GYROSTAT
RISK MANAGED EQUITY FUNDS

OPINION PIECE:

Traditional industry lack of risk management exposed - today's climate low interest rates with rising volatility - there is a solution

By Craig Racine, Managing Director and Chief Investment Officer, Gyrostat Capital Management

- Traditional investment approaches are **ill-equipped for today's climate** with low interest rates and rising levels of stock market volatility. **The lack of effective risk management is exposed.**

- Both asset classes 'income' and 'growth' assets have fragilities in today's investment climate. "Income" assets such as cash and term deposits provide **insufficient income with no prospect for any capital growth**. "Growth" assets, investing directly in blue chip high yielding shares, or conventional income funds, leave investors exposed to falls in the value of investments in this **fragile and highly indebted global environment.** The traditional approach is to blend the two.

- **There is a need for risk managed investments in growth assets.** The ideal solution is to buy blue chip shares with insurance with a "hockey stick" payoff always in place – <u>always</u> participate in the upside with minimal capital at risk. This delivers higher income while always protecting and growing the investors' capital.
- In this fortnightly report we provide insights into risk management of an equity portfolio.
  - Global macro conditions (in pictures) with key upcoming data release with market pricing of outcomes based upon the flow of money (where available)
  - "Do it yourself" risk managed equity income with protection current market costs, varying the duration of protection and capital at risk.
- Our investment view is that interest rates will stay low for an extended period, and stock market volatility will increase. During 2012-2016 the level of volatility was low by historical standards. Our expectation is that volatility will increase, leading to "risk-on", "risk-off" investing market characteristics only distantly related to fundamentals. **Relying on market predictions, as is the traditional approach, with a 'straight line' pay-off leaves investors exposed to large capital losses.**
- Falling interest rates and rising market volatility are ideal market conditions for risk managed equity income funds with a "hockey stick" payoff always in place. The more volatility, the more opportunities there are to capture upside and re-balance the portfolio.

Outlook

Our investment view is that interest rates will stay low for an extended period, and stock market volatility will increase. During 2012-2016 the level of volatility was low. Historically volatility has remained low for periods of 4 years - 1992-1996, 2002-2006, and 2012-2016. Volatility has started to increase and is likely to continue.

These are dangerous times for traditional investment approaches with global total debt outstanding as a percentage of GDP at historical highs. GDP growth remains below trend, interest rates are at historical lows, and central banks are implementing unconventional monetary policies.

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Increased volatility is often experienced around key data releases relating to interest rates, growth, inflation rates, and key political events. These dates are detailed, along with market pricing of likely outcomes where available. We present data from futures markets, credit default swaps, and online betting odds.

Our expectation is that volatility will increase, with "risk-on", "risk-off" investing occurring only distantly related to fundamentals. Investors should approach these markets with confidence with a 'hockey stick pay off' profile set to always participate in the upside with minimal capital at risk. Relying on market predictions, as is the traditional approach, with a 'straight line' pay-off leaves investors exposed to large capital losses.

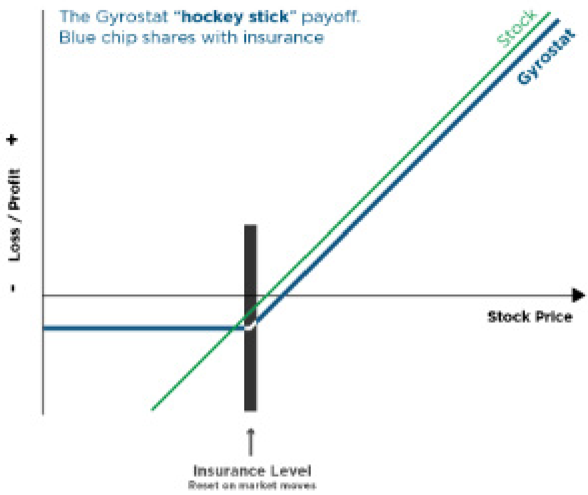
Volatility S&P500 (VIX) 1990 – 2016

The Gyrostat 3 step investment approach:-

1. **Buy and hold blue chip shares with insurance** on the Australian Stock Exchange

2. Technology enables our software systems to choose the lowest cost insurance from the many alternatives. The amount of **insurance is <u>set</u> to always participate in the upside with minimal capital at risk**.

3. **On market moves we <u>re-set</u> the insurance level.** If the share price rises, we buy more to 'lock in' the gains, on falls we sell some that is no longer required.



In contract, traditional approaches have a 'straight line' payoff with no protection in place.

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