2008 Report
of the
Connecticut State Treasurer
and the
Board of Governors of Higher Education

CONNECTICUT'S
529 COLLEGE SAVINGS PROGRAM

July 2008

prepared for the

Committee on Finance, Revenue and Bonding and Committee on Education of the Connecticut General Assembly

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Statutory Requirements

Section 3-22e(b) provides for an annual report to be submitted by the State Treasurer and the Board of Governors of Higher Education to the Committees on Education and Finance, Revenue and Bonding of the General Assembly. This report is submitted in accordance with that requirement.

As required by the CHET statute, 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 October 15 of each year. The audited financials are also transmitted to the CHET Advisory Committee.

There is a statutorily established CHET Advisory Committee, which meets annually. On December 6, 2007, the Committee met at the Office of the State Treasurer. The statutory members of the CHET Advisory Committee as of the 2007 annual meeting were:

Denise L. Nappier, State Treasurer
Robert Genuario, Secretary, Office of Policy and Management (John Mengacci, designee)
Valerie F. Lewis, Commissioner, Department of Higher Education (Mary Johnson, Associate Commissioner, designee)
Sen. Thomas P. Gaffey, Senate Chairman, Education Committee (Chuck Lockert, designee)
Rep. Andrew Fleischmann, House Chairman, Education Committee
Sen. Thomas J. Herlihy, Senate Ranking Member, Education Committee
Rep. Debralee Hovey, House Ranking Member, Education Committee
Sen. Eileen M. Daily, Senate Chairman, Finance, Revenue & Bonding Committee
Rep. Cameron Staples, House Chairman, Finance, Revenue & Bonding Committee
Sen. William H. Nickerson, Senate Ranking Member, Finance, Revenue & Bonding Committee
Rep. Craig A. Minor, House Ranking Member, Finance Revenue & Bonding Committee
James Blake, Executive Vice President, Southern Connecticut State University
William Lucas, Vice President of Finance, Fairfield University
Julie Savino, Dean of Student Financial Assistance, Sacred Heart University
Margaret Wolf, Director of Financial Aid, Capital Community College

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Background and Program Management

The Connecticut Higher Education Trust ("CHET" or "Trust") is a qualified state tuition program pursuant to Section 529 of the Internal Revenue Code, which was unanimously approved by the Connecticut General Assembly in Public Act No. 97-224 (the "Act") and signed into law by the Governor in July 1997. 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.

CHET is available to help families save and invest for higher education expenses, and is privately managed by professional money managers under the supervision of the state treasurer.

As part of her review of all Treasury programs upon taking office in January 1999, State Treasurer Denise L. Nappier reviewed the performance of CHET and its manager, Collegiate Capital Group. She found significant problems with the management of the program, including the fact that the manager was undercapitalized and unable to appropriately market and administer the program. After taking steps to end Collegiate's management of the CHET program, Treasurer Nappier concluded an agreement on December 17, 1999, turning over management of the program to Teachers Insurance and Annuity Association – College Retirement Equities Fund's (TIAA-CREF) Tuition Financing Inc. (TFI) division. On March 13, 2000, the assets of all existing accounts were transferred to the Managed Allocation Option with four underlying TIAA-CREF institutional mutual funds.

TIAA-CREF offers a wide range of products to the general public, including its core constituents in the academic, research, medical and cultural fields, and is recognized as a premier pension system provider in the United States. Ranked as one of *Fortune* magazine's 100 largest U.S. companies, TIAA-CREF manages total combined assets of approximately $435 billion.

When program management was transferred to TIAA-CREF in 2000, there was one investment option – the Managed Allocation Option. Since then six additional investment options have been added: the High Equity Option (2001), the Principal Plus Interest Option (2001), the 100% Equity Index Option (2006), the 100% Fixed Income Option (2006), the Aggressive Managed Allocation Option (2007), the Social Choice Option (2007), and the Money Market Option (2008). In addition, the original Managed Option was changed from 10 age bands to six age bands in 2005.

Asset allocation changes have been made on a periodic basis in order to broaden the underlying assets. These adjustments have taken the form of new or replacement underlying mutual funds, or inclusion of new asset classes, based on an improved risk-reward analysis and projected performance improvement for all categories. A total of eleven core TIAA-CREF institutional mutual funds underlie investment options. The Principal Plus Interest investment option is invested through a Funding Agreement with TIAA-CREF Life Insurance Company.

