The role of equity protected funds in retirement

- Investors require adequate income whilst protecting and growing capital
- Today's investment challenges
- A framework to review retirement income products
- A solution: buy blue chip high yielding shares for income, with insurance

<u>The requirement to generate adequate income whilst protecting and growing capital</u>

The Federal Government is committed to facilitate better retirement income products.

"We want to facilitate better retirement products that allow retirees to improve their standards of living", Assistant Treasurer Kelly O'Dwyer stated recently when addressing the Committee for Economic Development of Australia.

"… the retirement phase of superannuation is underdeveloped and provides **limited choice for managing risk**"

David Murray, Chair of The Financial System Inquiry

The Financial System Inquiry listed 3 criteria for "comprehensive retirement income products."

- Regular and stable income
- Longevity: invest in growth assets
- Flexibility: low cost, 'cooling off' period

In defining "better retirement products" in a new discussion paper by the Committee for Sustainable Retirement Incomes (CSRI), a non-partisan and non-profit body of retirement system experts concludes:

> "Super should not be about maximising wealth or minimising tax or funding 'nation building' projects. It should be about ***providing adequate income through all the*** **years of retirement for all Australians,"**
>
> CSRI executive director Patricia Pascuzzo

Lonsec Research, in its report "Income in retirement – the pros & cons" note:

> "It is a known fact that as people transition from the accumulation phase of investment into retirement, their investment objectives also change. Whereas in the accumulation phase the primary objective of most individuals is to maximise wealth for retirement, within the drawdown phase, a primary objective for most retirees will be to generate a level of **income** that will be commensurate with their lifestyle goals. Other objectives may include **growing capital**, or leaving a bequest for the next generation. At the same time, upon entering the retirement phase of investing individuals are also exposed to new risks, such as longevity risk, while other risks are magnified, notably inflation and market risk."

Today's investment challenge – macro environment and observations

There are 4 strategic trends that make achieving retirement income policy objectives more difficult:

- Low interest rates,
- Global debt levels,
- Ageing population,
- Limited choices in managing risk in existing retirement products.

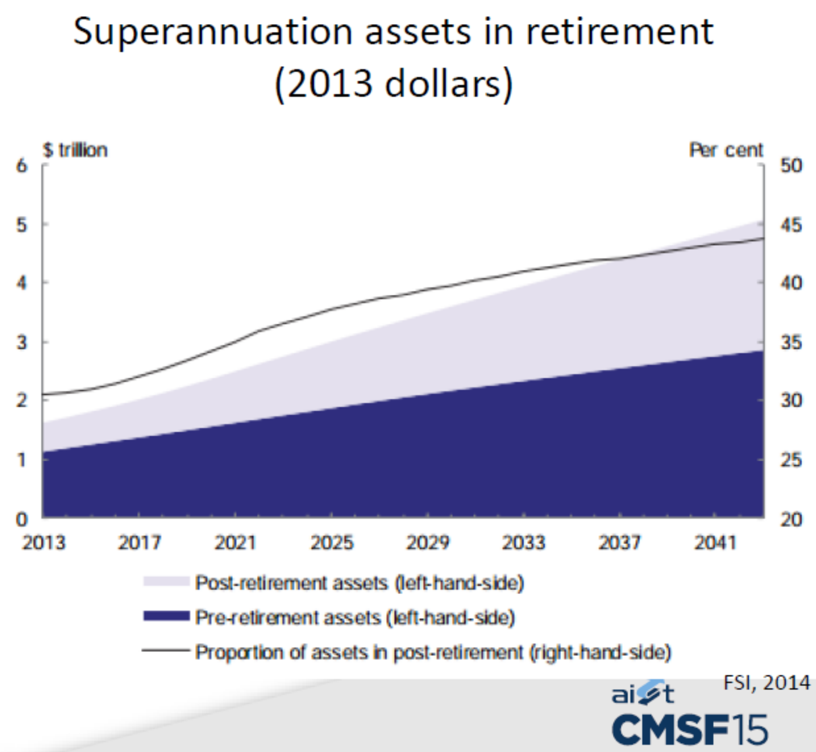
Low interest rates reduce the rate of return, and hence level of income from traditional 'lower risk' assets such as term deposits, annuities, endowment bonds, bond funds, and hybrid securities. The amount received at maturity, rate of return, and the date it will be received, is known at the time of purchase.

With historically high global debt levels and unconventional Central Bank activities, it is anticipated that volatility will increase.

> "We should expect ***greater-than-usual financial volatility***, with quite large swings (up and down) that are only distantly related to changes in fundamentals."
>
> Mohamed El-Erian, Chief economic adviser at Allianz, is chairman of Barack Obama's Global Development Council, ex-CEO of Pimco

> "Everywhere I go I talk with investment advisors and brokers who are scratching their heads trying to figure out how to create retirement portfolios that provide sufficient income without significantly moving out the risk curve at precisely the wrong time in their client's lives. It is a conundrum that has been made for more difficult by Federal Reserve policy."
>
> John Mauldin | Apr 03, 2015

In Australia, the scale of superannuation assets in retirement, and increasing proportion of post-retirement assets is shown in the table below:



Source: Australian Institute of Superannuation Trustees

The lack of choices is demonstrated by the existing asset allocation of SMSF assets.

