Investing through the life cycle

This paper explores the use of the Zurich Investments Equity Income Fund through the accumulation, transition to retirement, and retirement phases of an investor’s life cycle.

Table of Contents

Background 3
Accumulation phase 4
Super 4
SMSFs 4
   Case Study 1 – Investing in the Zurich Investments Equity Income Fund in Accumulation Phase 5
   Non-super 6
Transition to Retirement phase 7
Super and Pension 8
   Case Study 2 – Investing in the Zurich Investments Equity Income Fund in Transition to Retirement Phase 8
Retirement 9
   Pension 9
      Case Study 3 – Investing in the Zurich Investments Equity Income Fund in Retirement Phase 10
      Non-super/Pension 10
Conclusion 11
   Important Information 11
Zurich Investments Equity Income Fund is managed by Denning Price Pty Ltd which was established in February 2006 by Hugh Denning and Michael Pryce. Denning and Pryce own over 64 per cent of the shares issued in Denning Pryce Pty Ltd so interests are aligned to investors as a true boutique fund manager.

The investment strategy has three broad elements:

1. Invest in Blue Chip Australian shares that are expected to deliver regular income;
2. Maintain a portfolio of put and call options over the shares and equity index futures in order to deliver additional income and some portfolio protection; and
3. Manage the level of exposure to increase income and lower volatility.

The option strategy is designed to maximise the net amount of income received from option premiums whilst managing and controlling exposure to the share market.

Any short derivatives positions will be backed by physical assets or long derivatives positions. Any long derivatives positions will be backed by cash or other liquid assets. The Zurich Investments Equity Income Fund is not geared and the fund managers cannot use derivatives for the purposes of gearing.
The Zurich Investments Equity Income Fund is available both inside super and as a non-super investment. The nature of the fund – exposure to equity, regular monthly income payments including franking, and capital protection ensures it provides significant benefits within either tax structure during the accumulation phase.

**Super**

Holding Zurich Investments Equity Income Fund within super during the accumulation phase can be beneficial due to the high levels of income distributions that are reinvested being taxed as concessionally as actively managed Australian share funds.

Within super the treatment of income and capital gains distributed are generally the same from a tax perspective. Income is taxed at 15 per cent and capital gains are taxed at 15 per cent where held less than a year. The portfolio turnover of actively managed Australian share funds means capital gains distributed are typically non-discounted.

Super is preserved until a condition of release is satisfied, so the consistently high levels of income distributed monthly through the Zurich Investments Equity Income Fund means that where reinvested during the accumulation phase the investors income tax position remains unaffected.

**SMSFs**

Self-managed super fund (SMSF) advisers should also be aware of the over-allocation to cash and term deposits within SMSFs. The ATO reported in March 2011 that there was $1.14 billion in cash and term deposits (26 per cent allocation) of a total $4.32 billion in SMSFs. Accountants being able to establish a SMSF but then not being able to provide investment management advice is a factor in this differentiation to the total super industry – where 8.9 per cent is held in cash and term deposits. During the accumulation phase the impact of investing in a term deposit at a 6 per cent return on income and capital compared to investing in the Zurich Investments Equity Income Fund can have drastic consequences within a SMSF. Case Study 1 below shows that by investing in a term deposit with a return of 6 per cent per annum compared to investing in the Zurich Equity Income Fund at 10 per cent could lead to a difference a difference of $182,882 over 20 years.

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Case Study 1 – Investing in the Zurich Investments Equity Income Fund in Accumulation Phase

Mark is aged 45 and has $400,000 in their SMSF – 25 per cent of which or $100,000 is invested in term deposits. At a 6 per cent term deposit rate and assuming only the 9 per cent SG contributions, at retirement at age 65 the client would have $648,243 in term deposits. By switching the investment into the Zurich Investments Equity Income Fund with an accumulation return of 10 per cent before both fees and tax, the client would have accumulated $831,124 in the Zurich Investments Equity Income Fund. This represents an increase of 28.21 per cent in wealth over the period. This difference is highlighted in the table below:

![Graph](image-url)

