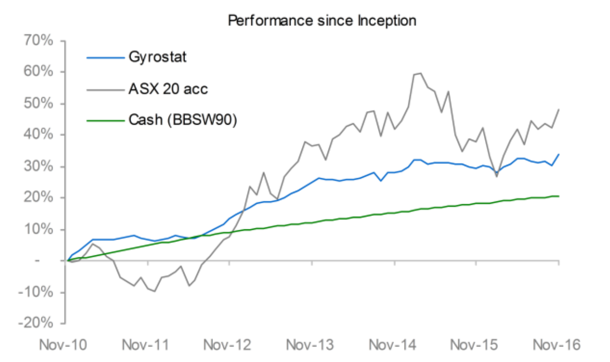
GYRATIONS

Insights into risk management of an equity portfolio

Gyrostat Capital Management Pty Ltd December 2016

THIS MONTH



Gyrostat Capital Stability Fund compounded returns are net of fees and include franking credits, cash (BBSW90) includes re-investment of interest.

* ASX 20 accumulation index is shown to illustrate the fund's protection with ASX falls, and participation in ASX gains

Gyrostat Capital Stability Fund is a 'risk managed equity fund', **delivering stable and rising investment returns through the market cycle with higher income than cash and term deposits**. Our innovative risk management technique has a risk-return profile at all times to participate in share price upside with minimal capital at risk ("hockey stick" payoff). We provide a solution for investors seeking "protected equity" (downside protection always in place as distinct from other risk management approaches) and/or "cash plus" (delivering higher income than cash and term deposits by passing through dividends and franking credits). We are always fully invested in blue chip high yielding shares and insure downside with lowest cost alternatives on the ASX. Our strategy **benefits** from increasing stock market **volatility.**

FRAMEWORK

Global debt as a percentage of GDP is at all time highs and the stock market has been rising for over 7 ½ years without a significant correction. Stock market 'bear markets' since 1929 have occurred every 4 ½ - 5 ½ years and have ranged for 25% to 90%. Geopolitical developments are resulting in changes to macro-economic policies.

The Gyrations risk model, depicted above, considers the implications of geopolitical, macro-economic, and company valuations on investor risk. The value of an investor's portfolio is impacted by political events, prevailing and forecast economic conditions and earnings expectations relative to current share values.

Geopolitical

- Election results change economic priorities and corporate earnings.
- Trade wars reduce economic growth and corporate earnings.
- Exchange rate devaluations lead to defaults of US denominated debts and capital flight thus impacting on corporate earnings.

Macro-economic

- Economic growth or decline determines corporate earnings.
- Debt defaults and resulting contagion effects reduce corporate earnings.
- Banking defaults can lead to liquidity issues for corporations.
- Inflation rate expectations impact on interest rates, with rising interest rates historically leading to lower market P/E levels.
- Central Bank changes to interest rate and quantitative easing policies impact on corporate earnings and P/E levels.

Company valuations

- valuations driven from earnings and changes in overall P/E level.
- human psychology tendency for herd or momentum behaviour.

Gyration will provide investors with a snapshot of these risks regularly. In our next edition, we will examine portfolio risk management techniques. We are of the view that in today's environment traditional approaches have significant deficiencies. To address the deficiencies in risk management for post retirement investors, there is a need to **expand the range of 'income' and 'growth' assets to include risk managed equity funds.** Such funds trade off some of the upside to insure against downside risk. It is possible to manage the risk profile of such funds by varying the underlying assets and the risk-return parameters.

OUTLOOK

Our investment view is that 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 briefly spiked post Brexit but has again returned to near historic lows.

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.

Increased volatility is often experienced around key data releases relating to interest rates, growth, inflation rates, and key political events. These dates are detailed in this report, 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. Relying on market predictions, as is the traditional approach, with a 'straight line' pay-off leaves investors exposed to large capital losses.

Gyrostat Capital Stability Fund has a 'hockey stick pay off' investment profile, set to always participate in the upside with minimal capital at risk. With this investment profile investors can approach these markets with confidence.

GEOPOLITICAL

Key Political Events

Political instability is increasing with anti-establishment parties gaining traction. This is particularly evident in Europe with recent polls indicating one in four support these parties.

