

# REIT

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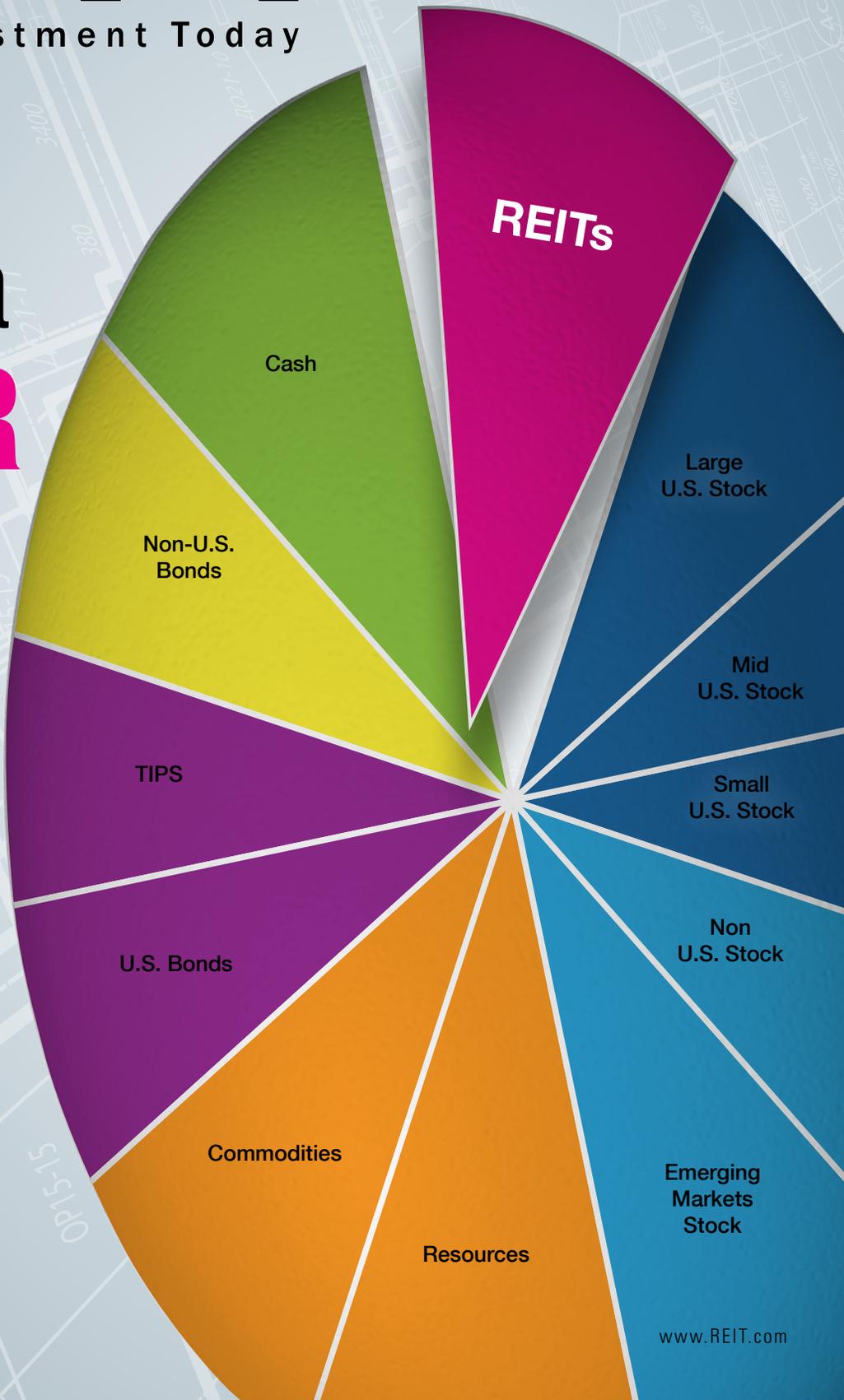
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## Building a **BETTER** Nest Egg

**REITs** are a key component to new approaches to retirement planning, including Craig Israelsen's 7Twelve plan.



# Craig Israelsen of Brigham Young University on Building a Better Nest Egg

By Chris Wright

**BRIGHAM YOUNG UNIVERSITY** Associate Professor Craig Israelsen chafes at the esoterica of academia and is happiest when he is writing something useful to ordinary folks. He has done just that in “7Twelve: A Diversified Investment Portfolio with a Plan,” an easy-to-read book intended to help individuals plan for their retirement. Israelsen recently shared his thoughts with REIT magazine on the value of investing in REITs and the benefits of a broad asset allocation approach.

**REIT: What is your view of REITs as an investment proposition?**

**ISRAELEN:** U.S. REITs have demonstrated the best return over the past 41 years of all the major asset classes, with risk comparable to small-cap U.S. stocks. So I think that REITs are one of the sweet spots in the investment landscape.

