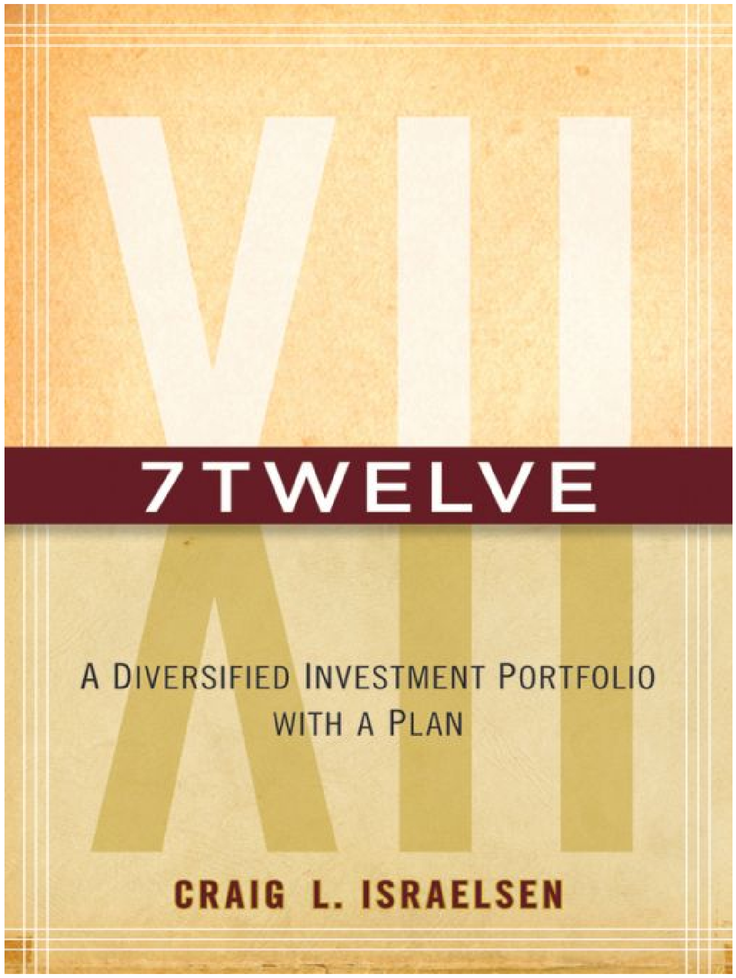
7TWELVE

A Diversified Investment Portfolio with a Plan

Craig L. Israelsen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John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey. Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data
Israelsen, Craig L.
7twelve : a diversified investment portfolio with a plan / Craig L. Israelsen.
p. cm.
Includes index.
ISBN 978-0-470-60527-1 (cloth); 978-0-470-64985-5 (ebk); 978-0-470-64986-2 (ebk); 978-0-470-64987-9 (ebk)
1. Portfolio management. 2. Investments. I. Title. II. Title: 7 twelve. III. Title: Seven twelve.
HG4529.5.187 2010
332.6—dc22 2010004724

Building rockets is complex. Building a diversified portfolio shouldn't be. This book isn't about rockets.

FOREWORD

I first encountered Craig Israelsen’s work on portfolio construction—that is, how to combine investments effectively and systematically so that your assets will grow over time—in 2005, when I became the editor in chief of *Financial Planning* magazine. At first, I found his efforts mystifying—he took a deep, deep dive into decades of performance data, sliced it up, and found patterns I had never encountered. Then, he described what he found in simple English—no flights of calculus or abstruse concepts to make him seem too smart to be questioned. At first, it seemed too simple to me to be as rigorous as it really is.

After a few months, I came to realize that Craig’s ideas, like so many great thoughts, seem simple just because they are true. Like many deep insights, his are the kind that make you say to yourself, “Of course—why didn’t I think of that before.” And after years of intense conversations about the ins and outs of portfolio construction, and invigorating exchanges of research ideas, I am delighted to say that Craig is one of those rare souls who can create intellectual elegance out of chaotic and sometimes contradictory facts. This is what makes his work appear to be so simple, and what makes learning from him such a pleasure.

Which brings me to the subject of this book, *7Twelve,* a collection of investments that can dependably build wealth for an investor’s entire life. I think of this portfolio as the culmination of Craig’s research. He has taken the many varied techniques of portfolio construction and distilled them into a reasonable, workable system that any individual can execute, either on his or her own or with the help of a financial advisor. Once again, the ease of this system is deceptive, as it integrates the most contemporary research with Craig's own investigations to come up with his ultimate recipe for long-term success.