Key dates are:

December 4: Italian Constitutional referendum, to limit Senate's legislative powers

Apr 2017: French Presidential election

Mid 2017: German elections

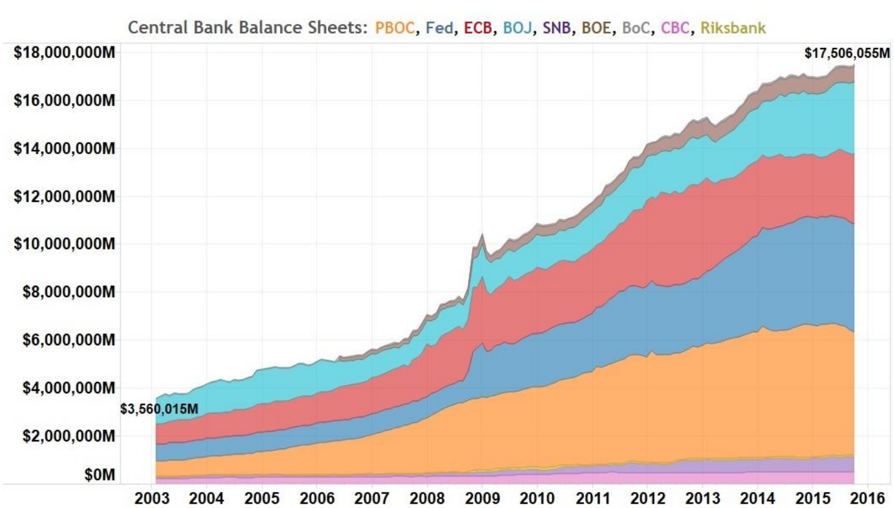
Trade

Trade wars can result from either currency devaluations or the introduction of trade barriers. This typically reduces overall economic growth, and subsequently company earnings. It can also cause capital flight, often the precursor to a debt crisis. There is increasing evidence of anti-globalisation activities.

The Trans-Pacific Partnership (TPP) trade agreement among twelve of the Pacific Rim countries will not be ratified. There remains uncertainty on the implications of any USA trade and foreign policy changes as a result of the Presidential elections.

Central Banks

Central Banks decide monetary policy by determining the price of money (short term interest rates). With interest rates globally in many jurisdictions at or below zero an additional policy is used to vary the quantity of money (quantitative easing or 'printing' money). Central Banks have been buying longer term bonds and stocks with the QE proceeds. There are increasing concerns this has inflated 'asset prices' and not sufficiently stimulated economic growth.

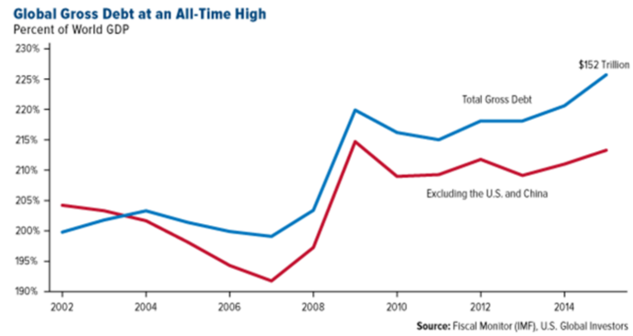


http://inflation.us/central-bank-balance-sheets/

MACRO ECONOMIC

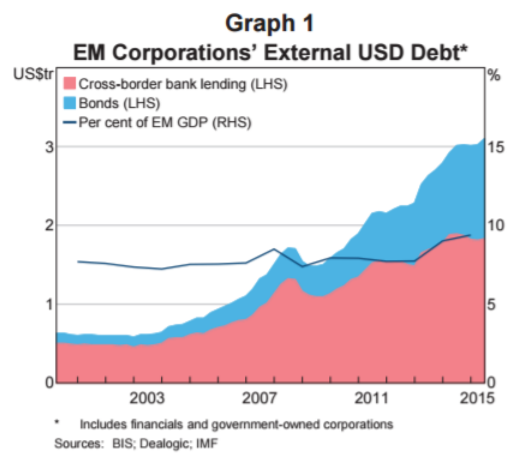
Debt

Global debt levels are at a record 225% of world GDP (IMF semi-annual fiscal monitor report October 2016)