**REIT: What are your thoughts on the market for the rest of the year?**

**ISRAELEN:** My goal in life is never to make a market forecast. I have no talent for prognostication. I have a real deep commitment to diversification, instead. I’m so broadly diversified that I’m guaranteed to hold some of this year’s winners and some of the losers in terms of asset classes.

**REIT: What is the “7Twelve” approach in a nutshell?**

**ISRAELEN:** Seven broad asset classes – stocks, commodities, real estate, etc. - with 12 specific actionable investments consisting of mutual funds or exchange-traded funds (ETFs). Think of it as seven columns and 12 buckets. Some asset allocation models are tactical, meaning someone has to be at the controls. My core model is completely strategic. No tactical skill is needed; the results don’t depend on timing the market or picking the “right” stocks and bonds.

My model is unique in starting with equal weighting among all 12 buckets, so cash, *i.e.*, money market, has the same weighting as U.S. large-cap stocks. However, there are three U.S. equity buckets, so not all seven “asset” columns are equally weighted. I built this model to be a competitor to the old “balanced” model, the 60/40 stock and bond portfolio that has been around since the 1930s. My goal was to build a better balanced model.

**REIT: Where do REITs fit into your 7Twelve portfolio?**

**ISRAELEN:** U.S. REITs are one of seven broad asset categories (columns) and it has one bucket assigned to it. This makes domestic REITs



## VITAL STATISTICS:

**Name:** Craig Israelsen

**Title:** Associate Professor, Brigham Young University, School of Family Life

**Experience:** Israelsen teaches personal and family finance at BYU. He taught the same subjects at the University of Missouri-Columbia for 14 years. He holds a Ph.D. in Family Resource Management from BYU, as well as bachelor’s and master’s degrees in agricultural business and economics from Utah State University. He writes regularly for *Financial Planning Magazine* and the *Journal of Indexes*. His research has been published in the *Journal of Financial Planning* and other scholarly journals. He is a principal of Target Date Analytics LLC which has developed indexes for benchmarking target date/lifecycle funds. His new book, “7Twelve: A Diversified Investment Portfolio With a Plan,” was published in 2010. He also wrote “The Thrifty Investor” (2000) and (as co-author) “Your Nest Egg Game Plan” (2009). The 7Twelve website ([www.7twelveportfolio.com](http://www.7twelveportfolio.com)) features pre-assembled 7Twelve portfolios with monthly performance updates.

one-twelfth of the total position given the equal weighting of all 12 ingredients.

**REIT: What about international REITs?**

**ISRAELSEN:** I use U.S. REITs because the data goes back to 1970. I can look with confidence at what the asset class has done. By the way, you always hear that past results are no indication of future performance, but what are we supposed to do – stare into a piece of toast?

So I use U.S. REITs because I have confidence in the data. We don't have international REIT data for nearly that long. If you have confidence in the international data, it would be reasonable to include foreign REITs in this bucket, perhaps 60 percent in a U.S. REIT fund and 40 percent in a foreign REIT index. The more diversified each bucket, the better. *(Editor's Note: The performance of real estate was measured using the FTSE NAREIT All Equity REITs Index for 1972-1977 and the Dow Jones U.S. Select REIT Index beginning 1978. Returns for 1970 and 1971 are regression-based estimates.)*

**REIT: Does it matter whether the 12 funds are actively managed (where the manager attempts to pick winning securities) or passively indexed?**

**ISRAELSEN:** Not really. The book shows you how to build active and passive versions of the 7Twelve portfolio. The passive version can use index mutual funds or ETFs. The active version is built with actively managed mutual funds.

In my results, the active version had a slight edge over a 10-year period, but that was attributable to 2000 through 2002 when active managers could produce smaller losses than index funds in the down market by partly moving to cash. Well, that's not really a pure asset play. In contrast,

index funds have to be 100 percent fully invested all the time. Active managers can sometimes produce better returns in down markets by escaping to cash. As I say, the difference was slight and, from a theoretical perspective, I prefer the passive index version with its full "pure" exposure to the major asset classes.

**REIT: Does it matter how frequently you rebalance the 7Twelve portfolio?**

**ISRAELSEN:** Yes. The less often the better. Annual rebalancing gave the best results over a 12-year period starting in 1998. The margin was 30 to 40 basis points better than monthly and quarterly rebalancing in that period. That's not a trivial difference. And annual rebalancing is less work.

**REIT: Why do you start out with equal weights? With four out of 12 ingredients either bonds or cash, isn't that far too conservative? Should 25-year-olds really be 33 percent in bonds?**

**ISRAELSEN:** That's a fair question, but can people really gauge their own risk tolerance accurately? I don't think they actually can.

