Book Review

7Twelve: A Diversified Investment Portfolio with a Plan

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Author: **Craig L. Israelsen**
Publisher: John Wiley & Sons, Inc. (2010)
ISBN: 978-0-470-60527-1

In the Preface of the book, *7Twelve: A Diversified Investment Portfolio with a Plan,* Dr. Craig Israelsen sets the stage, or maybe I should say table, for the entire book. He refers to 7Twelve™ as a recipe for an investment portfolio. "The recipe is more important than the ingredients. A poor recipe with good ingredients produces a poor end product. A great recipe with average ingredients produces an acceptable outcome. A great *recipe* with great *ingredients* is the ideal scenario…" (p. xiii). Chef Israelsen has measured this "recipe" book into 15 bite-sized chapters. He utilizes historical data to show the effectiveness of his recipe (as much as 40-year performance history); highlights key points using text boxes; and includes tables, graphs, and figures to help the reader understand the topic discussion. Dr. Israelsen is currently an Associate Professor at Brigham Young University, teaching personal and family finance to over 1,200 students every year.

Chapter 1, *A Recipe for Success*, enables investors to build a diversified, multi-asset portfolio. 7Twelve's ingredients are "7" core asset classes (or investment categories) by utilizing "Twelve" underlying mutual funds. One key issue here is that a 7Twelve portfolio will have both depth and breadth; diversification depth within separate mutual funds, and diversification breadth across the seven asset classes, with rebalancing on at least an annual basis.

The 7Twelve Portfolio Recipe

			7 Core Asset Classes			
U.S. Stocks	Non-U.S. Stocks	Real Estate	Resources	U.S. Bonds	Non-U.S. Bonds	Cash
			12 Underlying Mutual Funds			
Large Companies	Developed Companies	Real Estate	Natural Resources	Aggregate Bonds	International Bonds	U.S. Cash
Medium-sized Companies	Emerging Companies		Commodities	Inflation-Protected Bonds		
Small Companies						

Source: *7Twelve: A Diversified Investment Portfolio with a Plan*

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Dr. Israelsen indicates that using a variety of mutual funds or exchange-traded funds achieves maximum diversification, but the trick is to mix the right types of mutual funds (mostly index funds) together that complement each other (behave differently) and avoid redundancy. Throughout the book he compares 7Twelve to the typical "balanced" portfolio of 60% U.S. stocks/40% bonds. In 7Twelve, all 12 different mutual funds have the same weight or allocation of 8.33%. He talks about a portfolio being similar to salsa, in that salsa made with only two ingredients would not be something most of us would eat. However, a new salsa might require us to search for unfamiliar ingredients to complete the 12 ingredient recipe, even using ingredients we would not necessarily eat on our own.

For the remainder of Chapter 1, Dr. Israelsen describes each of the seven asset classes and 12 mutual funds. One item this reviewer noted to share in this review was the author's description of U.S. stocks. Dr. Israelsen stated, "Think of large-cap U.S. stocks as adults, midcap U.S. stocks as teenagers, and small-cap U.S. stocks as children. Children have the most growth potential, but they also present more risk" (p. 10). He also describes his website, www.7TwelvePortfolio.com, which serves as an additional resource where readers can download software (an Excel spreadsheet) to compare other portfolios to the 7Twelve.

In Chapter 2, *Lining Up the Ingredients*, Dr. Israelsen identifies 7Twelve as a strategic portfolio; one that is built and managed with established guidelines, definitely not a portfolio used by day-traders. 7Twelve is not affected by "whim, opinion, or market gyrations." It relies upon a commitment to follow the recipe as written. The 7Twelve recipe has "three simple guidelines: (a) select 12 different 'ingredients' or mutual funds, (b) equally weight the ingredients, and (c) rebalance periodically" (p. 29).

7Twelve consists of eight equity-based mutual funds; an approximately two-thirds allocation (with each mutual fund being weighted at 8.33%, the actual allocation is 66.6%). The four fixed income mutual funds make up the remaining 33.3%. Because of the 65/35 allocation, 7Twelve is considered a balanced portfolio with one definite advantage; it is more diversified than a 60/40 balanced portfolio.