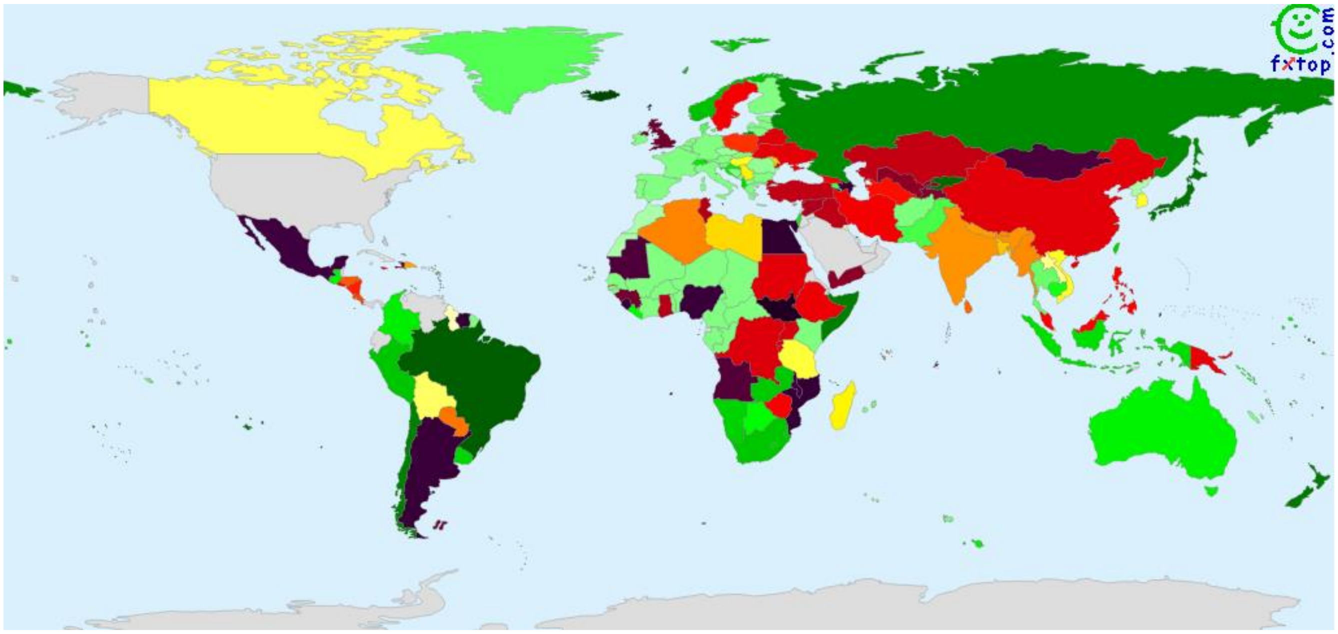
Gigantic Debt

US dollar-denominated borrowings by emerging market (EM) corporations have increased rapidly in recent years (currently in excess of $ 15 trillion), raising concerns about possible currency mismatch risk, debt defaults, and capital flight from those countries subject to currency devaluations.



http://www.rba.gov.au/publications/bulletin/2015/dec/pdf/bu-1215-6.pdf

Over the past 12 months, movements of currencies relative to the US dollar is shown below. In green is shown those countries with increases, in red those with devaluations. A rising US dollar increases the risk of debt defaults and capital flight in those countries with unhedged borrowings and domestically generated revenues. http://fxtop.com/en/forex-map.php



GDP Growth- World

Despite historic low interest rates, global GDP has continued below trend levels, IMF April world outlook "Too slow for too long."

http://www.tradingeconomics.com/calendar?g=world

Key dates are:

December 2: US unemployment. Previous 4.9% in line with consensus.

December 6: Euro zone GDP growth. Previous annualised 1.6% in line with consensus.

December 7: Australia GDP growth. Previous annualised 3.3% in line with consensus.

December 15: Australia unemployment. Previous 5.6% in line with consensus.

December 22: USA GDP growth. Previous annualised 3.2%, above consensus.

January 20: China GDP growth. Previous 6.7% slightly above consensus.

Inflation

Low inflation prolongs the elevated global debt levels by not growing nominal GDP. There remains the risk of deflation.

Key dates are:

December 9: China inflation. Previous 1.9% YoY to October in line with consensus.

