

The 7Twelve™ Balanced Strategy: The Core of “Core and Explore”

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Let’s consider several blueprints or models for the core holding in a portfolio. A common core portfolio holding for younger investors might be a mutual fund or ETF that mimics a well accepted equity market index, such as the S&P 500 Index or the Russell 1000 Index. Index funds and ETFs that mimic these particular indexes are plentiful. Another “core” portfolio holding might be a balanced fund with its nearly timeless 60/40 allocation pattern—60% equity and 40% fixed income. Still another possible core portfolio holding would be a multi-asset fund that incorporates domestic and non-US equity, diversifying assets, and a variety of fixed income exposures. In essence, such a core portfolio holding would itself be a diversified portfolio. If diversification is a central tenet of modern portfolio theory, then it is completely logical that the “basic, essential, or enduring” part of a portfolio—the **core**—should be diversified.

The 7Twelve “core” represents exposure to seven broad asset classes (US equity, non-US equity, real estate, resources, US bonds, non-US bonds, and cash). Each of the 12 sub-components (using mutual funds and/or ETFs) is equally weighted at 8.33%. The 7Twelve “core” is rebalanced periodically to maintain the 8.33% equal weighting. As you can see, the largest broad asset weighting is in US equity with $8.33\% \times 3 = 25\%$ of the overall core. In general, this diversified core has approximately a 65% allocation to equity and diversifying asset classes and a 35% allocation to fixed income. This general allocation categorizes it as a balanced model—albeit a more diversified balanced model than typically found.

Figure 1. 7Twelve™ Balanced Strategy: A Blueprint for a Diversified 12-Asset Portfolio “Core”

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

How has the 7Twelve diversified “core” performed in comparison to less diversified “core” portfolio holdings? As shown in Table 1, the 7Twelve diversified core built with low-cost exchange traded funds has dominated two traditional core holdings over the past 3, 5, and 10 years. The performance of the 100% US Stock “core” is represented by the performance of Vanguard 500 Index, which is a 100% equity fund that mimics the S&P 500 Index. The 60/40 two-asset “core” is represented by Vanguard Balanced Index which has a 60% allocation to large cap US equity and a 40% allocation to US fixed income.

Table 1. Performance of Various Portfolio “Cores”

Portfolio “Core” Models →	100% US Stock Core	60% US Stock/40% Bond Core	7Twelve Portfolio “Core”
			
<i>Performance of the “Core” as of December 31, 2011</i>			
10-Yr Average Annualized Return (%)	2.82	4.87	8.55
10-Yr Standard Deviation of Return (%)	15.92	9.81	12.68
10-Year Growth of \$10,000	\$13,209	\$16,093	\$22,723

The performance figures in Table 1 represent the performance of the “core” of a portfolio. The overall return of the entire “core and explore” portfolio would depend on the types of investments utilized in the “explore” portion of the portfolio. **The “explore” assets will likely vary with every client, but the core could be a consistent element in virtually every portfolio. The amount of the portfolio allocated to the core could also change over the investor’s lifecycle, but would likely always be the basic and enduring component over time.**

Ultimately, what I’m proposing is this: the “core” of a portfolio can be known in advance. The core does not need to be designed for each individual client because virtually every portfolio will use the same diversified core element. **A financial advisor should not be spending time designing a portfolio core for every client.** Rather, the advisor should be determining how much of the core to utilize for each client and what type of “explore” assets to add around the “core” to best meet the client’s unique needs and circumstances. Essentially, the core of a portfolio becomes a commoditized product used by financial advisors. The financial advisor adds considerable value by knowing what individualized “explore” assets should be added to the “core” to best serve the needs of each specific client.

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