

TIMING THE MARKET



1 Perfect timing will easily give you the best result... until you take fees and taxes into account

Timing the sharemarket makes a lot of sense. You buy at the bottom of the market, and you sell at the top. So you maximise your gains and eliminate your losses. Your investment return must be superior to everyone else's.

The problem, however, is that very few people – if indeed anyone – can time the sharemarket correctly on a consistent basis over the long term. The sharemarket is just not that predictable. Even investment professionals concede that perfect market timing is a skill that eludes them.

But let's for the moment assume that perfect timing was possible. Let's assume that an investor named Perfect Peter was able to pick the top and bottom of each major trend in the sharemarket to the exact day, and sold and bought accordingly throughout his lifetime. During periods of falling markets Perfect Peter keeps his money in a bank account, safely earning 3% p.a. We'll assume Perfect Peter started investing in January 1996, with \$10,000 to invest.

Compare Perfect Peter's endeavours with Patient Paula who also had \$10,000 to invest in January 1996. Patient Paula didn't know much about the sharemarket, and so was happy to make her investment and then leave it alone for the rest of her life. Surely Patient Paula's investment strategy would leave her a long way behind Perfect Peter in the 5 years since their initial investment?

Chart 1*: Perfect Peter vs Patient Paula



Source: Zurich

Assumptions:

- Based on a tax rate of 48.5%.
- Tax on dividends paid out of investors' pockets. Dividends re-invested.
- Capital gains tax calculated based on current CGT rules. CGT deducted on each sale. Dividends do not form part of cost base.
- Investments are not sold at end of 5 years. Should Patient Paula sell her investment in the future, capital gains tax may be payable.
- Transaction costs 0.25% on buying and selling.



ZURICH

Because life changes.

The answer is that yes she hasn't done as well as Perfect Peter so far, but she is only just behind. In fact, her \$10,000 has grown to \$21,231, while Perfect Peter's is now worth \$23,621 – a difference of only \$2,390 as shown in Chart 1, on previous page.

Commonsense dictates that Perfect Peter should be a lot further in front of Patient Paula. After all, against all odds, he has timed the sharemarket to perfection for 5 years.

So why isn't he winning by more?

The reason is that every time Perfect Peter sells his investments, he has to pay capital gains tax. In addition, on every transaction he has to pay 0.25% brokerage to his stockbroker.

The result is, that for all of Perfect Peter's effort and risk, he is only just in front of Patient Paula, an investor who simply placed her investment then left it for the duration.

"A 'buy and hold' strategy for quality investments is not only simple ... it also provides highly competitive after tax returns."

2 Failure to time the market correctly can be very expensive

Perfect Peter is, of course, an illusion. No one could hope to pick the top and bottom of the sharemarket so perfectly even just once... let alone consistently over a prolonged period.

The reality is that the vast majority of people who try to time the market end up getting it wrong – consistently.

As a result, most market timers miss out on many periods of high returns. This can be a very expensive exercise.

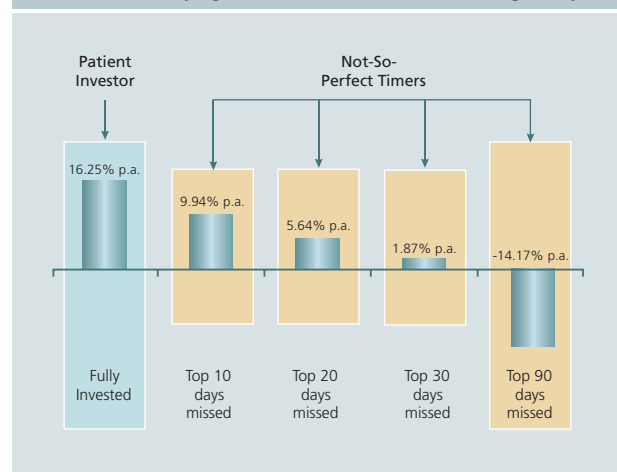
Consider Chart 2. It compares the return enjoyed by a patient investor over the past 10 years compared to a number of not-so-perfect timers.

The patient investor placed their investment in the Australian All Industrials Index in 1991 and then let it work for them over the ensuing 10 years. As a result, they were rewarded with a return of 16.25% p.a. over the period, assuming dividends were re-invested.

However, a not-so-perfect timer who tried to time the market but narrowly failed – and in so doing missed out on just the top 10 days of returns in this period – finished with a return of only 9.94% p.a.

Another not-so-perfect timer had even less luck – they missed out on the top 90 days of returns, and as a result finished the 10 years with less money than when they started. Their return would have been -14.17% p.a., even though they had mis-judged the market just 90 days over 10 years.