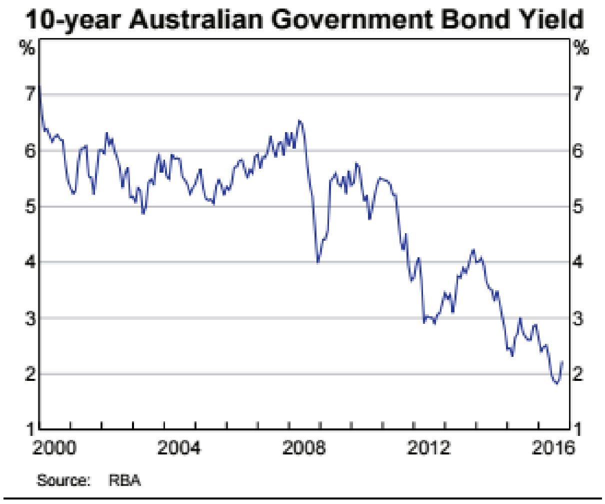
December 15: USA inflation rate. Previous 1.6% to October, in line with consensus.

December 27: Japan inflation rate. Previous 0.1% to October, above consensus.

January 5: EU inflation rate. Previous 0.5% at consensus.

January 26: Australia inflation rate. Previous 1.3% above consensus.

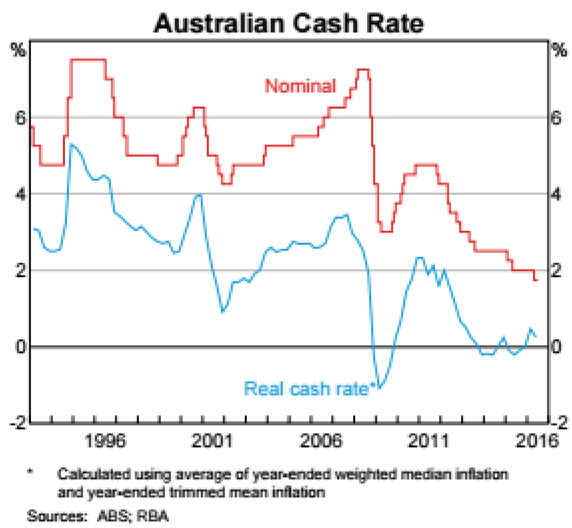
Bond yields



10 year bond rates are also typically used as an indicator of inflation expectations. Rates have risen over the past month, but remain near historical lows. These rates can move rapidly, and cause rapid changes in bond prices.

http://www.bloomberg.com/markets/rates-bonds

Cash Rate - Australia



Interest rates are at historical lows and anticipated to stay low for an extended period.

The RBA cut cash rates to 1.50% on 2 August 2016

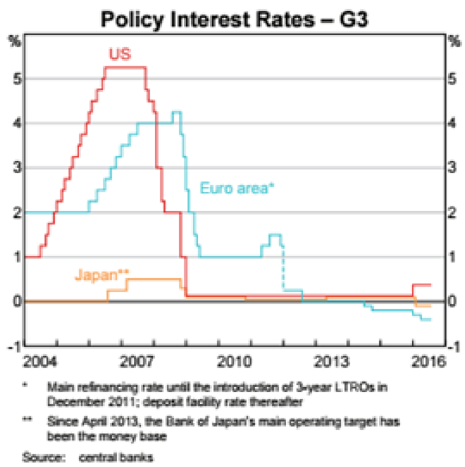
RBA meetings:

- December 4
- February 7

Market pricing of interest rate cut to 1.25% at December meeting based on inter-bank cash rate futures: no cut: 98%; cut 2%

http://www.asx.com.au/prices/targetratetracker.htm

Interest Rates - International



Key dates are:

US Federal Reserve decisions (now 0.25%-0.5%):

- December 15
- January 28

Bank of Japan decisions (now -0.1%):

- December 20
- January 29

European Union decisions (now 0.0%):

- December 8
- January 20

Bank of England decisions (now 0.25%)

- December 15
- January 13

COMPANY VALUATIONS

Company Earnings

Corporate earnings expectations are influenced by macro economic and company specific factors. Substantial changes in market valuations often occur as investors adjust for new data, particularly where it differs from the 'consensus' view.

