

A Better Balanced Benchmark

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It's time for a better benchmark for "Balanced" funds. Way back when, there were two dominant investment assets: US stock and US bonds. These two assets became the mainstay ingredients in balanced funds, with the typical ratio being a 60% allocation to large US stocks and a 40% allocation to bonds.

News flash...it's not 1940 anymore. Today, there are multiple mainstream asset classes that should be considered when building a diversified balanced benchmark. Shown below are 12 asset classes that should be included in a 21st century balanced fund. The 12 ingredients that belong in a balanced fund fall within 7 core asset groups: US equity, Non-US equity, Real Estate, Resources, US Bonds, Non-US Bonds, and Cash. Within the 7 core asset groups are 12 specific sub-assets (see "Balanced Remix").

Balanced Remix

Approximately 65% of the Portfolio Allocation in Equity and Diversifying Assets				Approximately 35% of the Portfolio Allocation in Bonds and Cash		
US Equity	Non-US Equity	Real Estate	Resources	US Bonds	Non-US Bonds	Cash
Large Companies	Developed Markets	Global Real Estate	Natural Resources	US Aggregate Bonds	International Bonds	US Money Market
Medium-sized Companies	Emerging Markets		Commodities	Inflation Protected Bonds (TIPS)		
Small Companies						

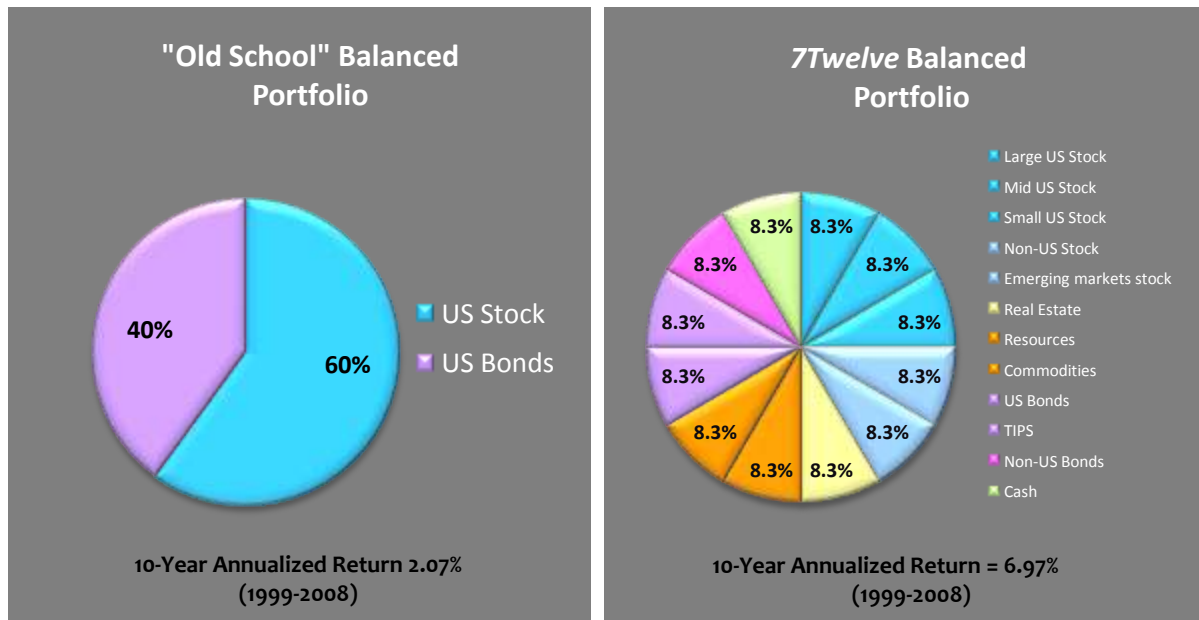
Balanced funds meet the requirements of a **qualified default investment alternative (QDIA)** under the provisions of the 2006 Pension Protection Act (PPA). The other QDIA is a target date fund. In addition to their built-in "glidepath" (i.e., dynamic asset allocation model) a common attribute of target date funds is broad diversification across many asset classes. Balanced funds don't have a glidepath because their allocation stays at or near the 60/40 level over time. However, balanced funds should be utilizing multiple assets to gain the benefits of true diversification. The current reality is that most balanced funds are not broadly diversified because they are based on an out-dated model which typically employs only two assets: US large stocks and US bonds. You know the drill: 60% S&P 500, 40% Lehman Aggregate Bond Index (now Barclays Capital Aggregate Bond Index). We can do better.

