

INVESTING IN SHARES



1 Shares may be intangible, but the businesses behind them are not

Many people choose to invest in property rather than shares because, they say, 'they could live in the property even if it was worth nothing, whereas if shares are worth nothing all they could do is burn the share certificates to try to keep warm'.

This is true – but only for poor quality share investments. Good quality share investments will never be worthless.

The difference between poor quality and good quality share investments is significant. A good quality share

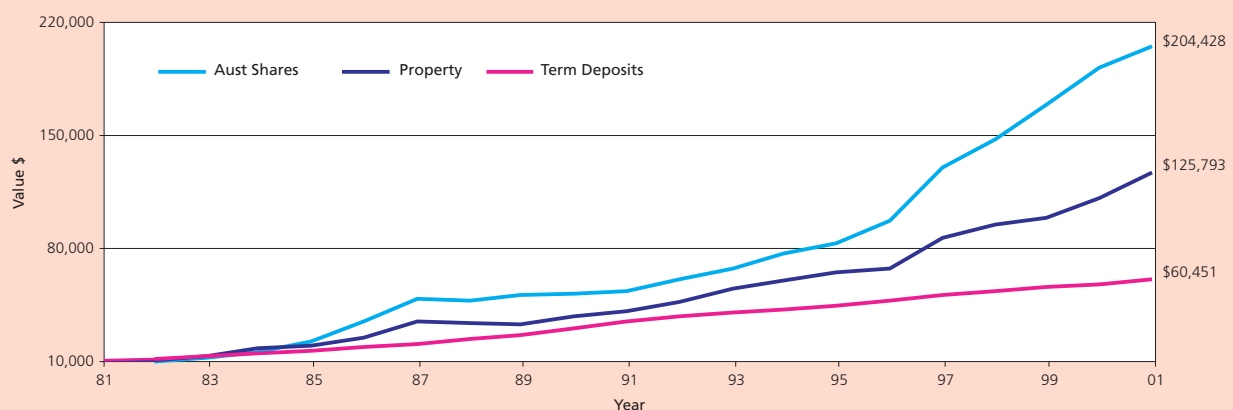
allows you to become a part-owner in a business which has substantial assets and profitable products or services, and provides consistent dividends to shareholders. A good quality business also has a modest level of debt, and a highly regarded management team.

And, if the sharemarket falls, a good quality business will continue to make profits, continue to own assets and sell its products or services. As a result, the market will soon enough remember that the business is a good one, and its share price will recover accordingly.

Good quality shares are also the highest performing asset class over the long term, as illustrated in Chart 1.

"Good quality shares are the highest performing asset class over the long term."

Chart 1*: Asset performance over 20 years (1981 - 2001) (Based on an initial investment of \$10,000 and assumes income re-invested)



Source: Zurich

2 Quality listed companies retain and re-invest profits... which leads to larger dividends and capital growth

Quality companies listed on the stock exchange do not pay all of their profits to shareholders. They retain part of their profits to help them build their businesses. For example, they use their retained profits to open new outlets and markets, to invest in new businesses, to buy technology which will create efficiencies, and so on.

When done well, this re-investment of profits leads to ever-growing future profits. And, as before, part of those higher profits are distributed to shareholders as dividends, with the balance retained for re-investment in the business.

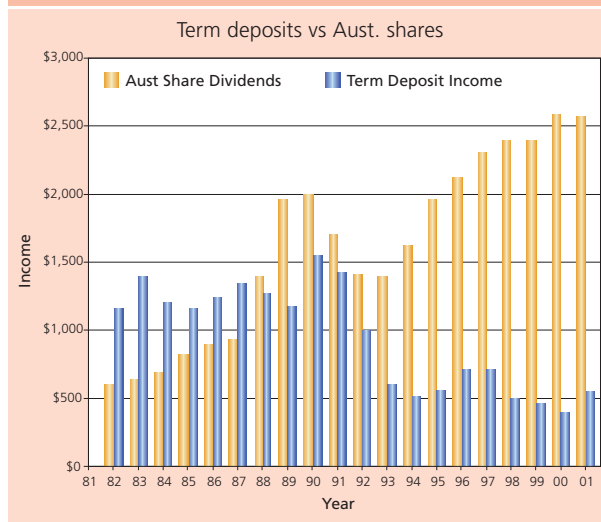
The result is a steadily growing dividend stream, and a growing capital base, both of which are treasured by investors. This is reflected in the growth of the company's share price.

Let's look at an example.

If you had invested \$10,000 into the 200-odd shares which make up the Australian All Industrials Index in 1981, you would have received the modest dividend of \$598 after one year, as shown in Chart 2. However, if you kept your investment, those dividends would have grown over time. So much so that last year your dividend would have been \$2,566 – that's a 25% return on your original \$10,000 investment.

Compare that to investing \$10,000 in term deposits in 1981. At the end of the first year you would have received a very healthy income payment of \$1,150. But that wouldn't last forever. Falling interest rates would see your income falling to just \$575 last year.

Chart 2: Income generated by \$10,000 investment (1981 - 2001)⁺



In fact, over the 20-year period, the total income from the term deposit investment was significantly less than that from shares, as shown below.

Total income on \$10,000 investment (1981 - 2001)⁺

	Initial Investment	Total Income
Shares	\$10,000	\$32,423
Term deposits	\$10,000	\$18,955

More importantly, shares experienced capital growth of 10.8% p.a. over the period of this study. As a result, your \$10,000 would now be worth \$78,069. While your term deposits would still have a value of \$10,000.

