Craig Israelsen's Seven Percent Solution

By Russell Wild *Mon, Oct 4, 2010*

Think your clients need $1.25 million to retire comfortably? In a new book, advisor Craig Israelsen argues that they can live even better on less than $750,000.

If your clients want to enjoy a retirement of 30 years, and they estimate that they'll need, oh, $50,000 a year to live on, how big a portfolio will they need if they want a reasonable assurance that they won't run out of money?

The conventional answer would be $1,250,000 (allowing for an annual withdrawal rate of four percent).

Craig Israelsen's answer would be $714,285 (allowing for an annual withdrawal rate of seven percent).

If you buy into the conventional wisdom, and think Israelsen is either a dreamer or a fool, destined to run out of money if he dares take his own advice, you should look at his extensive and impressive number crunching. It's all in his new book, *7Twelve: A Diversified Investment Portfolio with a Plan* (Wiley, 2010).

Israelsen, who teaches personal finance at Brigham Young University and writes regularly for various financial journals, told *RIJ* that even if he were to retire today, at age 51, with a life expectancy of 35 years, he would feel "pretty comfortable" taking a seven percent initial withdrawal rate and adjusting that each year for inflation—provided he had two years worth of cash to turn so that he didn't have to withdraw from the nest egg portfolio in a down market. "If I don't have cash in reserve, then a 5% withdrawal rate is safer."

His confidence comes from the power of a well-diversified portfolio, exactly the kind of portfolio he outlines in *7Twelve.*

The "7" refers to seven core asset classes; the "twelve" refers to 12 different funds used to represent those core asset classes. Put them all together, and rebalance regularly, Israelsen said, and you have something "vastly superior and more resilient" than the typical 60% U.S. stock/40% aggregate bond portfolio from which the common wisdom dictates you mustn't tap more than four percent a year.

The seven core asset classes and 12 specific funds recommended for the portfolio are as follows (core asset classes are in bold, specific funds in regular type)

- **U.S. Stock** (Large-company, mid-cap, and small)
- **Non-U.S. Stock** (Developed nations and emerging market)
- **Real Estate**
- **Resources** (Natural-resource stocks and diversified commodities)
- **U.S. Bonds** (Aggregate and Treasury inflation-protected securities)
- **Non-U.S. Bonds**
- **Cash**

Although Israelsen allows for the use of actively managed funds, he prefers index funds, and the book gives specific examples of index funds you can use—both mutual funds and exchange-traded funds.

The ideal mix of funds, per Israelsen, depends on whether you're still young or getting a bit older. For young, "early accumulation" investors, he recommends a portfolio with perfectly equal allocations (8 1/3% of your total pie in each of the 12 funds). That would give you two-thirds equity and one-third fixed-income.

For older, "late accumulation" investors and investors already in retirement, he recommends somewhat higher allocations to inflation-protected securities and cash, with everything else getting equal measure. Whatever your portfolio mix happens to be, Israelsen recommends yearly rebalancing by selling leaders and buying laggards.

Back-testing shows that such a portfolio, properly managed, would have survived all rolling 25-year periods in recent history with yearly withdrawals as high as 7.5% (with a 3% annual inflation bump). Even with yearly withdrawals of 10%, the 7Twelve portfolio would have survived 94% of all rolling 25-year periods since 1970. (Yes, even the hellish 2008 market freefall.) In contrast, a typical 60/40 vanilla stock-and-bond portfolio would have survived 94% percent of all 25-year periods with a 7.5% withdrawal rate and 63% with a 10% withdrawal rate. (An all-stock or all-bond portfolio would have fared considerably worse at either withdrawal rate.)

As for average annualized returns, the 7Twelve portfolio, in the 10-year period that ended in December 2009, earned 7.8% with a standard deviation of 15.1. That compares quite favorably with large-cap stocks (-1.0% return, standard deviation of 20.9) or an aggregate bond portfolio (6.3% return, standard deviation of 3.12).

Israelsen designed the 7Twelve portfolio, he says, to exploit the enormous power of diversification, but also to please more traditional advisors and investors, who might shy away from anything too complex or foreign. He has no objection to advisors tinkering with the basic recipe; in fact, he does so himself. "This is a work in progress," he said. Including less traditional asset classes, such as emerging-market bonds and small-cap international stocks, might even add muscle to the mix, he says.

The power of Israelsen's 7Twelve portfolio, and the high withdrawal rate that it promises, deserve serious attention. This new model for diversification could make retirement a whole lot easier for a whole lot of people.

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