Furthermore, even if there were a wide selection of broadly diversified balanced funds, there is a scarcity of multi-asset balanced indexes for use as performance benchmarks. Most providers of balanced funds simply create a benchmark index by blending a large cap US index with a bond index and then refer to that performance cocktail as a “balanced index”. It is odd that a QDIA would not have a clearly identified benchmark index. This glaring lack of a multi-asset balanced index is particularly noticeable in light of the fact that the other QDIA (target date funds) are increasingly employing multiple asset classes. Not surprisingly, an evolving set of target date “indexes” are portfolios comprised of multiple asset classes.

We have entered a new era. Whereas single asset indexes (e.g., S&P 500, Russell 2000, Barclays Capital Aggregate Bond Index, MSCI EAFE, etc.) have been the standard approach to this point, the evolution of multi-asset portfolios demands the development of multi-asset benchmark indexes.

This article introduces a multi-asset balanced portfolio that brings a higher standard to the important mutual fund category long known as “balanced”. This new age balanced portfolio is referred to as the “7Twelve Portfolio”. The name makes reference to “7” core asset classes with “Twelve” underlying sub-assets. The 7Twelve Portfolio is constructed to generally follow the time-tested 60/40 guideline, but uses eight sub-assets (instead of one) to create an overall equity exposure of about 65% and 4 fixed income sub-assets (instead of one) to create a “bond” exposure of about 35%. All 12 sub-assets are index-based exchange traded funds and are all equally weighted (each representing 8.3% of the 7Twelve portfolio). The equal-weighting is maintained by annual rebalancing. The difference between the old school balanced benchmark and the new age balanced benchmark are depicted in “Old School vs. New Age”.

Old School vs. New Age



The performance of the multi-asset 7Twelve Balanced Portfolio has been significantly better than a standard 60/40 balanced portfolio over the past 3, 5, and 10-year periods (see “Better Balanced”). Vanguard Balanced Index is a representative fund using the standard 60/40 balanced approach. Vanguard 500 Index is a clone of the S&P 500 Index, and is included simply for context.

Over the five-year period from 2004-2008, the 7Twelve Balanced Portfolio averaged a 5.00% annualized return, whereas Vanguard Balanced had a 0.96% average annualized return. The Vanguard 500 Index produced an average annualized return of -2.29% over the past five years. For the 10-year period ending on December 31, 2008 the 7Twelve Portfolio had a return nearly 500 bps higher than the Vanguard Balanced fund and nearly 850 bps higher than the Vanguard 500 Index. As shown in “Over the Top”, a \$10,000 investment in the 7Twelve Portfolio in 1999 grew to nearly \$20,000 by the end of 2008, compared to \$12,279 in the Vanguard Balanced fund, and \$8,630 in the Vanguard 500 Index.