Capital growth on \$10,000 investment (1981 - 2001)⁺

	Initial Investment	Value 2001
Shares	\$10,000	\$78,069
Term deposits	\$10,000	\$10,000

⁺Assumptions:

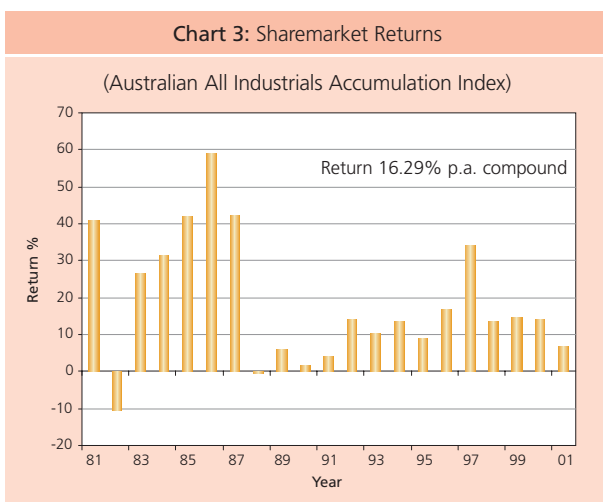
- Dividends/income not re-invested
- Shares: Australian All Industrials Index
- Dividends are the difference between Price & Accumulation Indices
- Term Deposits: Reserve Bank of Australia Interest Rates and Exchange Rates Statistical Table
- Source: Zurich

3 Shares experience volatility, but this should work in your favour

A lot of people are nervous about investing in shares because the prices of shares fluctuate so much. Those fluctuations are called volatility.

It's difficult to put sharemarket volatility into perspective because the media is constantly feeding us with information like "the market fell today by X%", and "such-and-such a stock fell X% since the market opened this morning" and so on. These headlines sell newspapers which is the media's job, but it doesn't do investors any favours. Rather, it prevents investors from focussing on the big picture - that volatility is normal, and that when it comes to quality investments, higher volatility generally leads to higher long term returns.

If you look at Chart 3 which shows the annual movements in the Australian All Industrials Accumulation Index since 1981, you can see that the Australian sharemarket has exhibited a high degree of volatility. Nonetheless, it has performed quite strongly. Over this 20-year period, it has returned 16.29% p.a. compound.



Source: Zurich

Why is that? Why are the returns so good when the volatility is so high?

It's because volatility is not just about falling values – it also refers to rising values. Quality share investments generally experience more rises in value than falls. In fact, since 1981, there have been 18 rises in the value of the sharemarket on an annual basis, compared to just 2 falls (assuming dividends are re-invested), as shown in Chart 3.

And, importantly, the extent of the annual rises is significantly greater than the extent of the annual falls.

Nonetheless, it can be a prudent strategy to reduce the effect of volatility on your portfolio, and this can be achieved by:

i) Investing in quality shares

Shares with reliable income streams and sound management are less susceptible to volatility. And, when prices do fall, these shares tend to recover – and prosper – the fastest.

ii) Diversifying

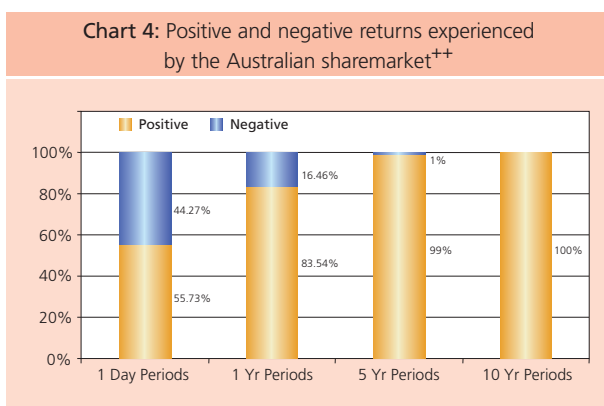
If your portfolio is invested in just one share, it will be fully exposed to the fortunes or otherwise experienced by that one share. It could be up or down. However, if your portfolio is diversified, even if one share is down your portfolio could still be growing because other shares could be performing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

In other words, you can smooth the overall return of your portfolio by investing in a broad range of shares, across many market sectors.

iii) Being patient – invest for the long term

Volatility is a short term problem only. It really has no impact on your long term returns.

Consider Chart 4. In the first bar, we see the proportion of negative returns and positive returns experienced by the Australian sharemarket in one-day periods. The ratio is around 56:44 in favour of positive returns. This means that on any given day the market could be up or down... and none of us have any idea what it will be until the end of the day's trading.



Source: Zurich ⁺⁺Australian All Industrials Accumulation Index (1981 - 2001)

Over one-year periods, though, the result is a little more certain, with a much greater proportion of positive returns (with a ratio of 84:16). You still wouldn't want to bet your home on the outcome of a one-year period, though.

However, over 5-year periods, the ratio is 99:1 in favour of positive results.

And, over 10-year periods, there were no negative returns whatsoever over this 20 year study. Every investor in this Index received a positive return over any 10-year period they happened to invest in. In other words, at the end of the day, all of the volatility in one-day periods had no effect on their long term result.

That's a comforting thought. That's why we recommend that you only invest in shares if you have a long term horizon.

"Volatility is a short term problem only. It really has no impact on your long term returns."

HOW TO INVEST IN SHARES

You can invest in shares directly, or you can invest via a managed fund or a superannuation fund. The best option for you will depend on your circumstances, and the time you have available to research and manage your portfolio.

Your financial planner can advise you on a full range of investment options, as well as appropriate tax effective strategies and asset allocation models. 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 Chart 1:

- 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.
- Property: S&P/ASX 200 Property Trusts Accumulation Index
- Term Deposits: Reserve Bank of Australia Financial Markets - interest rates and exchange rates statistical table, based on income re-invested

Disclaimer:

Historical performance is not a reliable guide to future performance.

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