

ASSET ALLOCATION



1 Trading-off between risk & return becomes easier over time

There are four major asset classes into which you can invest: cash, fixed interest, property and shares.

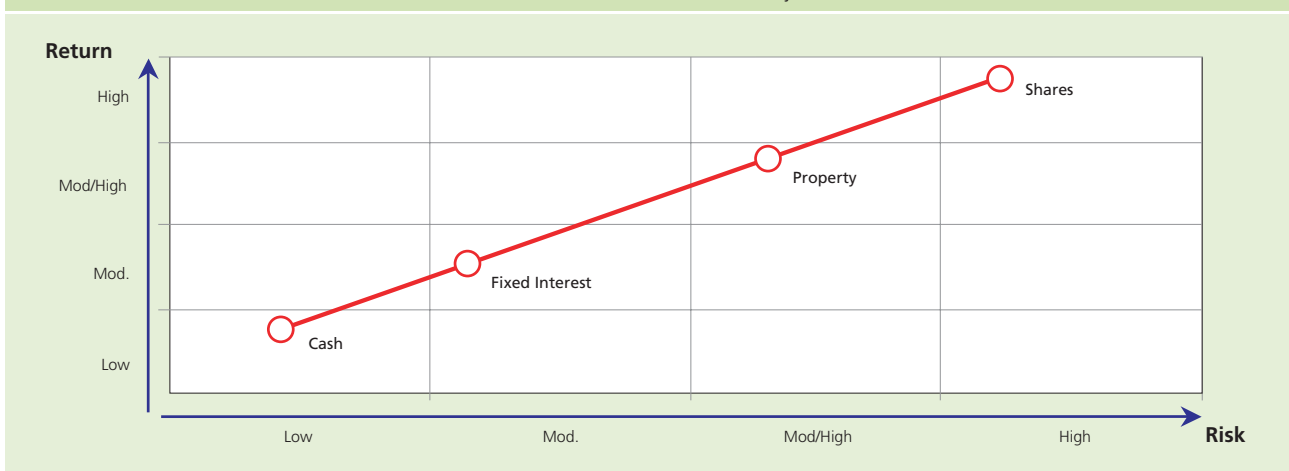
Each of these assets has its own set of risk and return characteristics. 'Risk' refers to the fluctuating returns experienced by the asset classes, and is also known as 'volatility'.

Over the longer term, cash and fixed interest have less volatility than shares and property, however property and

shares generally provide higher returns, as shown in Chart 1. This is known as the 'risk/return' trade-off.

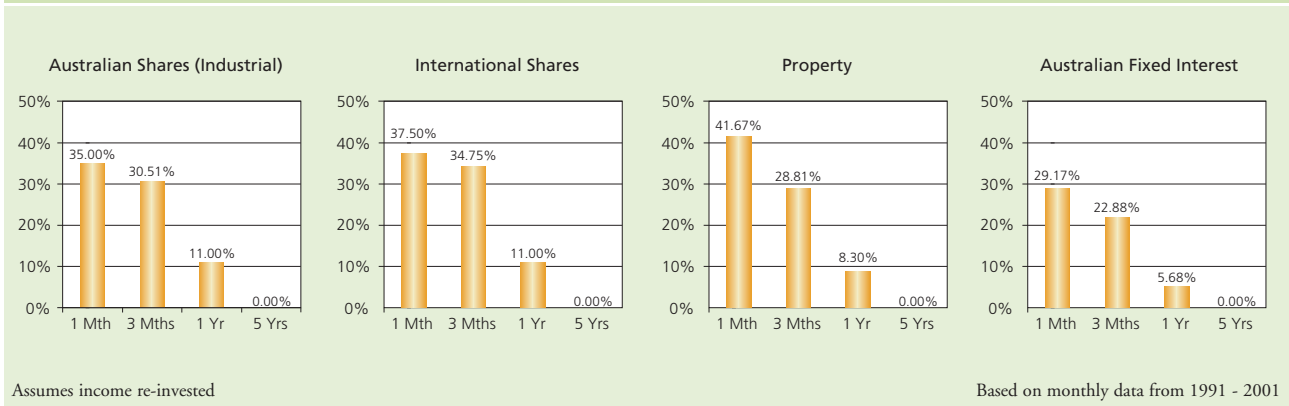
What each asset class invests in	
When you invest in...	You are investing in....
Cash	Bank bills and similar securities.
Fixed Interest	Government and semi-Government bonds, institutional bonds and mortgages.
Property	Direct property or listed property trusts (i.e. listed on the stock exchange). Property can be retail, commercial, industrial or residential.
Australian Shares	Companies listed on the Australian Stock Exchange.
International Shares	Companies listed on stock exchanges around the world.