TIAA-CREF's initial contract with the Trust to serve as Program Manager was for a five-year term ending March 13, 2005 with the provision for renewal. The Treasury determined that TIAA-CREF met performance standards set out in the initial management agreement, and the contract was extended for a second five-year term through March 13, 2010.

Federal Tax Laws and IRS Regulations

Earnings on after-tax contributions made to CHET are free from federal and state taxes while invested in CHET. Earnings are exempt from Federal and Connecticut income taxes when withdrawn for qualified higher education expenses which include tuition, room and board, fees, books, supplies, and equipment required by the beneficiary for enrollment or attendance at any eligible public or private educational institution.

Earnings on non-qualified withdrawals (which are not made as a result of death, disability, scholarship or attendance at military academies) are subject to federal taxes and, incur an additional federal tax penalty of 10% on earnings.

In 2006, Congress passed the Pension Protection Act of 2006, which made permanent the federal income tax-free treatment of qualified withdrawals and other federal tax benefits for all 529 plans.

Current Internal Revenue Service Regulations provide that total contributions may not exceed the amount determined by actuarial estimates necessary to pay tuition, required fees, and room and board expenses incurred by the designated beneficiary for five years of undergraduate enrollment at the highest cost institution allowed by the program. Effective July 2006, the CHET account balance limit for contributions was raised to $300,000. This contribution limit is periodically updated by the Treasury in accordance with IRS guidelines to keep pace with increasing college tuition costs and to align CHET's maximum levels with those of other state 529 plans.

State Tax Laws

The State of Connecticut offers tax-deferred earnings on contributions and tax-free withdrawals of earnings on CHET accounts when funds are used for qualified higher education expenses. CHET withdrawals are subject to Connecticut taxes if the distribution is not used for qualified higher education expenses and if the distribution is included in the federal gross income of a person other than the beneficiary.

In 2006, the Connecticut General Assembly enacted a state income tax deduction for contributions to the CHET program. The bill was signed into law on May 7, 2006, and provides for state tax deductions from Connecticut adjusted gross income on annual CHET contributions of up to $5,000 for eligible single filers and $10,000 for joint filers beginning in the 2006 taxable year. Connecticut is one of nearly 30 states that provide college savings tax benefits to state taxpayers for contributions to their home state 529 plan.

As a result of the passage of favorable Connecticut tax treatment for the CHET program in 2006 and in accordance with the existing management agreement with TIAA-CREF, the State Treasurer's Office successfully negotiated a further reduction in overall program management fees for existing and newly introduced investment options.

The Connecticut tax deduction for 529 college savings plans applies only to contributions to CHET. While the General Assembly has considered expanding this tax deduction to other 529 programs during the 2007 and 2008 legislative sessions, they have chosen not to do so.

Program Improvements and Changes

Low Minimum Account Balance and Minimum Contribution Requirements

Several program enhancements have been introduced since TFI assumed program management in 2001. These include the elimination of the annual account fee and the lowering of the minimum for opening an account from $500 to $25 ($15 if using payroll deduction). The program also provides for low minimum payroll and bank automated EFT contribution levels of $15 per period.

Program Manager and State Fees

CHET 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. Since inception, fee reductions have been negotiated by the Treasury three times, from a high of 1.55% to the current flat fee level of 0.65% on the average daily net assets of the Trust, with the exception of the Principal Plus Interest Option, for which the fee is 0.01%.

On July 1, 2005 the Trustee began collecting a new state fee of 0.01% of the average daily net assets of the Trust annually to pay for expenses related to oversight of the Trust (included in the fees above).

Investment Options

Managed Allocation Investment Option

CHET employs a Managed Allocation Investment Option with an age band investment approach. Since March 2005, this option has utilized a total of six individual age-based configurations ("Age Band Funds"). The age bands are structured as groups of beneficiaries born within the same three-year period. As the age-band group approaches college age, each Fund's assets are moved from more aggressive to more conservative investments in accordance with the Trust's investment policy. In previous years, the program supported up to ten age bands; however, the change to fewer, longer duration bands was designed to enable the beneficiary to realize the benefits of a selected asset allocation strategy over a longer investment horizon while also allowing investment allocations to track the beneficiary's attained age more closely.