How does the 7Twelve portfolio work? It molds the confusing world of investments into a system that requires just a little regular upkeep. It is not greedy. It is a collection of mutual funds, index funds, or exchange-traded funds that covers a wide variety of assets, from stocks and bonds to real estate and commodities, so it should enable you to profit when certain assets grow and protect you from losing too much when certain types of assets drop in value.

During the past two years, after the financial markets' near collapse in 2008 and its rocket-powered recovery in 2009 and 2010 (at least so far), people have lost faith in the ability of markets to reflect the true value of things. Money that people saved for years, even decades, disappeared, and much of that vanished wealth never returned. It was a harsh lesson for those who staked their future on the stock market—which was most of us.

It is disappointing but not difficult to understand why real estate prices dropped, and why they have not returned. But why did stocks fall so precipitously, and then rise again so rapidly? Why did they drag down so many other assets, too? How can one protect savings from that kind of disaster without eliminating any possibility of long-term growth?

A widely diversified portfolio that is rebalanced systematically, like the 7Twelve, is a good start toward answering those questions. What's more, the 7Twelve method ratchets down your exposure to market risk as you age, thereby consolidating and protecting your long-term gains.

The 7Twelve method is not rapid-fire and is not designed to get you rich. It may not be exciting. But it is useful, and its clarity and simplicity belie its sophistication. Try it—you just may like it.

MARION ASNES

March 2010

PREFACE

7 Twelve™ provides a recipe for building a multi-asset investment portfolio with 12 low-cost mutual funds. The recipe is more important than the ingredients. A poor recipe with good ingredients produces a poor end product. A great recipe with average ingredients produces an acceptable outcome. A great *recipe* with great *ingredients* is the ideal scenario—and this book provides information about both.

Too many investors have portfolios that lack diversification breadth. A few mutual funds that seem different are often cobbled together. 7Twelve, on the other hand, is a diversified, multi-asset portfolio by design.

In addition to providing a recipe for a diversified portfolio, 7Twelve also provides guidance on portfolio management over the entire lifecycle. From our early working years to the years beyond retirement, the 7Twelve portfolio can be adapted to meet our ever-changing personal and family circumstances.

The 7Twelve plan is rich in supporting historical performance data. No conjecture here. No Ph.D. needed either. The information is presented simply so that a person who is relatively new to the field of investing can easily grasp and implement the 7Twelve portfolio recipe.

The 7Twelve will be of value to young investors as they start building their investment portfolios; to middle-aged individuals who need to start ratcheting down the risk of their portfolios as they move closer to retirement; and to retirees who need to ensure that their retirement portfolio is durable and insulated from large losses. Very simply, investors of any age can benefit from the guidance in 7Twelve. Everyone is welcome in this kitchen.

The book is organized into 15 bite-sized chapters. Chapters 1 and 2 introduce the 7Twelve recipe for building a diversified, multi-asset investment portfolio, and Chapter 3 demonstrates how our diversification is actually achieved. Many investors are less diversified than they think.

Chapter 4 introduces various ways to meaningfully measure portfolio performance. Chapter 5 outlines the performance benefits of building a low correlation portfolio. Chapters 6 and 7 focus on the ongoing management of the 7Twelve portfolio—from periodic rebalancing to changes in the asset allocation over the lifecycle.

From there, Chapter 8 addresses the poignant issue of portfolio durability during the retirement years. Chapters 9 and 10 present research results on two much debated investing topics: value versus growth and active versus passive. Chapter 11 sheds light on two very prominent types of mutual funds offered in 401(k) retirement plans: target date funds and balanced funds.

Dilemmas created by undersaving are covered in Chapter 12. And then Chapter 13 investigates the equity premium and how that issue has a huge effect on how investment portfolios are built. Chapter 14 is a summary, outlining mutual funds and exchange-traded funds that could be used as the ingredients in the 7Twelve recipe.

Chapter 15 is the simple, *simple* summary of a straightforward portfolio design.

For the reader who just can’t get enough, my website (www.7TwelvePortfolio.com) contains monthly performance updates for the 7Twelve portfolio. In addition, there is downloadable software (an Excel spreadsheet) that allows you to compare the performance of other portfolios to the 7Twelve portfolio over various time periods that you control.

Author's Disclaimer

Past performance of the 7Twelve portfolio is not a guarantee of future performance. This book does not represent investment advice nor is it an investment solicitation.

ACKNOWLEDGMENTS

I appreciate the help of Meg Freeborn, Bill Falloon, Tiffany Charbonier, and Chris Gage of John Wiley & Sons in getting this book produced in a timely fashion.