Chart 1: Risk/Return characteristics of the major asset classes



Source: Zurich

Chart 2*: Negative returns diminish over time



Interestingly, the likelihood of an asset generating a negative return diminishes over time.

For example, Australian shares experienced negative returns for 35% of one-month periods since 1991.

Over one-year periods, though, negative returns were evident just 11% of the time. And, over five-year periods, there were no negative returns – as shown in Chart 2, above.

This highlights the importance of a long term investment timeframe when investing in shares and property.

Aligned with the likelihood of negative returns diminishing over time, there is also more certainty over time as to the possible range of returns generated by an asset class.

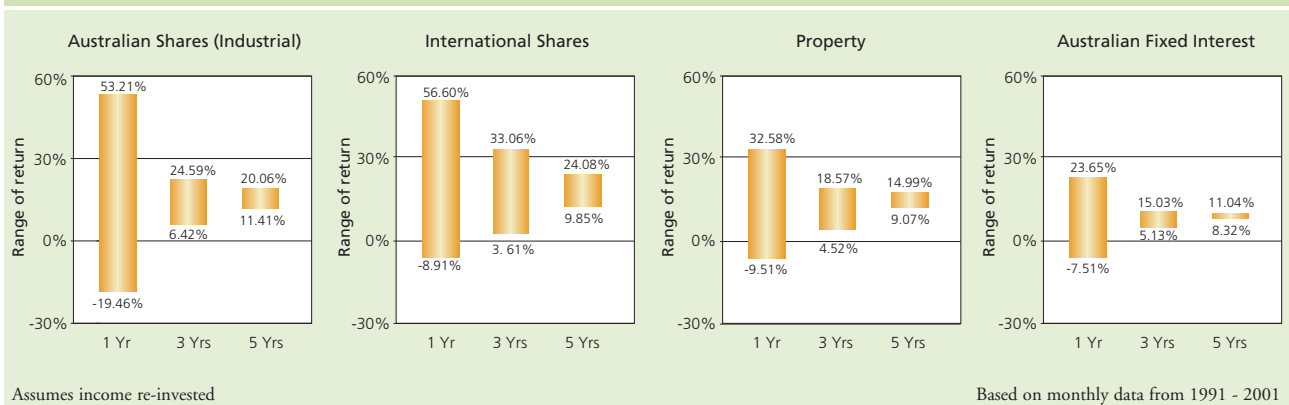
For example, the range of returns experienced by Australian shares in any one-year period since 1991 has been as low as -19.46% and as high as 53.21%, as shown in Chart 3, below.

However, over five-year periods it is a comparatively narrow range of 11.41% to 20.06%.

Once again, this reinforces the importance of a long term investment plan – the longer you have to invest, the more certain your return is likely to be.

"The likelihood of an asset generating a negative return diminishes over time."

Chart 3*: The range of returns becomes more certain over time



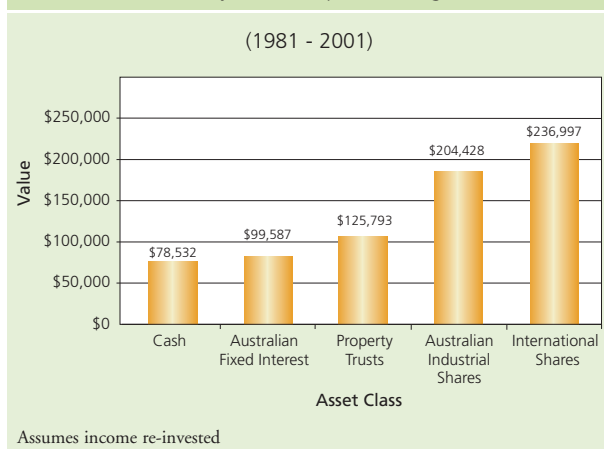
2 The penalty for not accepting higher investment risk can be substantial

If you choose to invest in the asset classes exhibiting lower volatility you will no doubt sleep well at night. However, you will also almost certainly be penalised in the form of lower long term returns.

Based on historical returns this penalty can be substantial, as shown in Chart 4, below.

As you can see, a \$10,000 investment in the volatile asset class of international shares 20 years ago is now worth \$236,997, while a similar investment in Australian industrial shares would have grown to \$204,428 (assuming income was re-invested). Listed property trusts turned \$10,000 into \$125,793, while the performance of the highly secure cash and fixed interest lagged even further behind shares, returning \$78,532 and \$99,857 respectively.

Chart 4*: Volatility has no impact on long-term returns



Source: Zurich

"A \$10,000 investment in international shares 20 years ago is now worth \$236,997, while a similar investment in Australian industrial shares would have grown to \$204,428."

