

# GYRATIONS



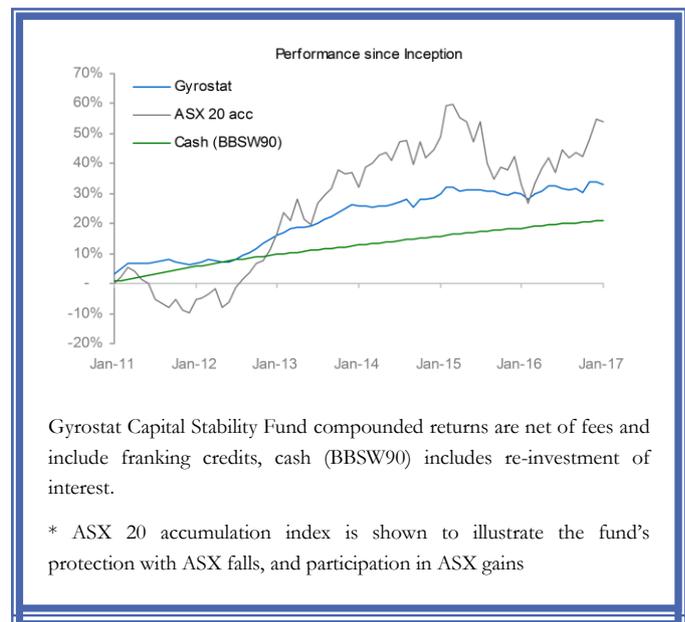
## Insights into risk management of an equity portfolio for retirement planning

Gyrostat Capital Management Pty Ltd

February 2017

### THIS MONTH

Sequencing risk protection: Risk management for retirement	p2
Risk framework: A framework for investor risk	p3
Outlook: Rising levels of volatility	p4
Geopolitical events: Netherlands, France elections	p5
Macro-economic factors: Global debt & growth	p6
Company valuation: Australian updates Stock market corrections	p10
What we are reading	p12



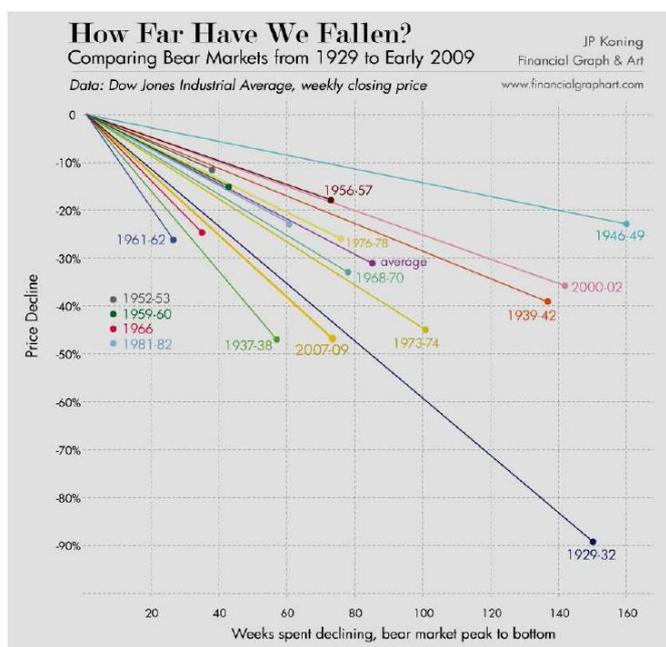
Gyrostat Capital Stability Fund is a risk managed equity fund (“protected equity”) and addresses sequencing risk – the impact of investment losses – in retirement. We buy and hold ASX20 blue chip high yielding shares and insure downside at the stock specific level with lowest cost alternatives on the ASX. We have a six year track record of **delivering stable and rising investment returns with regular income**. Our innovative risk management approach has at all times a risk-return profile to participate in share price upside with minimal capital at risk (“hockey stick” payoff). Our strategy **benefits** from increasing stock market **volatility**.



## SEQUENCING RISK PROTECTION

Investment returns have more impact at some points in your superannuation lifecycle than at others. *Sequencing risk is the risk that markets fall near or early in retirement.* The wrong sequence of returns can have a big impact on your retirement portfolio. Negative investment returns early in retirement can be particularly damaging.

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%, and duration of decline 22 to 160 weeks. The last correction occurred over 7 1/2 years ago.