Dr. Israelsen states that he did not start out trying to design a multi-asset portfolio. It is the indirect result of many years of mutual fund research of trying multiple variations of ingredients until he was satisfied he had perfected the recipe.

Chapter 3, *The More Ingredients the Better*, is all about diversification. Dr. Israelsen states "Diversification, in essence, is the art and science of combining ingredients that are sufficiently different from each other that the whole is greater than the sum of the parts" (p. 37).

7Twleve Asset Allocation

Equity **65% of Portfolio** **Four Broad Asset Categories** **Eight Specific Stock or** **Diversifying Mutual Funds**				**Fixed Income** **35% of Portfolio** **Three Broad Asset Categories** **Four Specific Bond or** **Cash Mutual Funds**		
U.S. Stocks	**Non-U.S. Stocks**	**Real Estate**	**Resources**	**U.S. Bonds**	**Non-U.S. Bonds**	**Cash**
Large Companies	Developed Companies	Real Estate	Natural Resources	Aggregate Bonds	International Bonds	U.S. Cash
Medium-sized Companies	Emerging Companies		Commodities	Inflation-Protected Bonds		
Small Companies						

Source: *7Twelve: A Diversified Investment Portfolio with a Plan*, p. 30.

He talks about risk in three different ways: volatility, worst-case return, and frequency of portfolio loss. Volatility is the standard deviation of return. It is "…commonly reported [but] is the least useful measure of risk because it is very difficult to understand in real-world terms" (p. 39). Worst-case return is examined over three-year periods using cumulative percentage return, which measures the total gain or loss from the start of the three-year period to the end of it. Frequency of portfolio loss refers to how often it is "underwater" (current balance is lower than the starting balance). Diversification is the key to reducing risk.

Diversification has a performance benefit. Chapter 4, *Growth of Money*, measures the performance of a portfolio by calculating the average annual return of an investment in percentage terms. We know this as the geometric mean. Dr. Israelsen suggests "a more useful and intuitive way to evaluate the effectiveness of an investment portfolio is to measure how it grows money or loses money over time" (p. 53). He considers this to be a pragmatic measure. Dr. Israelsen uses a variety of portfolios, time frames, and historical data to show the importance of a diversification in times of economy change, ups and downs.

Life Stage Portfolio Allocation Models

Life Stage Portfolio© (based on "allocation age")	**Core 7Twelve Model**	**7Twelve Life Stage 50-60**	**7Twelve Life Stage 60-70**	**7Twelve Life Stage 70+**
Approximate Asset Allocation Model (% equity/% fixed income)	65/35	50/50	40/60	25/75
Generally appropriate for…	Investors in the age range of 20-50	Investors in the age range of 50-60	Investors in the age range of 60-70	Investors in the age range of 70+
Investment Objective	Early accumulation years, preretirement	Late accumulation years, preretirement	Early distribution period, postretirement	Late distribution period, postretirement
	7Twelve Life Stage Asset Allocation Model			
7Twelve Mutual Funds	**Allocation to Each Equity Mutual Fund**			
Large-cap U.S. Stocks	8.33%	6.67%	5.0%	3.33%
Midcap U.S. Stocks	8.33%	6.67%	5.0%	3.33%
Small-cap U.S. Stocks	8.33%	6.67%	5.0%	3.33%
Non-U.S. Stocks	8.33%	6.67%	5.0%	3.33%
Emerging Markets	8.33%	6.67%	5.0%	3.33%
Real Estate	8.33%	6.67%	5.0%	3.33%
Natural Resources	8.33%	6.67%	5.0%	3.33%
Commodities	8.33%	6.67%	5.0%	3.33%
	Allocation to Each Fixed Income Mutual Fund			
U.S. Bonds	8.33%	6.67%	5.0%	3.33%
International Bonds	8.33%	6.67%	5.0%	3.33%
TIPS	8.33%	16.67%	25.0%	33.33%
Cash	8.33%	16.67%	25.0%	33.33%

Source: *7Twelve: A Diversified Investment Portfolio with a Plan*, p. 100.

