

THE PORTFOLIO

A Perfect Portfolio

DIVERSIFICATION IS THE KEY TO THE 7TWELVE, WHICH OUTPERFORMS ITS COUNTERPARTS—WITH LESS RISK. BY CRAIG L. ISRAELSEN

GREAT SALSA IS ABOUT DIVERSIFICATION. To make the best, you combine diverse ingredients to achieve the desired mix of spicy and sweet. Similarly, investment portfolios should include a wide variety of diverse assets. Each one adds an important dimension to the portfolio because it behaves differently. Most portfolios, however, are not sufficiently diversified. Stocks, bonds and cash won't get the job done. Welcome to my new portfolio, which I call the 7Twelve.

The “7” of 7Twelve denotes the number of asset classes in the portfolio, while “Twelve” represents the number of underlying funds. The 7Twelve portfolio has a 60/40 allocation: approximately 60% in equity and diversifying assets, and about 40% in bonds and cash. This is a classic ratio, but with more diversification than the typical balanced fund.

The seven asset classes are: U.S. equity, non-U.S. equity, real estate, natural resources, U.S. bonds, non-U.S. bonds and cash. Within each class, you can select mutual funds (active or passive) or exchange-traded funds. “Where the Funds Are,” on page 144, shows the distribution of the 12 underlying funds among the seven asset classes.

Each mutual fund (or sub-asset) is equally weighted, so each represents 8.33% of the portfolio. This allocation is maintained by rebalancing the portfolio back to equal portions at the start of each year. Using new cash inflows to accomplish this annual task can significantly enhance the tax efficiency of the portfolio



lio during the accumulation period prior to retirement. This technique will not affect the tax efficiency of the 12 individual funds within the portfolio, however.

Equal annual rebalancing is not tactical portfolio management. It's the opposite. It's a systematic technique designed to protect the portfolio from emotional buy-and-sell decisions, most of which cause more harm than good.

Any investor can adapt the 7Twelve asset allocation model to suit his or her level of aggressiveness. For example, a conservative investor may choose to overweight fixed income and cash. Most important, the 7Twelve design meets the two major objectives of a retirement portfolio: to grow wealth prior to retirement and protect it during the distribution phase in the retirement years.

THE PORTFOLIO

GROWING MONEY

As seen in “Performance Report” on page 145, over the 10-year period from 1998 to 2007, a \$10,000 lump-sum investment in the 7Twelve portfolio would have grown to \$29,782 (without considering taxes and inflation). That investment in the American Funds Capital Income Builder fund, a broadly diversified fund with net assets exceeding \$110 billion, grew to \$26,074. The Fidelity Global Balanced fund, a world allocation fund with \$380 million in assets, turned \$10,000 into \$24,447, while the \$1.5 billion T. Rowe Price Personal Strategy Balanced fund created \$20,982 from \$10,000. The \$9.8 billion Vanguard Balanced fund, a less-diversified fund that invests in domestic stocks and bonds, turned \$10,000 into \$18,717.

Finally, a \$10,000 investment in the Vanguard 500 Index—a \$122 billion fund that mimics the S&P 500 by investing in 500 U.S. companies—grew \$10,000 into \$17,624 over the period. It has the least diversified portfolio of the comparison funds. From 1998 to 2007, the 7Twelve had an average annualized return of 11.5%, well ahead of the other funds. The more diversified the fund, the closer its return was to the 7Twelve.

Here is a broader comparison. There were 1,979 mutual funds with at least 10 years of performance as of Dec. 31, 2007 (counting only the primary share class). All had at least 50% of their portfolio in stocks. The average 10-year annualized return of this group was 8.2%, with an average 10-year standard deviation of 21.4%. The 7Twelve portfolio had a higher 10-year return than 84% of the 1,979 funds. And with a standard deviation of 8.6%, it was less risky than over 98% of the 1,979 funds.