A brief summary of existing risk management techniques, and acknowledge deficiencies are:

- **Diversification of stocks:** exposed to the risk associated with investing in the markets generally (as distinct from stock specific) risks. Capital investment rises and falls with market cycles.
- **Non-correlated asset allocation** with both ‘growth’ and ‘income’ assets: produces portfolios with lower income (historical low interest rates) and substantial fluctuations in capital value (highly indebted world). Reduced effectiveness with higher correlation in times of market stress.
- **“Stop loss”** approach: may not be effective in large market downside gaps, and requires prediction and the identification of ‘exit’ and ‘entry’ levels. Exposure to losses when predictions are wrong.
- **“Predictive” techniques:** protection sometimes, but not always in place using derivatives such as ‘futures’ and ‘options’ to adjust risk-return profiles. Exposes investors to large potential losses if protection not in place.

Risk managed equity funds protect against the effects of sequencing risk by at all times protecting the downside at the stock specific level with lowest cost alternatives on the ASX.



## RISK FRAMEWORK



The Gyration 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. We are of the view that in today's environment traditional approaches have significant deficiencies. To address the deficiencies in risk management for 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 US elections and 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.

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.

The decision to 'solve' a debt crisis by printing tens of trillions of dollars more debt may have adverse longer

term financial stability threats from excessive debt, with adverse impacts for stock market valuations.

There are many potential triggers revealing the system fragilities. 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. Geopolitical developments are resulting in changes to macro-economic policies. Valuations are considered 'high' by historical standards.

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.

An effective strategy for addressing sequencing risk ensures the consequences of such an event do not materially adversely impact retirement lifestyle.

*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 supports these parties.*

### **Key dates are:**

**15 March:** Netherlands election

**23 April (round 1), 7 May (round 2):** French Presidential election

**24 September 2017:** German elections

**May 2018:** Italian elections, potentially early elections

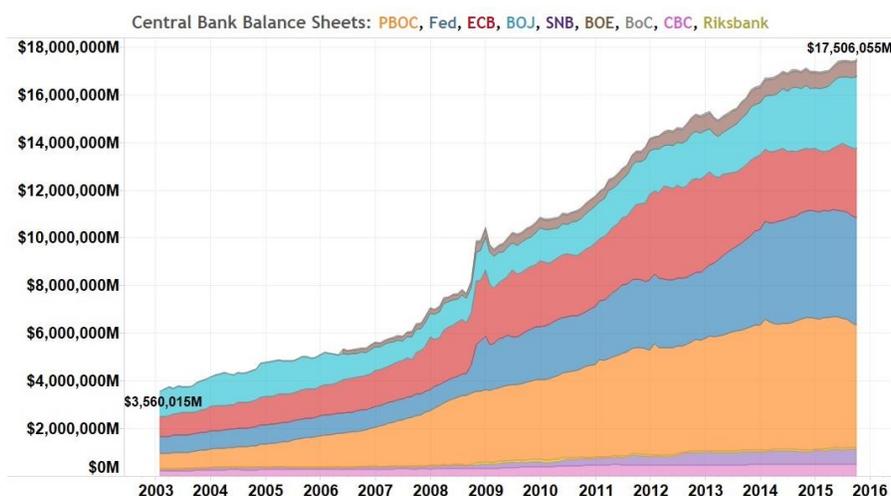
## Central Banks

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. Liquidity of commercial banks can be addressed by a Central Bank, solvency can not.

## 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.



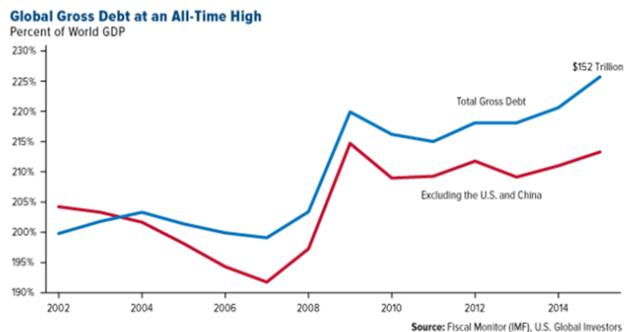
<http://inflation.us/central-bank-balance-sheets/>