The Age Band Funds consist of underlying investments in up to six TIAA-CREF institutional mutual funds – an institutional domestic equity index fund, an international equity fund, a bond fund, an inflation linked bond fund, a real estate securities fund and a money market fund. Each Age Band Fund represents a different asset allocation based on the age of the beneficiary for whom the account has been established. The assets in each age band are allocated in accordance with the investment policy adopted by Treasurer Nappier (as Trustee), after receiving guidelines recommended by TIAA-CREF (as program manager).

Over the past few years, there have been several asset allocation modifications and expansions to the Managed Allocation and other investment options. These include the addition and/or substitution of new underlying mutual funds, the expanded and broadened use of underlying funds from more diverse asset classes, and changes in the mix of equity, fixed income, and other instruments in the investment options. Asset allocation and underlying fund changes are generally made in response to annual asset allocation proposals provided by TIAA-CREF and may be supplemented by independently contracted asset allocation and mutual funds evaluations.

Aggressive Managed Allocation Option

The Aggressive Managed Allocation Option introduced in November 2007 also invests in the same underlying Funds as the Managed Allocation Option. However, the initial contributions to this investment option are more heavily invested in equities and real estate than in the Managed Allocation Option. The Aggressive Managed Allocation Option has a higher risk of losing principal than the Managed Allocation Option but is more likely to keep pace with rising tuition rates. In return for greater opportunity for reward, this investment also has possible heightened volatility. Thus, this Investment Option may be a good choice for investors who can tolerate greater risk and volatility in exchange for higher potential returns over time. It may also be appropriate for investors who already have substantial college savings in less volatile investments. This option may also be considered by account owners who intend to pursue enrollment at a later than typical college entrance age.

High Equity Investment Option

CHET's High Equity Investment Option was added in 2001, offering a more aggressive investment strategy to the core age-based investment strategy. The High Equity Option allocates contributions among a combination of mutual funds in accordance with the investment strategy policy adopted by the Trustee after receiving guidelines recommended by the Program Manager. It is designed for investors who can tolerate greater risk and volatility in exchange for higher potential returns over time. The current asset allocation plan for the High Equity Option, which has been in place since June 2006, includes the TIAA-CREF Institutional S&P 500 Index, Small Cap Equity, Mid Cap Value, Mid Cap Growth, International Equity Index, Inflation Linked Bond and Bond Funds.

100% Equity Index Option

The Program allocates contributions under the 100% Equity Index Option among a combination of equity mutual funds. The investment objective of this Investment Option is to provide the opportunity for long-term capital growth while avoiding the uncertainty associated with actively managed portfolios. However, the value of the Account will fluctuate based on the performance of the mutual funds underlying this investment option.

Social Choice Option

The Program allocates contributions, to the TIAA-CREF Institutional Social Choice Equity Fund, (introduced in November 2007) which invests primarily in equity securities of companies that meet certain social criteria, such as product safety, corporate citizenship, human rights and environmental performance. Because of the high exposure to domestic and foreign equities, and the corresponding degree of risk, this option may be appropriate for investors who have a long investment horizon and can tolerate a higher level of risk.

100% Fixed-Income Option

The Program allocates contributions under the 100% Fixed Income Option between the TIAA-CREF Institutional Bond Fund and the TIAA-CREF Institutional Inflation-Linked Bond Fund The investment objective of the 100% Fixed-Income Option is to provide the opportunity for favorable long-term total returns through current income, while maintaining the goals of preserving capital and providing a degree of protection from inflation.

Money Market Option

The Money Market Option (introduced February 2008) seeks to provide stability of principal by allocating 100% of contributions to the TIAA-CREF Institutional Money Market Fund. Unlike the Managed Allocation Option where the allocation changes as the beneficiary approaches the age when he/she would generally be expected to enroll in an eligible educational institution, the Money Market Option will not be changed to reflect the age of the beneficiary.