Sufficiently diversified portfolios can enhance return and greatly reduce risk. The 7Twelve gives all 12 funds in the portfolio a substantial allocation. Trivial allocations of 1% or 2% won't cut it. This is a common shortcoming in global and asset allocation funds. The portfolio may contain a lot of asset classes, but too many are assigned a trivial allocation.

WHERE THE FUNDS ARE

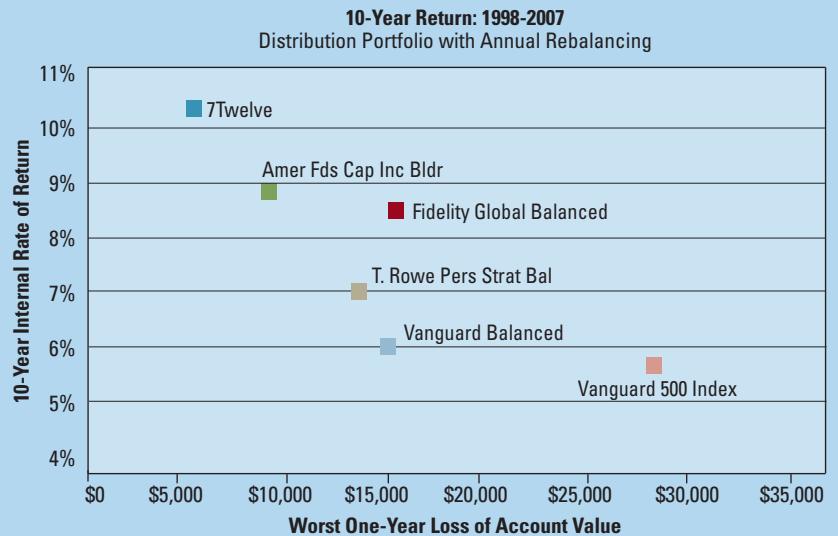
The 7Twelve portfolio uses 12 different funds across seven different asset categories.

Approximately 60% of the portfolio allocation in equity and diversifying assets				Approximately 40% of the portfolio allocation in bonds and cash		
U.S. Equity	Non-U.S. Equity	Real Estate	Natural Resources	U.S. Bonds	Non-U.S. Bonds	Cash
Large companies	Developed markets	Global real estate	Natural resources	U.S. aggregate	International bonds	U.S. money market
Medium-size companies	Emerging markets		Commodities	Inflation-protected bonds		
Small companies						

Source: Author research

DISTRIBUTION PORTFOLIO

During the withdrawal phase, the 7Twelve portfolio outperformed the other funds in the comparison group.



Source: Morningstar Principia

PROTECT MONEY

The best way to grow and protect wealth is to avoid large losses. From 1998 to 2007, the worst one-year return in the 7Twelve would've been 0.1% in 1998. The worst in the American Funds Capital Income Builder fund was -2.8% in 1999. Fidelity Global Balanced Fund's worst loss was 8.2% in 2001. The T. Rowe Price Personal Strategy fund's worst return was -7.7% in 2002—the same for Vanguard Balanced (-9.5%) and the Vanguard 500 Index (-22.2%).

Of the 1,979 fund group, only six had a positive annual return each year

from 1998 to 2007. In other words, 99.7% of the funds ended at least one year with a negative return. In fact, the average number of negative annual returns over the 10-year period was three (typically 2000, 2001 and 2002).

As shown in “Performance Report,” the 7Twelve portfolio had no negative calendar-year returns in the 10-year period. Thus, it outperformed 84% of stock and bond funds and avoided a loss, which only a handful of funds achieved.

Even more damaging than losses is panic over a tanking portfolio. Investors often bail out at the wrong time. A

PERFORMANCE REPORT

Over time, the 7Twelve portfolio outperformed comparative funds, with low risk and high tax efficiency.