My deepest appreciation will always be reserved for my eternal companion Tammy. I love her. And just as important, I trust and respect her. Our children are great, too, and I love them each in a very individual way: Sara and Jon, Andrew and Shannon, Heidi, Mark, Nathan, Emma, and Jared.

My parents, as well as Tammy's parents, have provided a lifelong example of integrity and endurance that has blessed our lives and the lives of our children.

Thanks also to Bob Vaughan, Robert Katz, Bryce Kurfees, and Andy Martin—each helpful in the early development of the 7Twelve portfolio.

Anciently, and almost cross-culturally, most numbers had an assigned symbolic meaning. So when people heard or read the number seven, for example, they were reminded of ideas of fullness and completion.

—Gaskill, Alonzo, The Lost Language of Symbolism (Deseret Book)

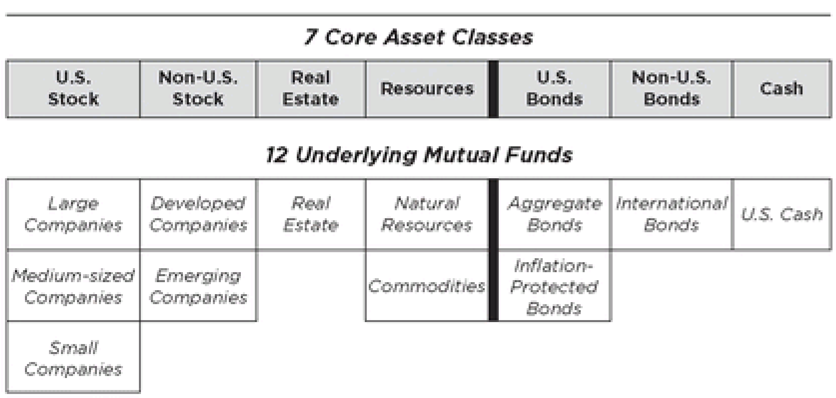
CHAPTER 1

A RECIPE FOR SUCCESS

A wise chef follows a good recipe. Likewise, wise investors should have a good recipe they follow when building a portfolio. The 7Twelve Portfolio is that recipe. By following it, investors will build a diversified, multi-asset portfolio.

The 7Twelve portfolio invests in “7” core asset classes (or investment categories) by utilizing “Twelve” underlying mutual funds—hence the name 7Twelve. The 7Twelve portfolio has both depth and breadth. 7Twelve has diversification *depth* within each separate mutual fund, and diversification *breadth* across seven core asset classes.

The 7Twelve Portfolio Recipe



7Twelve represents a complete portfolio by itself because it incorporates 12 different mutual funds. Alternatively, 7Twelve can be used as the starting point, or core component, in virtually any portfolio. The success of the 7Twelve portfolio is not the result of special skill. Rather, the success of the 7Twelve portfolio is the result of genuine diversification across multiple asset classes. The various mutual funds within the 7Twelve portfolio complement each other because they behave differently—the essential benefit of diversification.

Achieving diversification is critical to success in so many aspects of life. For example, only by combining a wide variety of very different instruments can an orchestra produce beautiful music. In the world of sports, the analogies abound. Teams combine players with different talents in order to maximize their chances for success.

Likewise, only by combining a wide variety of asset classes can an investment portfolio produce superior performance with lower levels of risk. Better risk-adjusted performance is the benefit from building broadly diversified investment portfolios.

The 7Twelve Recipe

Think of the 7Twelve model as a recipe for building a broadly diversified investment portfolio with 12 different mutual funds—where each mutual fund is itself a diversified investment product.

For those new to investing, a mutual fund is a collection of stocks, bonds, or any other investable asset. Mutual funds are purchased in shares, just as stock in a company is purchased in units called shares. The difference being that mutual funds represent a diversified collection of “stuff,” whereas a single issue of stock is not diversified. Building a portfolio using a wide variety of mutual funds is an ideal way to achieve maximum diversification. The trick is putting the right types of mutual funds together so that redundancy is avoided and diversification is maximized. Welcome to the

7Twelve portfolio "recipe"—your guide to building a portfolio that provides an ideal blend of risk-controlled performance.

As shown in Figure 1.1, each mutual fund has an equal share in the 7Twelve recipe, meaning that each mutual fund is equally valued for its specific contribution to the overall portfolio's performance.