Principal Plus Interest Investment Option

The Principal Plus Interest Option was introduced in 2001, providing for a more conservative and stable offering designed for investors, who for a variety of reasons and investment timelines, tolerate very limited risk. The Principal Plus Interest Option utilizes a Funding Agreement, which guarantees to the Trust principal and a minimum rate of return of up to 3.0% per annum with the opportunity for additional returns as may be periodically declared in advance by TIAA-CREF Life.

The Principal Plus Interest Option rate is reviewed and reset annually. The current funding agreement, which is issued by TIAA-CREF Life to the Trust, provides for a fixed rate of 3.55% for the one year period ending June 30, 2009.

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Account Activity and Asset Growth

As of June 30, 2008, there were 79,536 CHET program accounts. This compares to 66,731 accounts on June 30, 2007. Total assets on June 30, 2008 were $1.076 billion, compared to $954 million on June 30, 2007.

The Managed Allocation Option continues to be the most actively utilized investment choice in the CHET program. However, investment patterns have shifted over the past few years. The Principal Plus Interest Option has generally varied in popularity in response to fluctuating equity and bond markets and economic conditions, but has sustained a significant account holder base. Contribution activity in the High Equity Option has declined due to recent market volatility, and the 100% Equity and 100% Fixed Income Options have realized solid growth in the since their introduction in June 2006.

A review of net new contributions to CHET as of June 30, 2008 indicated that 52% of new funds were invested in Managed Allocation, 9% in Aggressive Managed Allocation, 19% in High Equity, 9% in 100% Equity Index, 1% in Social Choice, 3% in 100% Fixed Income, 6% in Principal Plus Interest, and 1% in the Money Market option.

Account Redemptions

The program has begun to realize an increase in account redemptions as account owners begin to withdraw funds for their beneficiaries' college tuition payments. In addition, there has been a modest increase in account rollovers and transfers as a result of an increasingly competitive college savings marketplace in the state.

Heightened awareness of the CHET program and its new state tax deduction has precipitated the need for tightened monitoring and controls over program use, including account rollovers and redemptions. In early 2007, the Treasury implemented new reporting mechanisms to review account activity in order to monitor carefully program use patterns and safeguard state tax benefit use for the intended purpose of saving for college.

Investment Performance

Program investment performance for all CHET investment options during 2007-08 reflected the financial market trends for the periods. Investment returns for all CHET options are reported net of fees, while benchmark returns are not reduced by applicable fees. The Managed Allocation Option investment returns closely tracked their benchmarks, which differ by age band depending upon the asset allocation of the underlying funds that comprise the Age Band Fund. As of June 30, 2008 annual returns for the age bands ranged from -8.90% for the youngest (beneficiaries 0-3 years of age) to +1.69% for the oldest (18 years and over). Younger age bands' underlying portfolios were more aggressive with higher allocations in equities that produced comparatively lower returns than the more conservative underlying portfolios with higher allocations to fixed income, which were assigned to older age bands. For the year ending June 30, 2008, The High Equity Option produced a -8.79% annual return versus the benchmark's index return of -8.91%. The 100% Equity Index and 100% Fixed Income Options, reported returns for the year ending June 30, 2008 of -12.63% and +7.72% respectively. Finally, the Principal Plus Interest Option produced a return of +3.89% for the year ending June 30, 2008 which outperformed its benchmark return +3.11%. The quarterly investment return (ending June 30, 2008) for the newly introduced Aggressive Managed Allocation option by age band ranged from -2.22% (beneficiaries 0-3 years of age) to -1.01% (beneficiaries 18 years and over) reflecting the recent market volatility. As of the same date, the Social Choice option produced a -1.80% quarterly return versus the benchmark's return of -1.69%.

Marketing and Public Awareness

The Treasury works closely with TIAA-CREF to enhance its marketing program to strengthen public awareness of the CHET program features and to increase understanding of the importance of saving for a college education. TIAA-CREF is committed to promoting the benefits of saving for college early to families of all backgrounds and cultures throughout Connecticut. During 2007 and the first part of 2008, multi-channel direct marketing campaigns were used to obtain the greatest reach. Major campaigns included Graduation (May), Back-to-School (July/August), College Savings Month (September), Year-end/Gift Giving (November/December). The multi-channel direct marketing strategy included print advertising, direct mail, e-mail, banner advertising and search engine marketing to target prospective account owners. Radio was introduced during the Year-end/Gift Giving campaign. The radio spots emphasized the importance of developing a college savings strategy and fostered general brand awareness of the CHET program.

