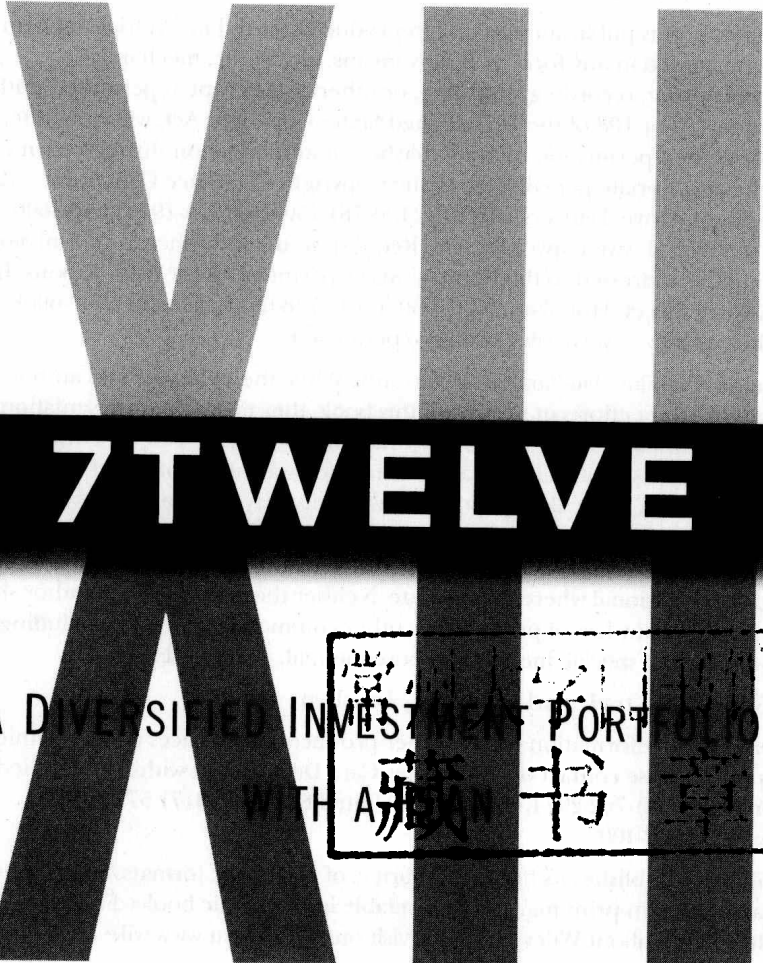




7 TWELVE

A DIVERSIFIED INVESTMENT PORTFOLIO
WITH A PLAN

CRAIG L. ISRAELSEN



7TWELVE

A DIVERSIFIED INVESTMENT PORTFOLIO
WITH A 

CRAIG L. ISRAELSEN



WILEY

John Wiley & Sons, Inc.

Copyright © 2010 by Craig L. Israelsen. All rights reserved.

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

Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 646-8600, or on the Web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at <http://www.wiley.com/go/permissions>.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

7Twelve™ is a trademark of Craig L. Israelsen

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our web site at www.wiley.com.

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.I87 2010

332.6—dc22

2010004724

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

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

Foreword

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

7Twelve™ 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

Preface

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

Preface

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.

CONTENTS

Foreword		xi
Preface		xiii
Acknowledgments		xvii
Chapter 1	A Recipe for Success	1
	The 7Twelve Recipe	2
	Salsa Anyone?	4
	U.S. Stock	7
	Non-U.S. Stock	12
	Real Estate	15
	Resources	16
	U.S. Bonds	19
	Non-U.S. Bonds	21
	Cash	22
	The Complete Recipe	23
Chapter 2	Lining Up the Ingredients	29
	A Recipe That Goes Waaay Back	32
	Getting Better and Better	34
Chapter 3	The More Ingredients, the Better	37
	Measuring Volatility and Risk	38
	Diversification by Design	40
	Diversification Requires Depth <i>and Breadth</i>	48

