

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

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We sometimes use phrases that are not clearly defined, hoping that the phrase conveys a generally understood meaning. One such phrase that pertains to portfolio design is “core and explore”. It’s unlikely that this phrase means the same thing to financial advisors. Possible questions and differences in opinion may include the following:

- \* “What asset classes should be included in the *core* portion of the portfolio?”
- \* “What asset classes should be included in the *explore* portion of the portfolio?”
- \* “What percentage of the overall portfolio is represented by the *core*?”
- \* “How much of the portfolio should be allocated to *explore* assets?”
- \* “Does the *core* change over time?”
- \* “Does the *explore* portion of the portfolio change over time?”

There are surely additional questions and issues, but the list above illustrates the point that using the expression “core and explore” clearly involves a lot of details that are not clarified. In this paper, I would like to focus expressly on the word “core”.

Two of the definitions of the word *core* (according to Merriam-Webster’s Collegiate Dictionary) are:

- 1) “a central and often foundational part usually distinct from the enveloping part by a difference in nature”, and
- 2) “a basic, essential, or enduring part”.

Using these definitions as a starting point, the *core* of a portfolio should represent a “basic foundation” which serves as the “essential and enduring” portion of the portfolio over time. In short, the *core* of a portfolio won’t change over time. What will likely change over time is the overall allocation to the *core*. Thus, the allocation to the *core* of a portfolio will either increase or decrease as the investor ages, based on what asset classes comprise the *core*. If the portfolio “core” utilizes fixed income products (such as bonds and bond mutual funds) then the allocation to the core will likely increase as the investor ages. Alternatively, if the core of the portfolio consists of equities (stocks, stock funds, diversifying assets) the allocation to the core will likely decrease as the investor ages. In either case, however, the core allocation will never go to zero. The “core” of a portfolio should always be present to a greater or lesser amount—otherwise it’s really not the core.

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.

We now face the question of what a well diversified core portfolio holding would include. What asset classes belong in the core, and what should the allocations be for each ingredient in the core? Clearly, elementary diversification requires the use of two core investment assets, namely equities and fixed income. But that simple distinction is too crude. Among the equity (or stock) portion of the core, we would want to distinguish between U.S. and non-US stocks. We would also want to have equities of various market capitalization and possibly style orientation (growth vs. value). We would want to include diversifying assets that tend to have low correlation to the equity assets, such as real estate and commodities. In the fixed income portion of the diversified core, we would want to diversify our fixed income exposures to at least include US and non-US bonds, inflation protected bonds, and cash. With this list as a starting point, consider a “core” blueprint—namely the *7Twelve* Balanced Strategy.




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	Global 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 Across Various Portfolio “Cores”

	100% US Stock Core	60% US Stock/ 40% Bond Core	<i>7Twelve:</i> A Diversified 12-Asset Core
Portfolio “Core” Models →			
<b>Performance of the “Core” as of December 31, 2010</b>			
10-Yr Average Annualized Return	<b>1.32</b>	<b>4.13%</b>	<b>8.49%</b>
10-Yr Std Dev of Return	<b>16.38</b>	<b>10.01</b>	<b>12.29</b>
10-Year Growth of \$10,000	<b>11,396</b>	<b>14,987</b>	<b>22,599</b>

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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