## MACRO ECONOMIC

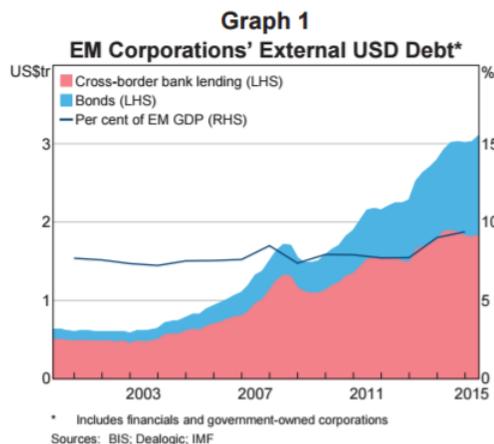
### Debt

*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.*

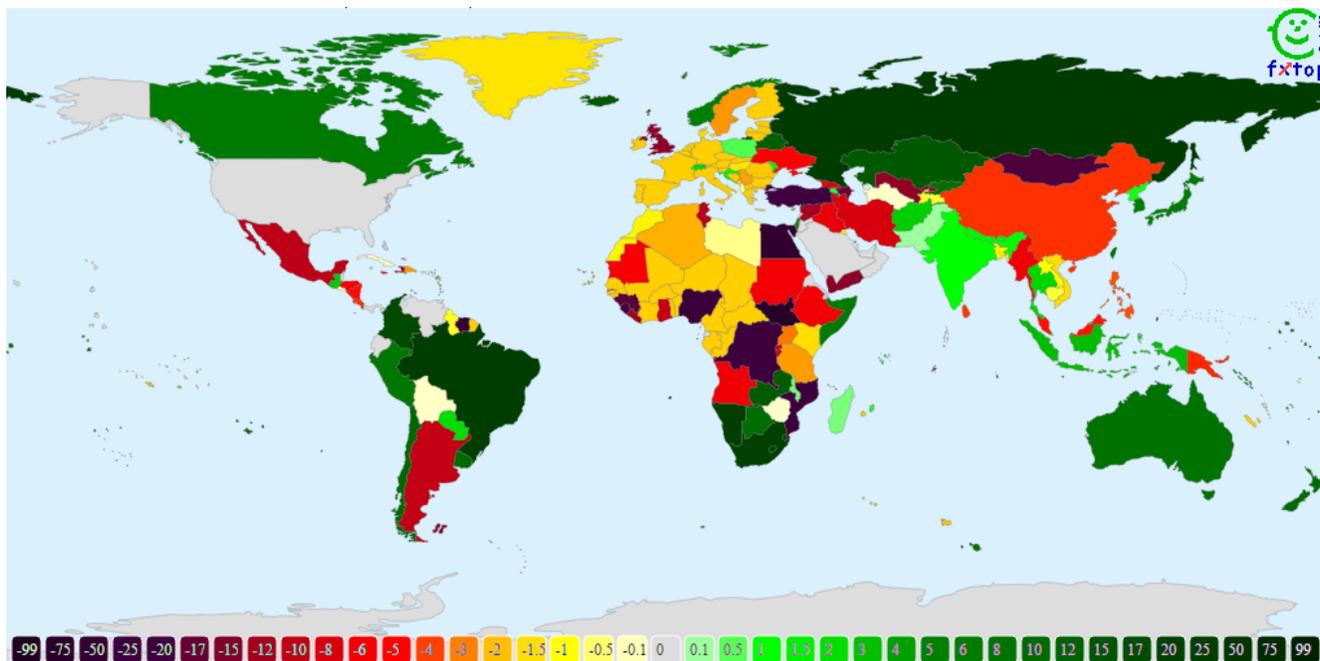


<http://www.rba.gov.au/publications/bulletin/2015/dec/pdf/bu-1215-6.pdf>

*Over the past 12 months, movements of currencies relative to the US dollar are shown below. In green is shown those countries with increases, in purple and 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>



fxtop.com



## GDP Growth- World

*Despite historic low interest rates, global GDP has continued below trend levels, IMF January 2017 “A Shifting Global Economic Landscape”*