Chart 2*: How trying to time the market can work against you

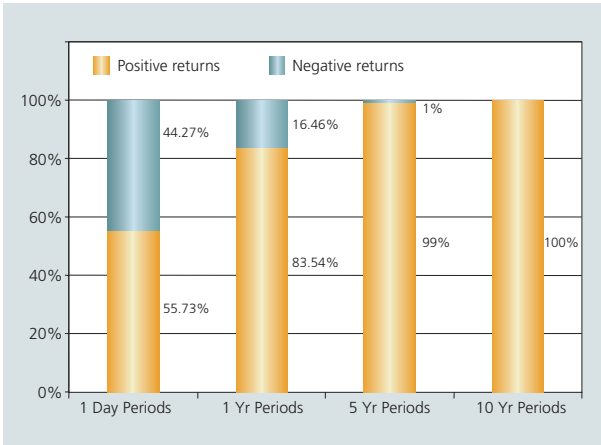


Source: Zurich Australian All Industrials Accumulation Index (1991 - 2001)

An added benefit of a 'buy and hold' strategy is that it means that you do not allow yourself to be influenced by the price fluctuations of shares (or 'volatility'). This is a key part of the strategy – because volatility is a short term problem only. It really has no impact on your long term returns.

3 things you need to know about timing the market

Chart 3*: Volatility has no impact on long-term returns



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

This is shown in Chart 3 (above) where we compare the number of negative returns experienced by the Australian sharemarket with the number of positive returns over different time periods since 1981. For example, in one-day periods, the sharemarket experienced slightly more positive returns (55.73%) than negative returns (44.27%).

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

And, over 10-year periods, there were no negative returns whatsoever. 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.

"The vast majority of people who try to time the market end up getting it wrong."

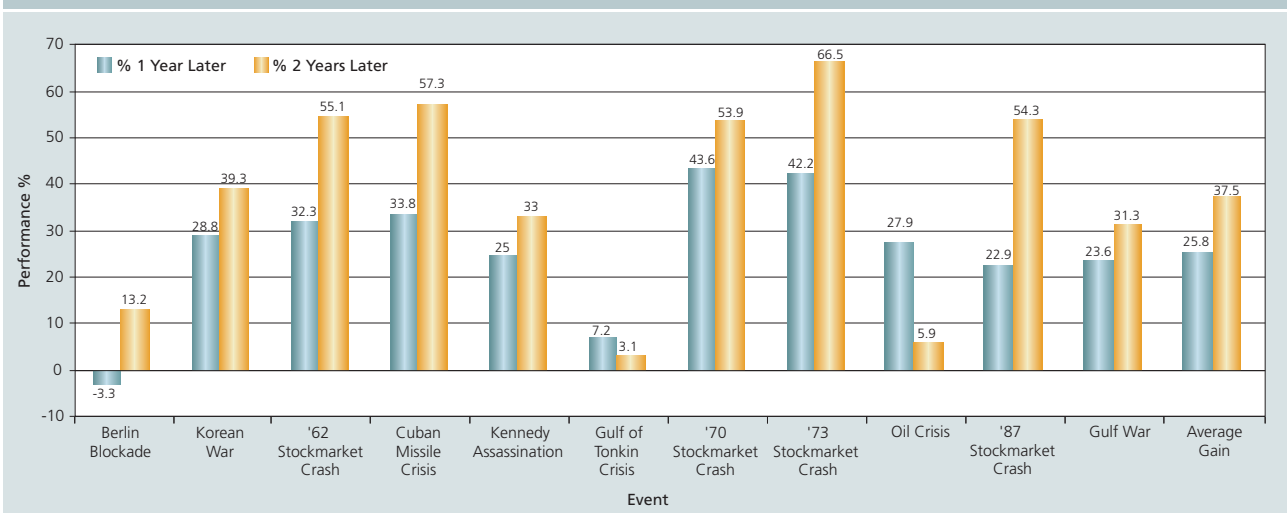
3 Don't panic when markets fall... buy more

Many investors in quality shares panic when markets fall. Their first reaction is to consider selling – when, in fact, a more appropriate course of action is often to buy more quality shares.

This is because quality shares usually recover fairly quickly after a general market fall, leading to very good profits for those investors who had the nerve to buy at a time when most other investors were selling.

As an example, consider Chart 4 which shows the performance of the American Dow Jones Index** in one and

Chart 4**: Post-Crisis Performance of the US Sharemarket (Dow Jones Index)



Source: Zurich

3

things you need to know about timing the market

two year periods following a major crisis. As you can see, the rewards for those investors who bought more quality shares after a market fall were substantial in most cases.

The average gain one year after a crisis was 25.8%.

The average gain after two years was 37.5%.

"The average rise in the American sharemarket one year after a major crisis has been 25.8%."

HOW TO DESIGN A LONG TERM INVESTMENT PLAN

Successful investment plans have many components, including an asset allocation model, tax saving strategies and investment selection criteria. The best options for you will depend on your investment needs, time horizon and tolerance to risk.

Your financial planner can help you to design an investment plan which will deliver the returns you require – after tax – in order to meet your investment objectives and circumstances. 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

* Index used in Charts 1, 2 & 3:
– 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.

** Index used in Chart 4:
– The Dow Jones Index: the best-known U.S. index of stocks. A price-weighted average of 30 actively traded blue-chip stocks, primarily industrials.

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