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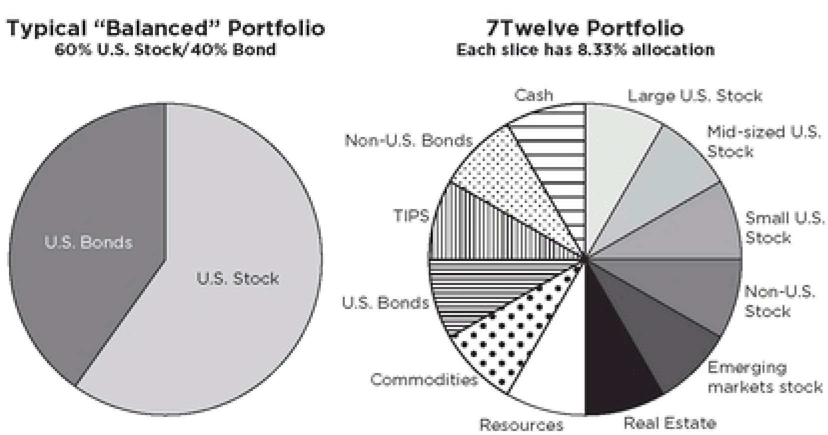
The 7Twelve is a diversified portfolio of 12 different mutual funds—where each mutual fund is itself a diversified investment product.

Figure 1.1 Two-Fund Portfolio versus Twelve-Fund Portfolio



The pie chart on the right (the multi-asset 7Twelve portfolio) is far more diversified than the pie chart on the left (a typical balanced portfolio that has a 60 percent stock allocation and a 40 percent bond allocation). The 7Twelve portfolio utilizes 12 different mutual funds to gain exposure to a wide variety of investable asset classes. The typical "balanced" portfolio utilizes only U.S. stock and U.S. bonds. As will be shown in this book, the broadly diversified 7Twelve portfolio provides better performance with less risk than the typical two-asset balanced portfolio.

Throughout this book, the words "stock" and "equity" will be used interchangeably. A stock mutual fund is the same as an equity mutual fund. Likewise, bonds can also be referred to as fixed income products. So a bond mutual fund might also be called a fixed income fund. Of course, there are many different kinds of stock funds and many varieties of bond funds.

Salsa Anyone?

The 7Twelve portfolio is a recipe for combining 12 asset classes that optimizes performance and minimizes risk. It's not complicated, but it does require more asset classes than typically used. It's like making salsa with 12 ingredients instead of salsa with just two ingredients. Salsa with two ingredients won't cut it.

Just as new recipes often call for unfamiliar ingredients, the 7Twelve portfolio recipe will integrate investment asset classes that may seem exotic. Remember that some recipes call for ingredients that we would never eat individually (say, Tabasco sauce). However, when combined with other ingredients the exotic ingredient is magically integrated in a way that enhances the overall dish . . . or portfolio.

It is the diversity of the ingredients that makes salsa taste great. It's just hard to imagine great salsa that has only two ingredients. Even if you use the best tomatoes and onions available, having only two ingredients will not produce great salsa. How about using a wide variety of tomatoes and a wide variety of onions? Nope, doesn't solve the problem. Even though you have diversity within the two ingredients, you still have only two ingredients—and that ain't salsa.

The salsa metaphor describes the approach many investors (and mutual fund companies) use today when building what they claim to be a diversified portfolio. Here is a common approach: A stock mutual fund that contains 500 U.S. stocks is combined with a bond mutual fund that contains several hundred bonds. The resulting portfolio is referred to as a diversified balanced portfolio—the classic 60/40 model, with 60 percent of the portfolio allocated to large-cap U.S. stocks and 40 percent of the portfolio allocated to bonds.

With so many individual stocks and bonds, it appears that a diversified portfolio has been created. Wrong. No matter how much diversification there is within each ingredient, this supposedly diversified portfolio still has only two different ingredients (or asset classes): large-cap U.S. stock and U.S. bonds. Variety *within* specific asset classes is very important, but variety *among* asset classes is just as important—perhaps even more important.

Variety within an asset class represents "intra-asset" diversification, whereas variety among asset classes represents "inter-asset" diversification. Both forms of diversification are important. Nearly all mutual funds provide intra-asset diversification. Very few provide inter-asset diversification. The 7Twelve portfolio provides both.

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The classic 60/40 balanced fund is 60 percent allocated to large-cap U.S. stocks and 40 percent allocated to bonds.