### Key dates are:

**February 14:** Euro zone GDP growth. Previous annualised 1.8% above consensus.

**February 16:** Australia unemployment. Previous 5.8% slightly above consensus.

**February 28:** USA GDP growth. Previous annualised 1.9%, below consensus.

**March 1:** Australia GDP growth. Previous annualised 1.8% below consensus.

**March 10:** US unemployment. Previous 4.8% slightly above consensus.

**April 18** China GDP growth. Previous 6.7% in line with consensus.



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



## Inflation

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

### **Key dates are:**

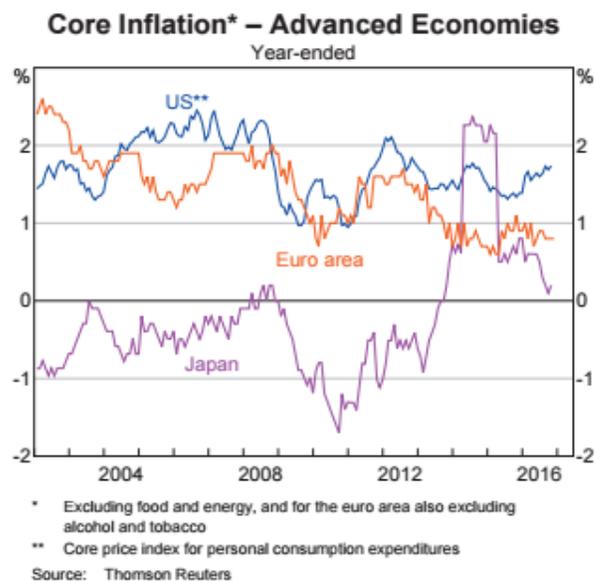
**February 14** China inflation. Previous 2.1% YoY to December, below consensus.

**February 15:** USA inflation rate. Previous 2.1% to December, in line with consensus.

**February 22:** EU inflation rate. Previous 1.8% to December, above consensus.

**March 3:** Japan inflation rate. Previous 0.3% to December, above consensus.

**April 26:** Australia inflation rate. Previous 1.5% slightly below consensus.



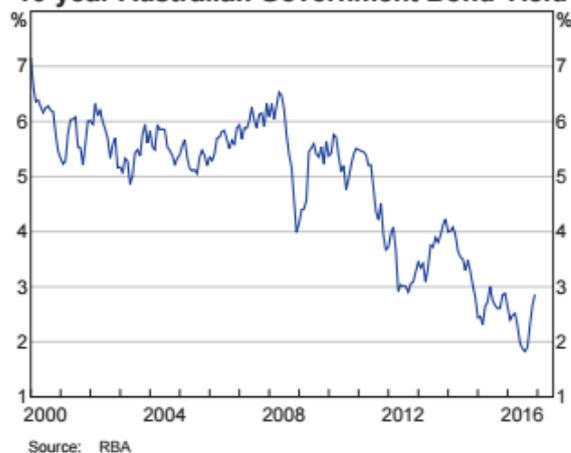


## Bond yields

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

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

### 10-year Australian Government Bond Yield



## 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

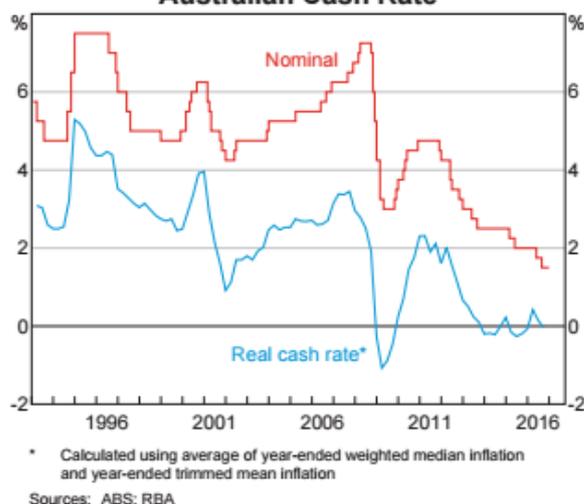
RBA meetings:

- March 7
- April 4

Market pricing of interest rate cut to 1.25% at March meeting based on inter-bank cash rate futures: no cut: 95%; cut 5%

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

### Australian Cash Rate



## Interest Rates - International

Key dates are:

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

- March 16
- May 4

Bank of Japan decisions (now -0.1%):

