owners. TFI also built an automated outreach program for individuals who inquire about CHET, whether online, via phone, at an event or any other activity, to follow up and encourage the opening of an account. Lastly, TFI significantly expanded outreach to prospects across the state through digital and direct marketing programs.
- In 2017, CHET executed a reenergized social media, public relations andmass media plan. The refreshed local plan resulted in a shift to direct TV, a more robust social strategy and increased media interview opportunities for Treasury staff representing CHET.
- CHET Baby Scholars continued as a flagship program, providing college savings accounts for newborns in Connecticut. The program was initially funded in 2014 with \$4,400,000 from the Connecticut Student Loan Foundation. By December of 2017, just over 7,789 families had enrolled in the program and \$1.88 million was distributed to accounts for Connecticut's newborns. Two key partnerships helped the Treasury promote this initiative. The first, with the Connecticut Department of Public Health, featured CHET Baby Scholars on the Connecticut birth certificate application. The second was with Read to Grow, an organization that staffs volunteers in CT hospitals to meet with new parents about the importance of reading to their children from an early age.
- The CHET Dream Big! drawing and essay competition celebrated its 10th anniversary at a special award ceremony held at the Connecticut Science Center in May. The 2017 competition garnered over 2,800 entries from across Connecticut. Schools in over 75% of Connecticut's 169 cities and towns participated. The contest asked children in kindergarten through third grade to draw a picture that answers the question, "What do I want to do after I go to college?" Fourth through eighth grade students were asked to write an essay responding to the question, "How will I change the world after I go to college?" The competition motivated parents to think about how to save for college education to support their children's dreams. There were 48 winners: 4 grand prize winners received a \$1,000 contribution to a CHET account and 44 students received \$500 CHET contributions

- The CHET *Advance* Scholarship program was again offered to high school seniors and freshmen, with 100 scholarships going to each group for a total of 200 scholarships awarded. To ensure that this scholarship opportunity reached students with the greatest need, half of the scholarships went to students in the state's underperforming schools. For all schools, senior students received \$2,500 for immediate use as they entered college the following fall. Freshmen were encouraged to save with an initial scholarship of \$2,000, with an opportunity for an additional \$500 match if they save at least \$500 in their own individual CHET account by the time they graduate from high school. CHET's plan managers, TFI and The Hartford, provided exclusive funding for this program.
- Between the CHET Dream Big! competition and CHET *Advance* Scholarship, CHET reached students, families and administrators in every grade (K-12) in every school in Connecticut, including public and private and home-schools.

CHET ADVISOR

CHET Advisor was established in 2010 with The Hartford Financial Services Group, Inc. ("HFSG") serving as program manager. As of December 31, 2017, CHET Advisor had 28,456 program accounts with \$531,483,952 in assets. This compares to 24,479 accounts and \$421,342,676 in assets from a year earlier. Accounts grew by 16 percent and assets by more than 26 percent from previous-year levels. Over the same time period, 1,019 account owners withdrew \$33.1 million for qualified educational expenses. Marketing in this plan is focused on educating financial advisors who then work with their clients to open CHET Advisor accounts.

Program Offerings

While CHET Advisor offers similar investment options to CHET Direct, the structure of an advisor-sold plan is different by its nature. This plan offers three different share classes (A, C and E) and has different fee structures for each share class. Share classes are structured to include compensation for the financial advisor.

Share classes and fee structure are as follows:

- Class A: Under the Class A fee structure, there is an up-front sales charge of up to 5.5 percent, which is reduced as the total value of all savings plan accounts of the account owner grows above certain levels. In addition, there are ongoing asset-based fees equal to an annual charge of approximately 0.76 percent to 1.18 percent of the total value of each account, depending on investment options selected.
- Class C: Under the Class C fee structure, there is no up-front sales charge. However, withdrawal of any contribution that has been in the account for twelve months or less will be charged a contingent deferred sales charge equal to 1 percent of the amount withdrawn. In addition, there are ongoing asset-based fees equal to an annual charge of approximately 1.51 percent to 1.95 percent of the total value of each account, depending on investment options selected. Class C shares that have been held for four years or longer as of September 15, 2017, converted to Class A on October 18, 2017. The shares that roll into Class A will not pay any Up-Front Sales Charge. Thereafter, contributions that have been in an account for at least four years, together with any earnings associated with those contributions, automatically transfer to the Class A fee structure within approximately a month of the four year anniversary of the Account holding such shares.

- Class E: This class is available only to certain groups associated with HFSG. Under the Class E fee structure, there is no up-front or contingent deferred sales charge. There are ongoing asset-based fees each year of approximately 0.51 percent to 0.95 percent of the total value of each account, depending on investment options selected.

Under all CHET Advisor asset classes, there is an additional state administrative fee of 0.01% to pay for expenses related to the oversight of the Trust.