People who refuse novocaine in the dentist's chair absolutely flip out when the dentist hits a nerve. There are so many ways I see people inaccurately assessing their own bravery and pain threshold. I'm not convinced we get a lot better at that when we fill out a risk-assessment questionnaire. A lot of people can't take the pain of a down market and will tell their brokers to sell at the worst possible time. The 7Twelve portfolio has more protection on the downside for those folks than financial planners commonly provide.

Also, there's more volatility in the 7Twelve portfolio than you might imagine. If you dig a little deeper into the fixed income components, you



## 7TWELVE™ ASSET ALLOCATION MODEL

Approximately <b>65%</b> of the Portfolio Allocation in Equity and Diversifying Assets				Approximately <b>35%</b> of the Portfolio Allocation in Bonds and Cash		
U.S. Equity	Non-U.S. Equity	Real Estate	Resources	U.S. Bonds	Non-U.S. Bonds	Cash
Large Companies	Developed Markets	U.S. REITs	Natural Resources	U.S. Aggregate Bonds	International Bonds	U.S. Money Market
Medium-Sized Companies	Emerging Markets		Commodities	Inflation Protected Bonds		
Small Companies						

find TIPS [Treasury Inflation-Protected Securities] are actually more volatile than U.S. aggregate bonds on a month-to-month return basis. TIPS can lose 8 percent in a month. That sounds more like equity to me. International bonds? That has some spice to it, as well.

But the real answer, and it's one of my basic points, is that if people save adequately for retirement, they won't need to be aggressive in their retirement planning. The contribution rate is far more important than the return achieved on the portfolio. If 25-year-olds will save 15 percent of their income, they can have a mediocre portfolio and be fine.

**I think that REITs are one of the sweet spots in the investment landscape.**

Under those circumstances, there's no need to be aggressive. But, for those 25-year-olds who want to goose things a bit, they can use 7Twelve as the core – maybe for 60 percent of the overall portfolio – and put the other 40 percent on steroids with pure equity. I'm disinclined to tweak the components of the 7Twelve model, but I'm perfectly comfortable with a “core and explore” approach. I'm not in direct contact with end users, I'm more the architect who makes the general asset allocation blueprint. “Site-adjusting” the blueprint is something people would do with their financial advisers or on their own.

**REIT: Your average portfolio for age 70 works out to about 25 percent equities and 75 percent fixed income. If people are supposed to plan to age 95, why be 75 percent in bonds when you have another 25 years to plan for? Won't people miss a lot of years of superior equity returns?**

**ISRAELSEN:** They could. But, again, the job of a portfolio is to prudently grow sufficient contributions. When sufficient contributions haven't been made, portfolios get asked to do more than they are supposed to do. Longevity risk properly belongs with the individual, not the portfolio. If you don't want to outlive your assets, then you need to save enough money to properly fund a 30-year retirement.

Tilting an inadequately funded retirement account toward equity is like trying to solve the problem of a car not having enough gas by putting in a bigger engine. If you remain over-exposed to equity, you run the risk of a disastrous year like

2008 happening shortly before you need to start drawing down your money. There's not enough time to make up what you lost.

**REIT: Not saving enough – a lot of people are in that boat. If aggressive investing isn't the answer, what is your advice to middle-aged people who haven't saved sufficiently?**

**ISRAELSEN:** I hope they find a job they enjoy. Sorry to sound hard-hearted, but there's no other answer. The people I feel sorry for are the ones who did the right thing but lost a bunch of their money because it was invested improperly and put in a portfolio that was way too aggressive.

This is why I have a beef with target-date funds that set the target beyond the retirement date. A target-date fund should end on the date of retirement and something else should happen to the portfolio after that point. If I lose one-third of a person's nest egg, I should fire myself. That's essentially what some so-called 2010 target-date funds did in 2008 by pushing the target date beyond the date of retirement and keeping people in too much equity far too long.

**REIT: Can people do all of this on their own or do they need a professional money manager?**

**ISRAELSEN:** That's a hard question. I had two kinds of people in mind when I wrote the book – do-it-yourselfers and people who would take the book to their financial advisers and ask for a fully diversified asset allocation approach. Some people are perfectly able to build a 7Twelve portfolio all on their own. But my white paper primarily gets purchased by advisers who are looking for an asset allocation model they can explain to their clients.

The adviser-client relationship is better if the client has a working knowledge of the structure of the portfolio and understands the potential for loss. In the middle are the people who want to get involved in some of the mechanics but not get their hands too greasy – maybe do the rebalancing on their own - it's not hard - but leaving the possible substitution of one ETF for another to the adviser.

One point on rebalancing, it's best to do it with new cash inflows, directing them to the three or four buckets that got hammered the worst in the past year. That's enough. It'll all work out over time. You don't need to rebalance everything to the penny every year. ♦

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*Christopher M. Wright is a regular contributor to REIT magazine.*