We have all heard the classic advice of not putting all your eggs in one basket related to investing. In Chapter 5, interestingly enough titled *Combining Ingredients and Zig and Zag*, the focus is combining assets with different attributes. Diversifying across various unrelated asset classes, a portfolio "should be less susceptible to large losses." Dr. Israelsen measures differences between investment assets by calculating the correlation. "When building portfolios, combining investment assets that have low correlations to each other is the goal. We want the average correlation among all the portfolio components to be close to zero" (p. 64). You want the mutual funds in the portfolio to move in different directions from each other as the economy fluctuates. When looking long-term, 40 years of correlation data, results are much less volatile than looking at a specific one-year or two-year time period.

Rebalancing or *Stirring the Mix,* as the title of Chapter 6 signifies, is the reallocation of the assets within a portfolio. With a 7Twelve portfolio, this means making purchases or sales of assets to keep the predetermined percentages (8.33%). Since not all the mutual funds will have the same return each year, this requires selling the best performing funds and using the funds to purchase shares of the poorer performers. However, Dr. Israelsen indicates there are tax advantages if new cash flows into the portfolio. In keeping with the salsa theme, "rebalancing assures that as time goes by our salsa recipe doesn't end up with too many onions or too little cilantro" (p. 79).

Our investment needs change as we move through the lifecycle, so we need to adjust our investment portfolio to meet those differing needs. By *Adjusting the Secret Sauce,* the title of Chapter 7, we can reduce the risk of loss. "Building an appropriate portfolio requires a great deal of consideration of the individual needs and resources of the individual investor, differences that tend to be more profound later in life, at least from a portfolio design perspective" (p. 89). Dr. Israelsen compares different age groups over time within the saving/accumulation phase and the spending/distribution phase. "The 7Twelve portfolio (with four Life Stage allocation models) is ideally suited for both the accumulation phase and distribution phase" (p. 96).

One question we ask ourselves regarding retirement income is *How Long Will My Nest Egg Last?* (Chapter 8). "Building and utilizing a retirement portfolio has at least three components: (a) investing adequately into your retirement accounts during your working career (10% of income), (b) withdrawing money a retirement portfolio at a sustainable rate (5% initial year withdrawal rate with 3% annual increase), and (c) utilizing a multi-asset portfolio design that properly balances goals for growth and capital preservation (7Twelve portfolio)" (p. 113). According to Dr. Israelsen, the multi-asset portfolio approach provides a "more durable nest egg with a higher probability of survival (not depleted in at least a 25-year period)" (p. 114).

Tilting the ingredients in 7Twelve toward value or growth is the focus of Chapter 9, titled *Should I Tilt Toward Value or Growth?*. It can be tilted in either direction depending upon the orientation of the mutual funds selected. Dr. Israelsen defines value as purchasing relatively less expensive stock, which typically means a lower price-to-earnings ratio. Therefore the opposite would define growth, higher price-to-earnings ratio. He also indicates both are relative measures. His research shows that if you are going to tilt, it is more advantageous to overweight in the value direction. This outcome potential is more likely as many as seven of the ingredients have a value bias.

Do you know when to leave well enough alone? This question can apply to a number of aspects of our lives. Regarding the 7Twelve portfolio recipe, it's *Should I Jump in or Let the Pot Simmer?* (Chapter 10). Dr. Israelsen is referring to mutual funds or exchange-traded funds being active versus passive, which can occur with the individual ingredients and portfolio management. He defines the terms and restates the original question into: Does the chef know when to leave the recipe alone? The key here is to be consistent – the investor's management style and the mutual funds selected should be consistent. Dr. Israelsen suggests that if you cannot decide whether to choose an active or passive approach, do both and set up a competition. Either way the investor wins with a 7Twelve portfolio.