Investment Options

CHET Advisor provides investors with the opportunity to invest in age-band portfolios that rebalance automatically as a child ages. This option is designed for investors and their financial advisors who wish to have their asset allocation decisions made and automatically updated for them over time. For those investors who wish to take a more active role in their asset management with their financial advisors, CHET Advisor offers individual options covering different asset classes.

Age Band Options

CHET Advisor shifted from five age bands to nine to smooth the investor glide paths. This process was implemented on September 15, 2017. The previous age bands were:

- 0-8 years
- 9-13 years
- 14-15 years
- 16-17 years
- 18 years and over

The new age bands are:

- 0-3 years
- 4-6 years
- 7-9 years
- 10-11 years
- 12-13 years
- 14-15 years
- 16 years
- 17 years
- 18 years and over

Individual Options

CHET Advisor also offers two types of individual funds for investors: static and individual portfolios.

Static portfolios are designed for different investment risk tolerances. The five static portfolios are comprised of different, specific proportions of equity, fixed income, and other investments.

Static Portfolios:

- Conservative
- Growth
- Aggressive Growth

- Balanced
- Checks & Balances

The other individual portfolios allow an active investor to choose among 12 asset-specific funds to create a customized portfolio of equity, fixed income, and capital preservation assets.

Individual Portfolios:

Equity Portfolios

- Small-Cap Growth
- Mid-Cap
- International Opportunities
- Growth Opportunities
- Dividend & Growth
- Equity Income
- Core Equity

Fixed Income Portfolios

- Inflation
- Total Return
- World Bond

Mixed Asset Portfolio

- Balanced Income

Capital Preservation Portfolio

- Stable Value

Underlying Funds

There are 15 funds that are used as underlying funds to the age-based and static portfolios, 12 of which are offered as individual options. Some options use multiple underlying funds. As of December 31, 2017, all CHET Advisor funds were actively managed by Wellington Management Company, the sub-advisor to The Hartford, with the exception of stable value (Invesco) and passive equity (BlackRock/iShares).

Investment Performance

CHET Advisor's five aged-based portfolios produced positive returns between 4.28% and 19.17% for the one year period ending December 31, 2017. The static portfolios generated returns of between 7.55% and 22.88% for the one year period ending December 31, 2017.

2017 Changes to CHET Direct and CHET Advisor

As part of ongoing efforts to offer high-performing 529 plans to residents of Connecticut, changes in investment products and allocations, along with fee reductions, have been approved by the Treasurer and were implemented in both the CHET Direct plan and the CHET Advisor plan.

In 2017, there were changes made to the CHET Direct program that involved reallocation of funds among portfolios, as well as the replacement of existing investment products. The strategy was designed to improve performance through higher returns, lower fees, and further risk diversification. The money market fund and short-term bond fund were replaced with a funding agreement with TIAA Life that offers a significantly higher interest rate. The number of age bands was expanded from six to nine, mitigating some risk from rebalancings during adverse market conditions. A high yield fund was added to the age-based options. Index funds replaced some actively managed funds thereby significantly reducing manager fees. A REIT index replaced an actively managed real estate fund in the age-based options. Two actively managed mid-cap equity funds were replaced with a mid-cap index fund in both the Active Global Equity option and the High Equity Balanced option. Asset allocation analysis based on market conditions and outlook is a normal part of portfolio rebalancings, and changes in weightings occurred in a number of portfolios.

The objectives for modifications made in the CHET Advisor plan were to improve performance through changes in products, fee reductions and diversification of risks. As noted above and consistent with the expansion of age bands in CHET Direct, CHET Advisor moved to nine age bands from five. This will smooth the equity step-downs to minimize market timing risk. Some proprietary funds were replaced with third party funds that offered better investment performance potential and/or lower fees and to introduce low-cost index funds. Products in equities, fixed income, global real assets and short-term strategies were replaced in various options. In addition to significant fee reductions related to the switch to new external fund managers and index funds, administration and share class fees also were reduced.

Federal Tax Law Changes Impacting 529 Plans, including CHET Direct and CHET Advisor

The Tax Cuts & Jobs Act of 2017, signed into law in December of 2017, contains two provisions that impact 529 plans. First, the bill expands the purposes for which 529 college savings plan assets can be used, by allowing up to \$10,000 per beneficiary per year to be withdrawn to pay for tuition for kindergarten through 12th grade (“K-12”) at public, private, and religious schools. Second, the bill allows for up to \$15,000 annually to be rolled over from a 529 account to an ABLE account, a tax-advantaged savings accounts for individuals with disabilities.

As a result of these federal changes, K-12 tuition is a qualified educational expense for federal tax purposes, and withdrawals for this purpose are free from federal tax on interest earned. Connecticut’s tax law, however, does not define K-12 tuition as a qualified expense. Consequently, for Connecticut taxpayers, the interest earnings portion of any withdrawal for purposes of K-12 tuition may be subject to state tax.