Account owner marketing continued to be a critical component of the overall marketing strategy. Existing account owners were encouraged to re-contribute, automate their contributions with Automated Contribution Plan, and to roll over funds from other college savings plans. The primary communication channels used to target account owners included direct mail, email, electronic newsletters, birthday card mailings, statement messaging and inserts.

In 2007 a series of direct mail and e-mails was developed to target persons who request more information about the program (inquirers) in response to our ongoing events, direct mail and online communication to prospects. This new contact strategy was designed to establish a more aggressive method to educate inquirers about the many advantages of saving early for college via CHET. It also provides an opportunity for inquirers to request to have a phone center representative contact them directly to discuss the CHET program. The communication series is established such that inquirers receive a monthly direct mail piece or email upon initial contact, and again in 30 days. It culminates with a final communication piece approximately 60 days following their initial inquiry.

Throughout 2007, CHET used very cost-effective direct marketing communications to prospects, account owners and inquirers. Throughout the duration of the program agreement with TIAA-CREF, the costs of the marketing and public awareness campaigns have been borne by TIAA-CREF and not Connecticut taxpayers.

Web-Based Marketing and Account Activity

Online enrollment has continued to be an increasingly popular method of opening accounts in addition to boosting awareness of and access to CHET. In 2007, 56.8% of all new accounts were opened directly via the Internet. CHET has realized a significant shift toward online activity over the past few years and has been increasingly successful in attracting and converting new prospects into account owners via this marketing medium.

Web-based advertising has become an increasingly important marketing medium for 529 plans nationally, and is particularly critical to the future success of CHET as a direct-sold program. The Connecticut marketplace has been heavily dominated by indirect college savings plans that are marketed through investment advisors and financial institutions. In order to keep pace with the industry and transform what had historically been an informational web-based tool into an effective marketing engine, the Program Manager has continued to make enhancements to the CHET website to meet the needs of different types of clients in a more user-friendly manner, and to provide self-help tools and resources. The CHET website features enhanced comparative information on investment options and related performance information compliant with industry disclosure standards.

CHET has also worked with the College Savings Plan Network, a national membership organization for state 529 plan providers, and Savingforcollege.com to promote awareness of the program through new interactive college savings comparative informational databases that are available online.

Media Events

In January, 2008, Connecticut State Treasurer Denise L. Nappier hosted more than 50 grade school winners of the first statewide Connecticut Higher Education Trust (CHET) College Savings Challenge at the State Capitol building. The CHET Challenge for K-6 school children in Connecticut was designed to engage students and families and to heighten awareness of the importance of a college education as well as the benefits of saving early with CHET. The CHET Challenge was launched in late 2007 and culminated with the awards ceremony in January.

The Challenge had over 250 entries. Students at each grade level entered a poem, essay or drawing depicting what they want to be and how they hoped to affect the world after they go to college. The top award recipients -- a male and a female winner were selected for each grade -- received a $100 award. Additional awards are provided for second and third place and honorable mention.

Students submitted essays and drawings in response to two CHET Challenge contest questions: "What do I want to do after I go to college" and "How will I change the world after I go to college?" The successful entries revealed serious thinkers with humanitarian instincts among Connecticut grade schoolers, some of whom said they wanted to cure cancer, bring clean water to children in Africa, work with autistic children or become the first kid president. Other submissions expressed goals of a lighter nature, such as making a new ice cream flavor, traveling through the Bermuda triangle, or helping the Mets vanquish the Yankees in the upcoming baseball seasons.

In addition, to the CHET Challenge, several press releases were distributed to the media promoting the Graduation, Tax-Time, and Year-end/Gift giving Campaigns.

Program Outreach

Education and Cultural Community Outreach and Events

TIAA-CREF employs Connecticut-based outreach personnel to educate Connecticut employers, financial influencers and community organizations about the benefits of the CHET program. The outreach strategy is two-fold: promote the message that saving for college is available to most through CHET, as well as to differentiate CHET from competing 529 plans being offered in Connecticut. Our outreach will continue to focus on offering more program access and exposure to Connecticut residents by leveraging relationships with existing account holders, employers, financial advisors, educators and community-based influencers.

