Building a Better Balanced Fund

Craig L. Israelsen, Ph.D.
www.7TwelvePortfolio.com
November 2010

It's time for a better "balanced" fund. Way back when, there were two dominant investment categories (or asset classes), namely 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 1959 anymore. Today, there are multiple mainstream asset classes that should be considered when building a diversified balanced fund. Shown below in Table 1 are 12 sub-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.

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. The typical allocation is 60% S&P 500 Index and 40% Lehman Aggregated Bond Index (now Barclays Capital). We can do better.

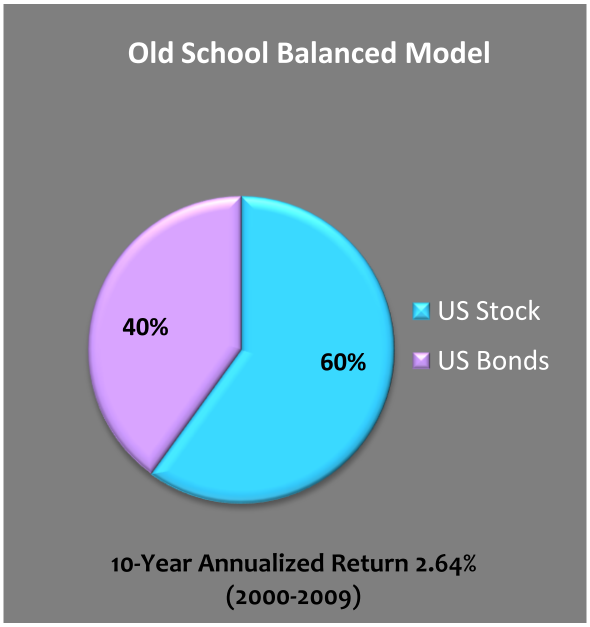
This article introduces a multi-asset balanced fund that brings a higher standard to the notion of "balanced". This new age balanced fund is referred to as the "7Twelve Balanced Strategy". The name makes reference to "7" core asset classes with "Twelve" underlying sub-assets. The 7Twelve Balanced Strategy 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 can be low-cost index-based exchange traded funds (ETFs). All 12 ingredients are equally weighted (each representing 8.3% of the 7Twelve Balanced Strategy). The equal-weighting is maintained by monthly rebalancing (annual rebalancing is also appropriate). The difference between the old school balanced fund and the new age balanced fund are depicted below in Figure 1 (Old Balanced vs. New Balanced).

Table 1.
7Twelve Balanced Strategy

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*	*Global Real Estate*	*Natural Resources*	*US Aggregate Bonds*	*International Bonds*	*US Money Market*
Medium-sized Companies	*Emerging Markets*		*Commodities*	*Inflation Protected Bonds*		
Small Companies						

Figure 1.
Old Balanced vs. New Balanced



The performance of the multi-asset 7Twelve Balanced Strategy has been significantly better than a standard 60/40 balanced fund over the past 3, 5, and 10-year periods as shown in Table 2 (A Better Balanced Model). 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 as a context for the performance history.

Table 2.
A Better Balanced Model

Calendar Year Total % Return *(Assuming monthly rebalancing)*	7Twelve Balanced Stratgey*	Vanguard Balanced Index	Vanguard 500 Index
2000	6.34	-2.04	-9.06
2001	-1.44	-3.02	-12.02
2002	-1.10	-9.52	-22.15
2003	26.60	19.87	28.50
2004	17.77	9.33	10.74
2005	12.02	4.65	4.77
2006	15.22	11.02	15.64
2007	10.84	6.16	5.39
2008	-25.74	-22.21	-37.02
2009	25.23	20.06	26.50
3-Year % Return (2007-2009)	1.01	-0.28	-5.66
5-Year % Return (2005-2009)	5.88	2.87	0.35
10-Year % Return (2000-2009)	7.47	2.64	-1.03
10-Year Growth of $10,000	20,559	12,978	9,019

* Performance reflects the actual performance of 12 underlying ETFs

Over the five-year period from 2005-2009, the 7Twelve Balanced Strategy averaged a 5.88% annualized return, whereas the Vanguard Balanced Index had a 2.87% average annualized return. The Vanguard 500 Index produced an average annualized return of 0.35% over the same five years. For the 10-year period ending on December 31, 2009 the 7Twelve Balanced Strategy had an annualized return of 7.47% versus 2.64% for the Vanguard Balanced fund and -1.03% for the Vanguard 500 Index. A $10,000 investment in the 7Twelve Balanced Strategy on January 1, 2000 grew to $20,559 by the end of 2009, compared to $12,978 in the Vanguard Balanced fund. A $10,000 investment in the Vanguard 500 Index was "under water" at the end of 2009 by virtue of the fact that the initial $10,000 investment had fallen to $9,019.

How to Fix What Happened in 2008

The results shown thus far illustrate how the equally-weighted 7Twelve Balanced Strategy has behaved over the past 10 years. There is another way to implement the 7Twelve Strategy which reduces risk as an investor ages. The approach is very simple: **your overall portfolio allocation to bonds should equal your age**. For example, a 45-year old would have a 45% allocation to bonds, with the balance of the allocation (in this case 55%) invested in the 7Twelve Balanced Strategy. One year later this particular investor would have a 46% allocation in bonds and 54% in the 7Twelve Balanced Strategy. No guess work--just follow the **age-based 7Twelve model**. Table 3 shows what would have happened in 2008 to investors of various ages using the age-based 7Twelve model.

A 45-year old investor with 45% of their overall portfolio in bonds and 55% in the 7Twelve Balanced Strategy would have lost 11.32% in 2008. A 65-year old investor would have lost 4.43% during 2008 (assuming 65% in bonds and 35% in the 7Twelve Balanced Strategy). **Recall that the S&P 500 Index lost 37% in 2008.**

Table 3.
Age-Based 7Twelve Model*

Age of Investor in 2008	Performance in 2008 (%)	10-Year Annualized % Return as of 12/31/08
45 year old	-11.32	6.62
55 year old	-7.92	6.54
65 year old	-4.43	6.45

* Age-based Model: Age = percentage allocation to bonds. Remainder invested in 7Twelve Balanced Strategy.

Building a broadly diversified balanced portfolio enhances the inherent virtues of the classic 60/40 balanced model. Achieving better "balanced" performance is not the result of skill, but simply the natural byproduct of meaningful diversification and systematic rebalancing. Using the 7Twelve Balanced Strategy in an age-based portfolio model offers protection when it is needed most—as an investor approaches retirement.

Craig L. Israelsen, Ph.D. is an associate professor at BYU where he teaches Family Finance to over 1,000 students each year. He is a principal at Target Date Analytics (www.OnTargetIndex.com) and the designer of the 7Twelve Portfolio (www.7TwelvePortfolio.com). He is the author of "7Twelve: A Diversified Investment Portfolio with a Plan" by John Wiley & Sons.