Please note that these graphs are based on flat line assumptions. The Zurich Investments Equity Income Fund is an Australian equity-based fund and therefore returns cannot be forecast or predicted.
Non-super
As a non-super investment the Zurich Investments Equity Income Fund could be a good replacement for investors with the objective of regular income and capital protection generally available with term deposits but are seeking higher levels of income than 6 per cent yield currently available. The Zurich Equity Income Fund has continued to meet its 10 per cent per annum income objective since inception based on a running yield. Franking levels during this period were 10.4 in 2010, 13.6 in 2009 and 8.6 in 2008. Despite the high level of tax-effective income yielded, and exposure to Australian shares, the inherent option strategy and active management has enabled the fund managers to produce less volatile growth for investors than the S&P/ASX 200 Accumulation Index. This can be highlighted in the table below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Zurich Investments Equity Income Fund</th>
<th>S&amp;P/ASX 200 Accumulation Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>$16,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>2008</td>
<td>$12,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>2009</td>
<td>$8,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>2010</td>
<td>$4,000</td>
<td>$0</td>
</tr>
<tr>
<td>2011</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>

2 Lonssec Fund Review, Zurich Investments Equity Income Fund, September 2010.
Since 1 July 2005 the transition to retirement condition of release has been available for those who are aged 55 and still working. This enables access to super in the form of a non-commutable income stream – commonly referred to as a transition to retirement pension. A transition to retirement income stream is non-commutable pension that is restricted to a maximum pension income drawdown of 10 per cent with normal age-based minimum pension income requirements also applying.

While this condition of release was initially seen as a means of prolonging workforce participation, transition to retirement is now a common wealth creation strategy. This involves maintaining current employment or self-employment and rolling over existing super benefits to commence a transition to retirement pension. Importantly, there is no work test and no restriction on capital.

The transition to retirement wealth creation strategy is the most effective way to dramatically increase total superannuation benefits from age 55 to retirement. This is because it provides the following key tax advantages:

- Tax-free earnings within the pension compared to 15 per cent in super;
- From age 55 to 59 pension income receives the pension and annuity tax offset of 15 per cent;
- From age 60 pension income is tax-free;
- Salary sacrifice contributions back to super are taxed at 15 per cent; and
- Enhanced ability to qualify for additional tax offsets such as Low Income Tax Offset and Mature Age Worker Tax Offset (as these are generally based on income from working).

The transition to retirement wealth creation strategy also provides other significant benefits. The most notable – the ability to access both super and pension tax structures simultaneously.
Super and Pension

Having access to both a super fund and pension fund simultaneously allows financial advisers to structure the investor’s asset allocation between two tax structures – super, where earnings are generally taxed at 15 per cent and pension, where earnings are tax-free. The cyclical operation of the transition to retirement strategy, drawing a pension from existing super balance, which in turn enhance contributions back to super.

The minimum pension drawdown is 4 per cent (or 3 per cent with the 25 per cent discount in 2011/12) and the maximum pension drawdown is 10 per cent. By utilising the Zurich Investments Equity Income Fund within the pension, regular monthly income payments being made from the fund facilitate necessary pension payments to the client.

Case Study 2 – Investing in the Zurich Investments Equity Income Fund in Transition to Retirement Phase

Let’s assume that Mark commences a transition to retirement pension with the 25 per cent of superannuation benefits he has in term deposits once he reaches age 55. By investing in the Zurich Investments Equity Income Fund through accumulation phase to age 55 and then within transition to retirement he increases his benefits at retirement dramatically. If he were invested in term deposits at a rate of 6 per cent during the same period, at retirement at age 65 he would have $823,621. By switching the investment into the Zurich Investments Equity Income Fund with an accumulation return of 10 per cent before both fees and tax, Mark would have increased his benefit at retirement to $1,044,982 – a difference of $221,361 over 20 years. This represents an increase of 26.87 per cent in wealth over the period. This difference is highlighted in the table below:

Please note that these graphs are based on flat line assumptions. The Zurich Investments Equity Income Fund is an Australian equity-based fund and therefore returns cannot be forecast or predicted.
Pension

In retirement phase there are significant benefits that the Zurich Investments Equity Income Fund can provide. These include the following key characteristics which reflect the drawdown and pension tax structure in which it will be invested:

1. **Regular Income** – With the Zurich Investments Equity Income Fund distributing around 10 per cent of yield each year on average, liquidity required for pension payments will be available. This prevents the premature disposal of other illiquid assets within pension phase. Income distributed after age 60 will be tax-free and where excess income exists, this can be reinvested into the Zurich Investments Equity Income Fund and treated as earnings which will also be tax-free within the pension. The Zurich Investments Equity Income Fund has continued to meet its yield objective of 10 per cent per annum since inception of the fund based on a running yield, despite volatile equity markets.