Very simply, more types of ingredients are needed to create a truly diversified portfolio (or great tasting salsa). Investment portfolios with genuine diversification have variety *within* and *among* asset classes, just like a good salsa that has a variety of tomatoes and onions *and* a wide array of other ingredients, such as peppers, lime juice, cilantro, salt, vinegar, and so on. Similarly, a great recipe for a diversified investment portfolio calls for 12 diversified ingredients, not just two.

In broad terms, the 7Twelve portfolio has an allocation of about 65 percent (66.6 percent to be exact) that is devoted to “Equity and Diversifying Funds” (U.S. stock, non-U.S. stock, real estate, resources) and about a 35 percent allocation (33.4 percent to be exact) to “Fixed Income Funds” (U.S. bonds, Non-U.S. bonds, and cash).

This two-thirds/one-third allocation pattern between stocks and bonds represents a classic “60/40 balanced” model, where 60 represents a 60 percent allocation to stocks (or equity investments) and 40 represents a 40 percent allocation to bonds (or fixed income). This general 60/40 allocation pattern is a useful starting point when building investment portfolios. However, the 7Twelve portfolio represents a much-needed diversification “upgrade” to the generic 60/40 model. In fact, the 7Twelve portfolio will be compared to the classic 60/40 portfolio throughout this entire book.

The seven core asset classes in the 7Twelve portfolio include U.S. stock, non-U.S. stock, real estate, resources, U.S. bonds, non-U.S. bonds, and cash. Underneath the seven core asset categories are 12 specific mutual funds. You can also use exchange-traded funds (ETFs) instead of mutual funds. An exchange traded fund is a mutual fund that trades like a stock.

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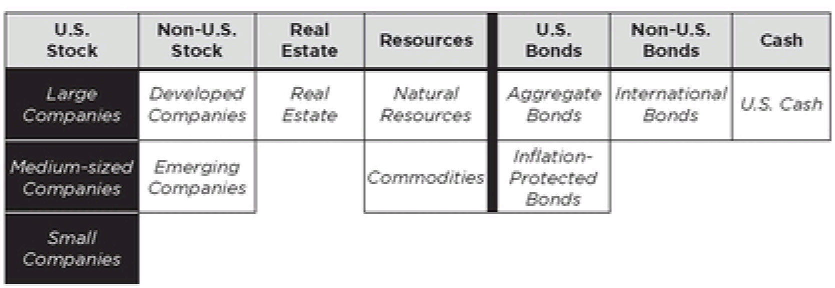
The seven core asset classes in the 7Twelve portfolio include U.S. stock, non-U.S. stock, real estate, resources, U.S. bonds, non-U.S. bonds, and cash.

The 12 different mutual funds represent the specific ingredients in the 7Twelve recipe. Let’s take a look at the ingredients in first four broad asset classes, namely, U.S. stock, non-U.S. stock, real estate, and resources.

The first asset class to examine is U.S. stock. U.S. stock is often considered to be the “core” of many investment portfolios.

U.S. Stock



The 7Twelve portfolio utilizes three specific mutual funds in the U.S. stock asset class:

- Large-cap companies
- Midcap companies

- Small-cap companies

Each mutual fund has an 8.33 percent weighting (or allocation) in the 7Twelve portfolio; thus the U.S. stock “asset class” has a total allocation of about 25 percent in the 7Twelve portfolio—which is the largest allocation to any of the seven core asset categories. In other words, the 7Twelve portfolio’s largest single commitment is to the U.S. stock asset class.

Let’s talk first about large-cap U.S. stock, the first mutual fund in the U.S. stock asset class. Examples of large-cap U.S. stock (i.e., companies) are ExxonMobil, Microsoft, General Electric, Procter & Gamble, Johnson & Johnson, and the list goes on. Companies are classified as large cap (or midcap or small cap) based on their market capitalization (or “cap”), which is simply the current price of their stock multiplied by the number of shares of their stock that have been sold to investors. Large-cap stocks have a market cap of something over $8 billion. Small-cap stocks are market cap below about $1.5 billion. Midcap stocks are in between. These market cap boundaries are flexible, but these figures are general guidelines.

A well known collection of large-cap U.S. companies is the Standard & Poor’s 500 Index (or S&P 500). There are dozens of mutual funds that mimic the S&P 500 Index. Such funds are referred to as “index” funds, and index funds can mimic any index they choose. The most popular index to mimic is the S&P 500 Index. Funds that attempt to replicate the performance of the S&P 500 Index are referred to as *S&P 500 Index funds* (weird, huh?). More generally, they are simply referred to as *index funds*. But it’s important to remember that there are other indexes that can be replicated by “index” funds. (This may come as a shock to the good folks at Standard & Poor’s.)