Calendar Year Total % Return	7Twelve	American Funds Capital Income Builder A (CAIBX)	Fidelity Global Balanced (FGBLX)	T. Rowe Price Personal Strategy Balanced (TRPBX)	Vanguard Balanced Fund (VBINX)	Vanguard 500 Index (VFINX)
1998	0.05	11.75	17.75	13.90	17.85	28.62
1999	15.50	(2.78)	23.03	7.96	13.61	21.07
2000	12.23	12.52	(5.97)	5.60	(2.03)	(9.06)
2001	2.17	4.75	(8.15)	(2.49)	(2.98)	(12.02)
2002	2.31	0.65	(6.15)	(7.74)	(9.45)	(22.15)
2003	28.61	21.57	29.90	24.38	20.02	28.50
2004	17.46	17.40	13.67	12.55	9.37	10.74
2005	12.31	4.94	9.00	6.44	4.80	4.77
2006	15.13	22.04	13.70	11.92	11.06	15.64
2007	12.46	10.68	13.77	7.70	6.31	5.39

Portfolio Allocations (12/31/07)

% in U.S. Stock	29.6	27.0	21.1	49.8	60.4	99.6
% in Non-U.S. Stock	29.7	38.5	32.2	15.7	0.1	0.0
% in Bonds	25.9	19.3	27.6	29.2	37.7	0.0
% in Cash	14.0	14.5	9.1	2.3	1.8	0.3
% in Other	0.8	0.8	9.9	3.0	0.0	0.0
10-Year Average Annualized Return (%)*	11.53	10.06	9.35	7.69	6.47	5.83
10-Year Standard Deviation (%)	8.57	8.47	12.97	8.85	9.49	17.30
Worst 1-Year % Loss	0.05	(2.78)	(8.15)	(7.74)	(9.45)	(22.15)
Correlation to S&P 500 Index (10-year)	0.49	0.44	0.94	0.89	0.97	1.00
Growth of \$10,000	\$29,782	\$26,074	\$24,447	\$20,982	\$18,717	\$17,624
Annual % Expense Ratio of Portfolio	0.69	0.56	1.18	0.79	0.20	0.18
(%) 5-Year Tax Cost Ratio (lower is better)	1.21	1.62	1.41	1.14	0.77	0.29

Performance assumes equally weighting each sub-asset and annual rebalancing on Jan. 1 of each year to original portfolio allocations. Taxes and inflation were not accounted for. Past performance is no guarantee of future performance.

Raw data used in the study was obtained from Morningstar Principia and other sources.

*Average annualized return is a geometric mean, not an arithmetic mean.

lot of protecting wealth is minimizing events that cause panic, such as big losses. Another way to protect money is with tax efficiency. Relative to other globally allocated multi-asset funds, the 7Twelve is equally or slightly more tax efficient.

DISTRIBUTION POWER

The performance of the 7Twelve in "Performance Report" assumes a lump-sum investment. We also tested it as a distribution portfolio (see page 144).

This analysis assumed an initial account balance of \$100,000 at the start of 1998. The first withdrawal was at the end of the year and represented 5% of the initial balance (\$5,000). Subsequent annual withdrawals were at the end of each year and increased by 3% per year.

At the end of 2007, the final account balance for the 7Twelve portfolio was over \$192,000. Recall that there were 10 annual withdrawals (each 3% more than the prior year's) from 1998 to 2007. This translated into a 10-year internal rate of return (IRR) of 10.2%. (IRR is the measure of performance when a portfolio is in distribution mode; average annualized return is the measure of performance in the accumulation phase.) The worst calendar-year loss for the 7Twelve portfolio was \$4,947, compared with more than \$15,000 in the Vanguard Balanced fund. As "Distribution Portfolio" shows, the risk and return characteristics of the 7Twelve during withdrawal are superior to the other funds in this comparison.

The 7Twelve is a portfolio for life. Its design prudently grows wealth during the preretirement accumulation period and protects it in the post-retirement distribution period. The 7Twelve portfolio can also serve as a performance benchmark against which entire portfolios can be measured. **FP**

For more information about the 7Twelve portfolio, go to www.7TwelvePortfolio.com, or contact Craig Israelsen at craig@TDBench.com.

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