Chapter 11, *A Better 401(k)*, compares traditional retirement plans (target date funds and balanced funds) with the 7Twelve portfolio using companies that provide both types of traditional plans, and a comparable index fund. Dr. Israelsen points out some flaws with respect to target date funds; almost all of them fail to dramatically reduce portfolio risk within 5-10 years of the stated date and the inability for the investor to make up for undersaving – big mistakes for many investors.

Whereas retirement portfolios may have some problems, investors also have a problem with undersaving that is discussed in Chapter 12, *The Problem of Undersaving*. Dr. Israelsen shares his philosophy on investing and retirement portfolio preparation in this chapter. He indicates "there are two engines of growth in an investment portfolio: (a) contributions from the investors, and (b) growth produced by the performance of the investment portfolio" (p. 151).

The investor controls the contributions but not the performance. Investors who rely on the performance to make up for their lack of contributions often encounter equity exposure, thus too much risk. Performance cannot and should not have to make up for an investor's undersaving. Dr. Israelsen emphasizes that investing is not supposed to be glamorous (actually he used the descriptors of exciting and laced with bravado this reviewer selected a different descriptor). "It is a long-term, systematic, and rather boring endeavor" (p. 152). He also uses the terms patient, perspective, and persistence as good attributes of successful investors

Chapter 13, *Of Stocks, Bonds, and Risk,* discusses the term equity premium. This is the extra return gained by investing more in stocks and less in bonds, usually related to the 60/40 balanced portfolio. As an investor, your portfolio return can be strongly impacted by your focus on equity premium. A diversification premium can arise due to multi-asset allocations in the 7Twelve portfolio.

We have identified all our salsa ingredients. We know the steps involved preparing the recipe portfolio. Now it is time to make our salsa. Chapter 14, *Assembling Your Portfolio*, is all about mixing together the 12 mutual funds or exchange-traded funds from the seven asset classes into the 7Twelve investment portfolio. Dr. Israelsen states that is time to put on the apron. In this chapter, he restates the performance of the 7Twelve portfolio with respect to other portfolio types. He shares a short list of funds, as well as indicating the presence of some prebuilt 7Twelve portfolios on his website.

The final chapter is entitled *3 Secrets + 4 Principles = 7Twelve Perfection*. Dr. Israelsen states that "The 7Twelve portfolio is a starting point for every investor" (p. 181). It has a core, but also can be adapted to fit the investor. He stresses the lifecycle approach that changes with the age of the investor, not with changes in the market, and precision is not necessary. His investing secret is actually three secrets: "(a) First secret; successful investing requires patience that is measured in years, not weeks, (b) Second secret; successful investing is boring. If you want thrills, ride a bike in a big city, and (c) Third secret; successful investing requires diversification depth and breadth" (p. 184).

This book focuses on secret number 3. Dr. Israelsen suggests that once you have built your 7Twelve portfolio, follow these four principles: (a) do not over manage your investments, (b) expect ups and downs, (c) enjoy your life, and (d) from Joseph and the Amazing Technicolor Dreamcoat – build up a reserve in the good years to prepare for the lean years.

Recommendations and Summary

This book was a real eye-opener for this reviewer. I even read it twice; highlighting, underlining, and adding notes and questions in the margins. Dr. Israelsen used his vast expertise in the area of mutual funds to write a book that is thought-provoking, educational, and humorous. It was written in easily understood language and terminology. He used interesting metaphors and analogies with which all of us can identify.

JFCP readers and colleagues can utilize the information in the redevelopment of their own retirement nest egg. Dr. Israelsen's 7Twelve model has been tested with 40 years of historical performance data. If you do not have time to read this book, at least take some time to visit 7twelveportfolio.com. He gives the rationale for the model, as well as historical performance data, and additional articles and support documents. A key item to know is that he uses the 7Twelve model himself. He started the development of 7Twelve when he was at the University of Missouri and my own 457(b) is one of his initial test portfolios. Dr. Israelsen is truly a master chef. Read this book and give the 7Twelve portfolio recipe a try and enjoy your salsa!