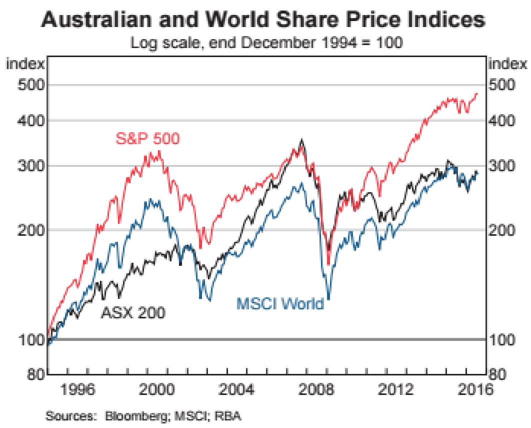
Details of upcoming Australian company earnings announcements are available at:

http://www.morningstar.com.au/Stocks/CorpCalendar

Listed companies also have continuous disclosure requirements to advise the market of any material changes in the companies projected earnings, particularly where they vary from the market consensus.

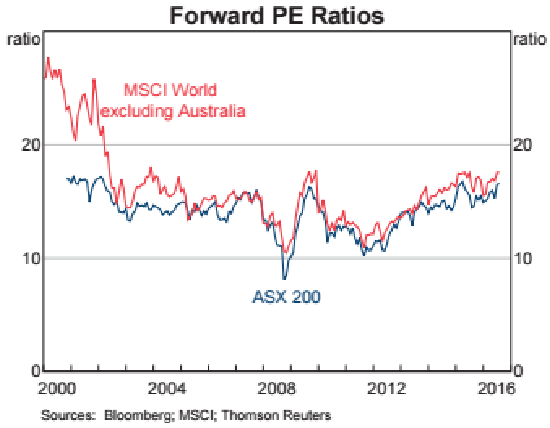
Share prices

Globally share prices have rallied strongly since 2009 market lows with the US market rising nearly 200%.



Price Earnings Ratios

The price/earnings ratio is often used as a metric for stock market valuations.

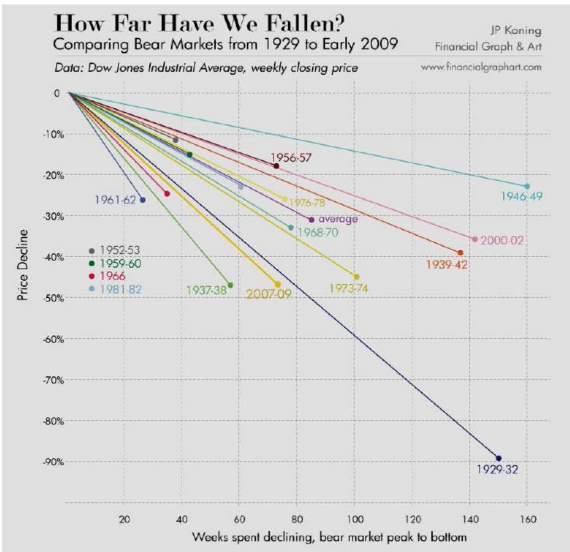


A historical context of market levels using normalized earnings since 1900 as calculated by Crestmont Research.

http://www.crestmontresearch.com/docs/Stock-PE-Report.pdf

Stock Market Corrections

Stock market corrections historically occur every 4 ½ to 5 ½ years. From 1929 to current, the range of falls and duration has been 25% to 90%, average 38%) and duration of decline (22 to 160 weeks). The last correction occurred over 7 1/2 years ago



http://www.marketoracle.co.uk/images/2009/Mar/fallen.jpg

WHAT WE ARE READING

The stakes of Italy's referendum:
https://www.project-syndicate.org/commentary/italy-referendum-constitutional-reforms-by-mario-margiocco-2016-11

SMSF Association innovative retirement income products:
http://trustees.smsfassociation.com/wp-content/uploads/2016/07/Innovative-retirement-income-products.pdf

Ray Dalio: Are we at the end of the long term debt cycle:
http://www.valuewalk.com/2016/10/ray-dalio-asks-end-long-term-debt-cycle/

Stock market valuations through the lenses of history:
http://www.crestmontresearch.com/docs/Stock-PE-Report.pdf

Gyrostat revolutionary risk management technique risk-return payoffs explained:
http://www.gyrostat.com.au/news/risk-return-profile-at-all-times-to-participate-in-share-price-upside-with-minimal-capital-at-risk-how-we-invest/

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