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THE 2015 INVESTMENT GUIDE

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STOCKS, BONDS AND FUNDS

THE MAGIC NUMBER

How many funds should you own in a diversified portfolio? A dozen, according to one Utah professor.

BY LAURA SHIN

While teaching family finance at Brigham Young University, Craig Israelsen got a question that bugged him: What should be in a diversified portfolio? "That's the perfect question," he says. Except that he didn't have a good answer—or at least not one that would make sense to and for the average individual investor. So in 2008 he came up with his own diversification formula, which has been catching on with financial planners.

Craig Israelsen: Twelve funds beat one.

Israelsen, 55, calls it the 7Twelve Portfolio, because it consists of 12 equal slices of mutual funds drawn from seven asset classes (U.S. equity, non-U.S. equity, real estate, natural resources, U.S. bonds, non-U.S. bonds and cash). The 12 include seven fund types whose performance he could track back to 1970 and which he felt had earned a place (U.S. large cap, U.S. small cap, non-U.S. stocks, bonds, cash, real estate and commodities). Because the world has changed since 1970, he added U.S. midcap, emerging markets, natural resources, inflation-protected bonds and non-U.S. bond funds. Some asset classes are more heavily weighted; three investment slices of 8.3% each are from the U.S. equity class. (The cash slice is there for liquidity; those with other sources of cash can substitute something like managed futures or high-yield bonds, Israelsen suggests.)

So what does owning 12 funds achieve that owning one balanced fund doesn't? From 1999 through November 2014 the Vanguard Balanced Index fund, which is 60% U.S. stocks and 40% U.S. bonds, had an average annual compound return of 5.7%, whereas an index fund version of the 7Twelve portfolio returned 7.6%, Israelsen calculates. The main difference, his analysis shows, is that the 7Twelve portfolio sustained much smaller losses in bad years, as a well-diversified portfolio theoretically should.

An obvious question is whether Israelsen created 7Twelve simply by back-testing which allocation performed best in recent years. "If I were trying to juice the returns," he answers, "I wouldn't equally weight." He dismisses the more precise asset allocation recommendations some robo-advisors produce—for instance to keep 0.5% of a portfolio in a particular asset class. "What's that going to do? It's window dressing."

What about the varying risk preferences of different investors? Israelsen argues that the risk tolerance questionnaires in wide use are vague and poor predictors of how investors will really react if their investments nosedive. Still, he endorses the "core and explore" approach: Use 7Twelve as the diversified core of your portfolio and then make personalized picks outside the core.

Israelsen, now a principal at Target Date Analytics (which designs retirement target date funds) and teaching at Utah Valley University, reports that more than 1,000 financial advisors have paid for a package to help them implement 7Twelve. (Do-it-yourselfers can buy guides for $75 that offer suggestions for either index or managed funds for each slice.) One enthusiastic planner is Lisa Kirchenbauer of Arlington, Va. The 2008 financial crisis and the losses clients suffered convinced her they needed a more formal diversification model. The virtue of 7Twelve, she says, is it's "simple, easy to get a handle on" and can be easily tweaked for each investor. F

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