The SMSF Association in its periodic review "2015 Intimate with Self Managed Superannuation – an annual study of self managed superannuation funds" shows how investors are allocating their assets in dealing with this dilemma.

Figure 10 – Please indicate roughly how you have allocated your SMSF assets between the following areas.

[8] ATO Self-managed super fund statistical report – September 2014

The Australian equities allocation receives regular dividends but is subject to varying capital returns from market movements, whereas the cash and term deposits have stable capital value whilst generating a historically low level of income.
Investing too much in defensive assets like cash and term deposits may mean that the growth in their portfolio does not keep up with what is required and savings may run out earlier than anticipated. However, investing too much in growth assets exposes to market volatility and share price losses, so capital may also run out earlier than anticipated.

A framework to review 'retirement income' products

The Lonsec report referred to above considers the asset classes commonly used to generate retirement income:

- Term deposits
- Annuities
- Endowment Bonds
- Bond funds
- Equities – income focused
- Hybrids

Most "income" alternatives don't invest in growth assets.

When evaluating income products, look for the following:

- Straight forward business model, minimal capital at risk at all times
- Regular income, from dividends and franking credits
- Opportunity to protect and grow investment capital
- Financially strong counter party for protection – Australian Stock Exchange
- Transparent mark to market valuations of fund value
- No leverage within the fund

In essence, there are two attributes to a successful retirement product: diversified income with capital stability (protecting and growing your investment at all times.) There are many financial products being marketed on the basis of the risk mitigation. However, protection on your investment at all times is rarely in place.

A solution: buy blue chip high yielding shares for income, with “insurance”

In the Lonsec Report referred to above, they note:

> “Funds that apply derivatives based strategies will also seek to manage the volatility of their funds via various options trades, with the aim of reducing downside risk, while at the same time dampening potential return upside.”

The perception has been historically that having protection always in place is ‘expensive’. The ASX handbook “Guide to Equity Options for Investment Managers: Additional ways to achieve return and manage risk in equity portfolios” states:

> “Perpetually protecting a stock can be expensive. For example, 12 month at-the-money put options typically cost between 5% and 10% of the value of the shares. In most instances, this would be a large part of your expected return on the stock. Therefore, it is usually not cost-effective to have protection in place twelve months of the year – this strategy is generally more appropriate for shorter periods when you expect the share price may decline. On the other hand, long-term protection can be considered better value for money because time decay accelerates towards expiry. Just as in other real-world situations where protection is expensive but necessary, the same is true of equity portfolio management in certain instances.”

Active management of the ASX options is the key to lowering its cost. This is enabled by developments in technology and deregulation. (see below for Gyrostat Capital Stability Fund investment approach.)

At Gyrostat, we publish the ‘do it yourself’ index that shows the current market pricing to protect your investment at expiry by varying the duration and level of protection.

This is regularly updated and available at: www.gyrostat.com/news/

Active management of the ASX options is the key to lowering its cost. Gyrostat’s key competitive advantage is the ability to have cost effective downside protection in place at all times, at a stock specific level.

In particular:

- There are differing levels of ‘implied volatility’ in the option market from differing maturities, or within the same maturity across a different range of strike prices. This has been observed by academics and market participants for many decades. Technology and software enables these to be identified in ‘real time’.
- To further lower the cost of protection, you can receive premiums in return for limiting some of the upside. This is achieved by selling call options. Again, there are many series to choose from.

- With market movements, the “options” component can be actively managed. The trading reduces the cost. By actively managing, on market rises - locking in the gains with more protection; on market falls - sell some protection which is no longer required. Sophisticated software allows instant monitoring of a large number of price movements simultaneously.
- Transaction costs have fallen with deregulation. Deregulation allows funds managers and individuals to execute transactions at a low cost without the requirement to use a full service broker.

About Gyrostat Capital Stability Fund

We are a diversified income fund with capital stability – delivering income greater than cash returns (minimum 3% above the cash rate, currently 5.1% pa paid semi-annually) with downside protection always in place. We buy and hold blue chip stocks and pass on the franked dividend. We simultaneously enter the Australian Securities Exchange ("ASX") options market to hedge risk. We are always fully invested with minimal capital at risk. Throughout the investment cycle we protect capital when markets fall and have a track record of capturing 30%-50% of stock upside. Our strategy benefits from increasing stock market volatility.

- ✓ Minimum distribution cash rate plus 3% (currently 5.1%)
- ✓ Preserve capital when markets fall
- ✓ Participate in upside on market rises
- ✓ 20 consecutive quarters of no losses exceeding 2%
- ✓ Compounded returns of 30% since inception

Our Track Record

Period	ASX 200	Gyrostat
Apr 2011 - Aug 2011	-22%	1%
May 2012 - Jun 2012	-10%	0%
May 2013 - Jun 2013	-12%	1%
Aug 2014 - Oct 2014	-10%	-2%
Apr 2015 – Jan 2016	-20%	-1%

We participate in the upside if markets rise, and protect the downside when markets fall.

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