- March 16
- April 27

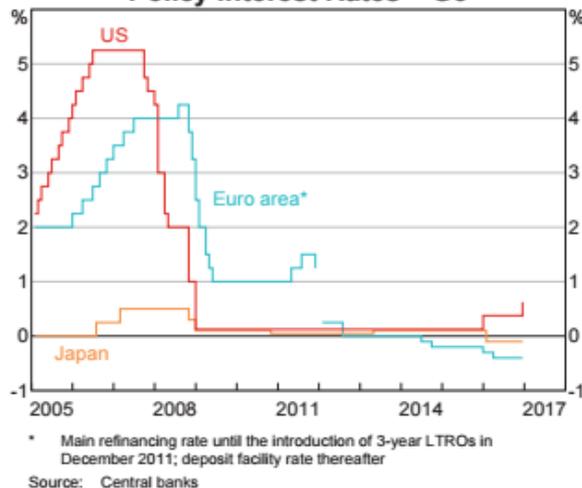
European Union decisions (now 0.0%):

- March 9
- April 27

Bank of England decisions (now 0.25%)

- March 16
- May 11

### Policy Interest Rates – G3





## 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>

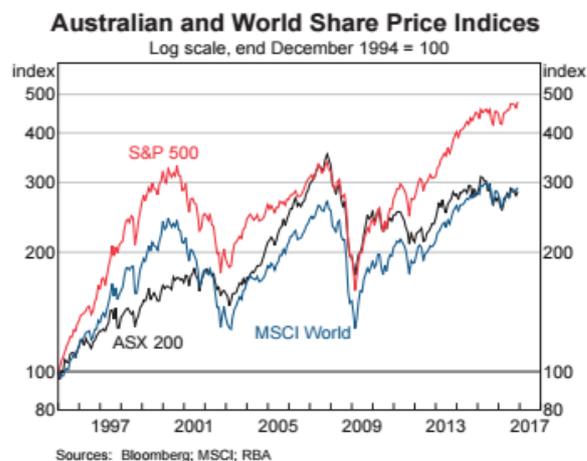
Listed companies also have continuous disclosure requirements to advise the market of any material changes in the companies projected earnings, particularly where they vary from the market consensus.

The graph opposite shows the changes in forecast earnings for the shown years. Over recent years, earnings estimates have been downgraded as time has progressed.



### 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.*



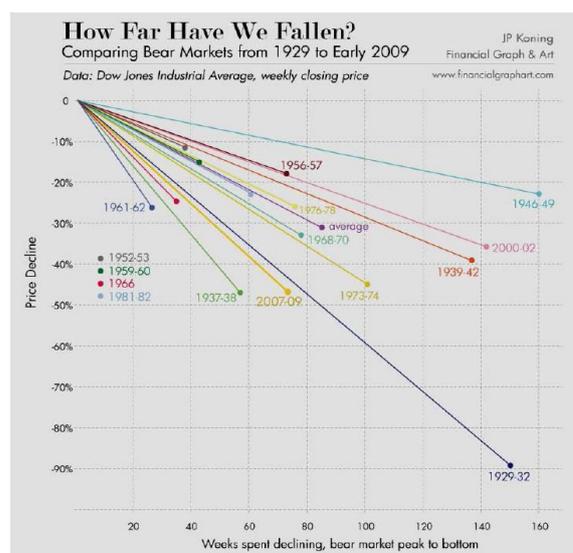
*A historical context of market levels using normalized earnings since 1900 as calculated by Crestmont Research.*

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



## Stock Market Corrections

*Stock market corrections historically occur every 4 1/2 to 5 1/2 years. From 1929 to current, the range of falls and duration has been 25% to 90%, 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

William White: Ultra easy money: Digging the hole deeper?  
[http://www.williamwhite.ca/sites/default/files/11369\\_2016\\_12\\_OnlinePDF.pdf](http://www.williamwhite.ca/sites/default/files/11369_2016_12_OnlinePDF.pdf)

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

Stephen Roach: The Achilles heel of Trumponomics  
<https://www.project-syndicate.org/commentary/achilles-heel-of-trumponomics-by-stephen-s--roach-2016-11>

"Trillion Dollar Plan" Sends Stocks To Record Highs As 'Volatility' Hits Record Lows  
<http://www.zerohedge.com/news/2017-01-24/trillion-dollar-plan-sends-stocks-record-highs-volatility-hits-record-lows>

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/>

### Further details available at:

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Investors should download and review the Information Memorandum available at [www.gyrostat.com.au](http://www.gyrostat.com.au) before making an investment in the Fund.