In 2007 CHET partnered with the CT Parent Teacher Association and the CT Association of Principals and Superintendents, to create the first CHET College Savings Challenge contest (mentioned above). CHET also partnered with other community-based organizations and agencies specializing in promoting financial literacy and economic empowerment including the annual Money Conference for Women, CT Hospital Association conference, and the CT PTA conference. CHET representatives also worked closely with the CT Foster and Adoptive Parents & Guardians association to host a college savings conference, which promoted education and guidance on a wide variety of topics regarding higher education affordability and financial aid.

As a means of offering more branding of the program in a family-friendly setting, CHET began its sponsorship of Sunday home games at the Bridgeport Bluefish baseball club at the Harbor Yard. The sponsorship afforded CHET great exposure to thousands of families attending all Bluefish Sunday home games. In addition, hundreds of CHET brochures and other materials have been distributed to families throughout the community who were interested in learning more about saving for college and the CHET Program.

Employers and Financial Influencers

During 2007 and 2008, CHET made significant strides in expanding its relationships with Connecticut's business leaders and employers as well as financial influencers. New program enhancements continue to make CHET's marketing message and general appeal stronger than ever before.

CHET's business outreach included contact with many of Connecticut's larger employers and has resulted in securing Pitney Bowes, New Milford Hospital, and several chapters of the Connecticut Visiting Nurses Association as new CHET employers. CHET is also expanding its outreach with TIAA-CREF, Connecticut-based employers and participants through its internal wholesaling activities. Several of those relationships have developed promising results including Charlotte Hungerford and Lawrence Memorial Hospitals as potential CHET employers. As of June 2008, over 500 employers offered CHET payroll deduction opportunities to their employees, a sizeable increase over the past twelve months. The program has also made substantial inroads with financial influencers, including accountants, financial advisors and other financial professionals.

TIAA-CREF participated in several financial conferences held by such organizations as the Connecticut Society of CPAs and the Connecticut Financial Planning Association. CHET was also successful in developing a continuing education course on CHET and college financial aid, which was conducted at the CPA headquarters in Torrington with over 60 CPAs in attendance.

CHET outreach representatives will continue to work closely with the Treasurer's office to promote the program to all residents of the state who have an interest sending their families to college.

Competitive and Regulatory Environment

On a national level 529 plans sold by financial advisors are offering expanded flexibility and investment choices similar to those traditionally offered in retirement plans, and provide an additional layer of commissions to broker-dealers not included in directly sold 529 plans. While many of the indirect advisor plans actively market services to predominantly upper-income individuals, TIAA-CREF continues to maintain Connecticut Treasurer Nappier's commitment to be a low-cost, directly sold program with attractive competitive options that is marketed and made accessible to all socio-economic groups. CHET program fees have continued to remain competitive and were lowered further during the past year. The program's management and state oversight fees total 0.65%, the lowest level since inception, ranking among the lowest in the industry.

The Securities and Exchange Commission and the Municipal Securities Rulemaking Board provided continuing guidance and new rulings governing the disclosure of program information including investment options and performance as well as fees and other program features. This enhanced oversight has brought 529 plans into closer alignment with investment securities guidelines. New rulings that relate to broker administered plans, have also significantly affected 529 plan marketing and communication practices, including increased media advertising disclosure requirements and provisions. One new stipulation requires that 529 disclosure and marketing materials adequately inform consumers about potential state tax benefits for investments made in plans administered within their home state.

The National Association of State Treasurers (NAST) expanded its collaborative work with the College Savings Plan Network (CSPN) on addressing regulatory, media and consumer concerns relating to adequacy of disclosures and program comparability. The Connecticut Treasurer's Office and TIAA-CREF have been actively engaged in national planning efforts regarding program administration and marketing practices and standards, and actively monitor new industry trends. CHET has implemented all of the new CSPN disclosure principles and participates in the new CSPN college savings Web-site, which provides comparative information on all state qualified and prepaid 529 college savings programs.