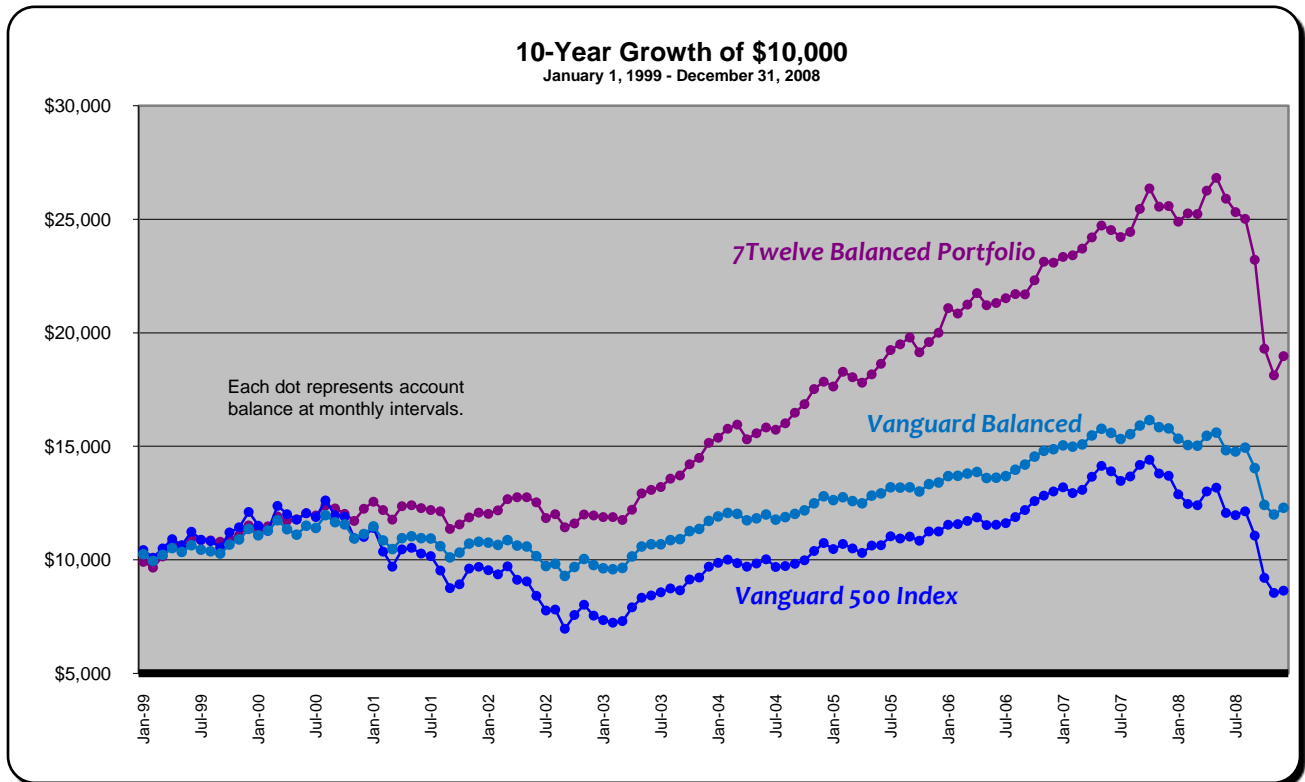
Better Balanced

Calendar Year Total % Return	7Twelve Balanced Portfolio	Vanguard Balanced	Vanguard 500 Index
1999	16.06	13.61	21.07
2000	6.78	(2.04)	(9.06)
2001	(1.68)	(3.02)	(12.02)
2002	(0.69)	(9.52)	(22.15)
2003	27.00	19.87	28.50
2004	17.77	9.33	10.74
2005	12.20	4.65	4.77
2006	15.35	11.02	15.64
2007	11.30	6.16	5.39
2008	(24.75)	(22.21)	(37.02)
3-Year Return (2006-2008)			
	(1.14)	(2.85)	(8.44)
5-Year Return (2004-2008)			
	5.00	0.96	(2.29)
10-Year Return (1999-2008)			
	6.97	2.07	(1.46)
10-Year Growth of \$10,000			
	\$19,617	\$12,279	\$8,630

Building a more diversified *balanced* portfolio enhances the inherent virtues of the classic 60/40 balanced model. As a result of the Pension Protection Act the usage of balanced funds as a default investment vehicle will increase among retirement plan sponsors and among the general investing public. In fact, at the end of 2008 there was approximately \$170 billion invested in balanced funds. Interestingly, the largest 10 funds held nearly 80% of all the assets. The average 10-year performance of the 10 largest balanced funds from 1999-2008 was 3.74%, whereas the 7Twelve Balanced Portfolio generated a 10-year return of 6.97%.

Better “balanced” performance is not the result of skill, but simply the natural byproduct of meaningful diversification and systematic rebalancing. The 7Twelve Balanced Portfolio is not only a better benchmark for balanced funds, it’s also an investable product. www.7TwelvePortfolio.com.

Over the Top



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