3 A properly diversified portfolio generates smoother, more competitive returns

If your portfolio is invested in just one asset class it will be fully exposed to the fortunes or otherwise experienced by that one asset class. It could be up or down. However, if your portfolio is diversified across asset classes, even if one asset is performing poorly, your portfolio could still be growing because other asset classes could be performing well.

In other words, you can smooth the overall return of your portfolio by investing in a broad range of assets. In addition, it is important to diversify *within* each asset class. For instance, if you are investing in shares, you should invest in a number of countries and across many market sectors. This extra diversification will help to smooth your returns further.

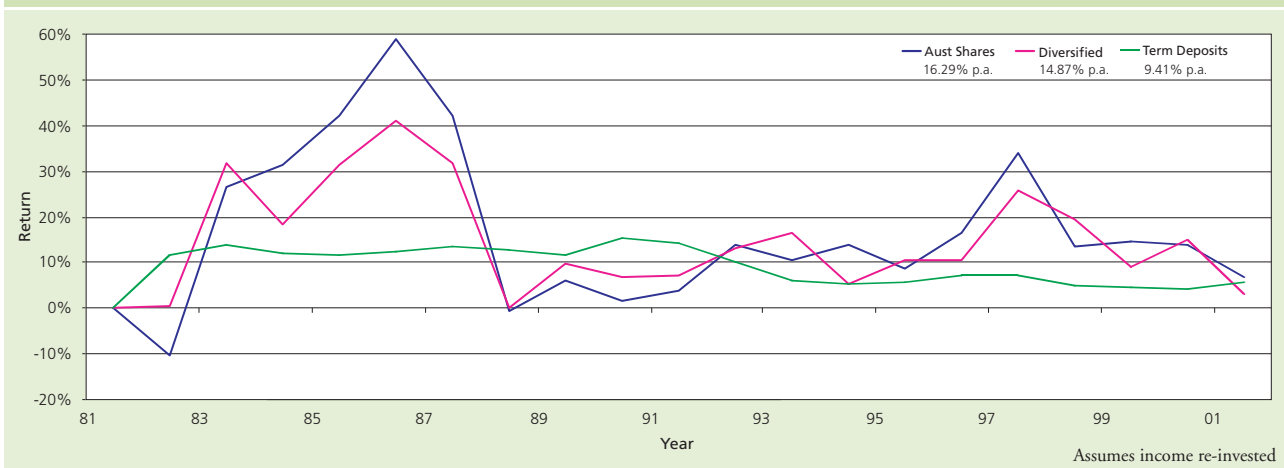
For example, Chart 5 (next page) compares the annual returns (with income re-invested) generated since 1981 by investing in Australian shares (All Industrials Index) to investing in term deposits to investing in a diversified portfolio⁺.

As you can see, the diversified portfolio provided a much smoother return than the share portfolio, but not as smooth as the return from term deposits.

However, the trade-off is that the diversified portfolio (14.87% p.a.) generated a higher return than term deposits (9.41% p.a.), just as Australian shares (16.29% p.a.) generated a higher return than the diversified portfolio.

"A diversified portfolio provides a smoother – but lower – return compared to a portfolio of shares."

Chart 5*: Rates of return – Aust. Shares vs Diversified Portfolio⁺ vs Term Deposits



Source: Zurich

How to design an asset allocation model

The combination of shares, property, fixed interest and cash into which you should be invested will depend on your return requirement, your tolerance to risk and your time horizon.

Your financial planner can assess your circumstances and needs, and then design an asset allocation model to suit you... as well as advise you on investment options and tax effective strategies. They can also show you the superior performance of Zurich's range of managed funds.

You can also visit our website at www.zurich.com.au

* Indices used in Charts:

- Australian Shares: All Industrials Accumulation Index (S&P/ASX 200 Accum) – a measurement of the average movements in share price of major Australian industrial companies listed on the Australian Stock Exchange. It is an accumulation index, which means that it assumes that dividends have been re-invested.
- International Shares: MSCI Accumulation World ex Australia in \$A Net Return
- Property: S&P/ASX 200 Property Trusts Accumulation Index
- Australian Fixed Interest: UBSWA Composite Bond All Maturities Index
- Term Deposits: Reserve Bank of Australia Financial Markets Interest Rates and Exchange Rates Statistical Table
- Cash: UBSWA 90-day Bank Bill

⁺ The diversified portfolio comprises:

- Cash (15%)
- Australian fixed interest (25%)
- Property (10%)
- Australian shares - All Industrials (30%)
- International shares (20%)

Disclaimer:

Historical performance is not a reliable guide to future performance.

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