A Better Balanced Fund

Get greater diversification than traditional 60/40 benchmarks provide.

WAY BACK WHEN, THERE WERE two dominant investment assets: U.S. stocks and U.S. bonds. These became the mainstay ingredients in balanced funds, with the typical ratio being a 60% allocation to large-cap U.S. stocks and 40% to bonds.

News flash: It's not 1959 anymore! It's time for a better benchmark for balanced funds. "A More Diversified Balanced Fund," on page 31, shows 12 asset classes that should be included in a 21st-century balanced fund. These 12 ingredients fall within seven core asset groups: U.S. equity, non-U.S. equity, real estate, resources, U.S. bonds, non-U.S. bonds and cash. Within the seven core asset groups are 12 specific sub-assets.

MULTIPLE ASSETS

Balanced funds meet the requirements of a qualified default investment alternative (QDIA) under the provisions of the 2006 Pension Protection Act, which means they are funds that are deemed safe enough to be a default safe harbor investment option in people's 401(k) funds. The other QDIA is target-date funds, which Congress revisited last month because target-date funds, which supposedly get more conservative as the target date, or retirement year, approaches, got surprisingly trounced in the recent market meltdown (see "Are Target-Date Funds Failing?" April 2009). Target-date funds have a built-in "glidepath" (i.e., dynamic asset allocation model), or schedule on which they supposedly become more conservatively allocated. These funds also commonly hold a portfolio that's broadly diversified across many asset classes.

Balanced funds don't have a glidepath because their allocation stays at or near 60% stocks/40% bonds. However, balanced funds should be using multiple kinds of assets to gain the benefits of true diversification. Currently, most balanced funds are based on an out-dated model: 60% S&P/500, 40% Lehman Aggregated Bond Index (now Barclays Capital Aggregated Bond Index).

SEEKING AN INDEX

Furthermore, there are no multi-asset balanced indexes to use as performance benchmarks. Most providers simply create a benchmark index by blending a large-cap U.S. index with a bond index and refer to that performance cocktail as a "balanced index." It's odd that a QDIA would not have a clearly identified benchmark index. Target-date funds (the other QDIA) are increasingly employing multiple asset classes and an evolving set of target-date "indexes" are portfolios made up of multiple asset classes. Why isn't that the case with balanced funds and indexes?

Single-asset indexes (e.g., S&P 500, Russell 2000, Barclays Capital Aggregate Bond Index, MSCI EAFE, etc.) have been the standard approach until now, but the evolution of multi-asset portfolios demands the development of multi-asset benchmarks.

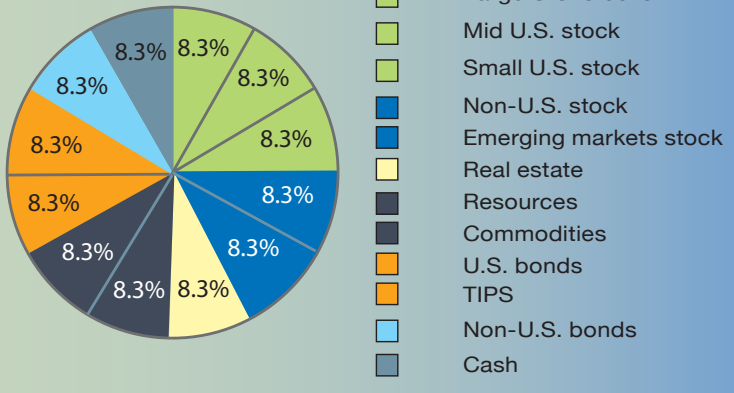
That's why I created a multi-asset balanced portfolio. I call it the "7Twelve Portfolio." The name refers to seven core asset classes with 12 underlying sub-assets. The 7Twelve Portfolio is constructed to generally follow the time-tested 60/40

guideline, but it uses eight sub-assets instead of one to create an overall equity exposure of about 65% and four 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 all are equally weighted: Each represents 8.3% of the 7Twelve portfolio. The fund is rebalanced annually to maintain the equal weighting. The new-era balanced benchmark is depicted below.

The performance of this multi-asset 7Twelve Balanced Portfolio has been significantly better than a standard 60/40 balanced portfolio over the past three-, five- and 10-year periods (see "Enhanced Performance," bottom left). Vanguard Balanced Index represents the standard 60/40 balanced approach. Vanguard 500 Index is a clone of the S&P 500 Index, and is included for context.

A MORE DIVERSIFIED BALANCED FUND

The 7Twelve portfolio creates a 65% stock/35% bonds balanced portfolio that holds three sub-asset classes of bonds and eight sub-asset classes of stocks.



10-year annualized return = 6.97% (1999-2008)

Source both charts: Craig L. Israelsen, based on Morningstar data

ENHANCED PERFORMANCE

The better balanced fund outperformed both a traditional balanced fund and a stock index over the past three-, five- and 10-year periods.

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

A REWARDING CHANGE

Over the five-year period from 2004 to 2008, the 7Twelve Balanced Portfolio averaged a 5.00% annualized return, compared with 0.96% for the Vanguard Balanced Index. Meanwhile, the Vanguard 500 Index produced an average annualized return of -2.29%. For the 10-year period ending on Dec. 31, 2008, the return of the 7Twelve Portfolio was nearly 500 bps higher than the Vanguard Balanced Index and nearly 850 bps higher than the Vanguard 500. A $10,000 investment in the 7Twelve Portfolio in 1999 would have grown to nearly $20,000 by the end of 2008, compared with $12,279 for the Vanguard Balanced fund, and $8,630 for the Vanguard 500.

These results show that building a more diversified balanced portfolio enhances the inherent virtues of the classic 60/40 model. This is particularly important since the Pension Protection Act will increase the use of balanced funds as a default investment vehicle among retirement plan sponsors and investors.

In fact, at the end of 2008 there was about $170 billion invested in balanced funds. The largest 10 funds held nearly 80% of all the assets, and the average 10-year performance of the 10 largest balanced funds from 1999 to 2008 was 3.74%, versus 6.97% for the 7Twelve Balanced Portfolio. Achieving better "balanced" performance is not the result of skill, but the natural by-product of meaningful diversification and systematic rebalancing. **BIC**

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