2. **Equity Exposure** – During the pension phase, clients will typically move into more conservative risk profiles such as Balanced or Defensive and their corresponding asset allocations will also move into more defensive assets such as cash and fixed income. The Zurich Investments Equity Income Fund provides exposure to blue chip Australian shares without the level of volatility that generally exists with exposure to equity markets.

3. **Capital protection and reduced volatility** – Reduced volatility exists within the Zurich Investments Equity Income Fund through the fund’s option strategy which aims to mitigate both upside and downside movements in the equity markets. The option strategy and active management of the fund provides capital protection which is also necessary within the pension to prevent premature erosion of capital. This is particularly important for those in retirement phase as because the opportunity to contribute to their existing capital diminishes they are seeking to protect existing capital and derive income and growth return from that capital for as long as possible.

4. **Decumulation of capital** – An interesting characteristic of the Zurich Investments Equity Income Fund, and often misunderstood, is that the capital value of the fund may decumulate over time due the objective of distributing high levels of income. The decumulation of capital within the Zurich Investments Equity Income Fund is consistent with what occurs during the pension phase – the payment of income and decumulation of capital over time. The fund option strategy enables capital to be turned into income which funds the regular monthly income distributions equivalent to around 10 per cent per annum since inception on a running yield basis.
Case Study 3 – Investing in the Zurich Investments Equity Income Fund in Retirement Phase

The impact of Mark investing in the Zurich Investments Equity Income Fund as opposed to term deposits during the accumulation phase highlighted in Case Study 1 is best illustrated in terms of the additional income and capital experienced during retirement.

If Mark had invested in term deposits at 6 per cent it was determined that his balance of that part of his superannuation would be worth $648,243 in retirement. If he had invested in Zurich Investments Equity Income Fund it was determined that he would have accumulated $831,124 at retirement.

If Mark wanted to draw $60,000 per annum in today’s dollars in retirement his term deposit balance would have been exhausted at age 76. However, by investing in the Zurich Investments Equity Income Fund he would have been able to drawdown $60,000 per annum in today’s dollars until age 89. That is 13 more years of $60,000 per annum (in today’s terms).

Please note that these graphs are based on flat line assumptions. The Zurich Investments Equity Income Fund is an Australian equity-based fund and therefore returns cannot be forecast or predicted.

Non-super

Holding the Zurich Investments Equity Income Fund as a non-super investment during the retirement phase assists in providing additional income to the client which will generally be taxed at lower rates than usual taxable income. This is because utilising a pension income within super will typically enable tax arbitrage to occur through accessing concessional taxed pension income from age 55 to 59 and tax-free income from age 60. This can have the effect of moving the client into a lower individual marginal tax bracket, thus reducing the tax payable on monthly income distributed through the Zurich Investments Equity Income Fund.
The Zurich Investments Equity Income Fund is an income focused Australian equities fund. By investing in blue chip shares and using conservative derivatives strategies it has continued to meet its objectives since inception which includes delivering 10 per cent income per annum based on a running yield in all market conditions. The fund also provides some downside protection in falling markets and aims to provide conservative growth over a three to five year cycle.

The fund is well suited to those investors concerned about market volatility but considering investing in the sharemarket. It is also well suited as an investment choice for all stages of an investor’s life cycle.

For more information, please contact your local Business Development Manager on 1800 004 480 or go to www.zurich.com.au/investments

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Please note that all figures contained within this paper are based on flat line assumptions of a 10 per cent income return continuing regardless of market conditions. Investing this fund does not guarantee income levels or capital returns.