Contents

Chapter 4	Growth of Money	53
	Why Measure Growth of Money?	54
	Expect Ups and Downs	56
Chapter 5	Combining Ingredients That Zig and Zag	63
	Getting Close to Zero	64
	Finding Assets That Play Nicely Together	65
	Don't Forget Broad Diversification	68
	Quantifying Correlation	73
Chapter 6	Stirring the Mix	79
	Rebalancing versus Buy-and-Hold	80
	Choosing a Schedule	86
Chapter 7	Adjusting the Secret Sauce	89
	The Saving Years and the Spending Years	91
	How Portfolio Mechanics Change in the Golden Years	94
	Allocation Age versus Chronological Age	96
	Life Stage Portfolios	98
Chapter 8	How Long Will My Nest Egg Last?	105
	Survival of the Fittest	106
	Reviewing the Nest Egg Guidelines	113
Chapter 9	Should I Tilt toward Value or Growth?	117
	Does It Make a Difference?	118
	The 7Twelve's Value Bias	125
Chapter 10	Should I Jump in or Let the Pot Simmer?	129
	To Stir or Not to Stir?	130
	The 7Twelve Works Both Ways	133
	But If You <i>Still</i> Can't Decide . . .	135

Contents

Chapter 11	A Better 401(K)	137
	Switching the Default	137
	Introducing Target Date	
	Funds and Balanced Funds	138
	The 7Twelve Portfolio Approach	139
	Determining Your Lifecycle Phase	144
	Mismatch 101	147
Chapter 12	The Problem of Undersaving	151
	Chasing Returns Is a Loser's Game	152
	Add Plenty of Patience, Perspective, and Persistence	156
Chapter 13	Of Stocks, Bonds, and Risk	159
	A Tale of Two Time Frames	159
	The "Diversification" Premium	166
Chapter 14	Assembling Your Portfolio	171
Chapter 15	3 Secrets + 4 Principles = 7Twelve Perfection	181
About the Author		187
Index		189

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

7 Core Asset Classes

U.S. Stock	Non-U.S. Stock	Real Estate	Resources	U.S. Bonds	Non-U.S. Bonds	Cash
------------	----------------	-------------	-----------	------------	----------------	------

12 Underlying Mutual Funds

Large Companies	Developed Companies	Real Estate	Natural Resources	Aggregate Bonds	International Bonds	U.S. Cash
Medium-sized Companies	Emerging Companies		Commodities	Inflation-Protected Bonds		
Small Companies						

7Twelve

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

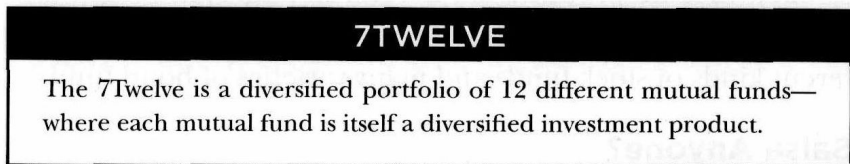
Think of the 7Twelve model as a recipe for building a broadly diversified investment portfolio with 12 different mutual funds—where each mutual fund is itself a diversified investment product.

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

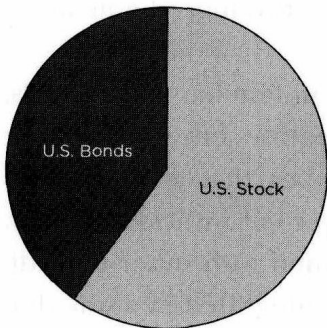
A Recipe for Success

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.



Typical “Balanced” Portfolio
60% U.S. Stock/40% Bond



7Twelve Portfolio
Each slice has 8.33% allocation

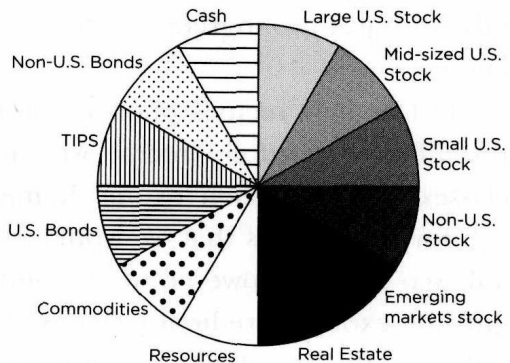


Figure 1.1 Two-Fund Portfolio versus Twelve-Fund Portfolio

7Twelve

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

A Recipe for Success

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

7TWELVE

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