GYROSTAT
RISK MANAGED EQUITY FUNDS

Shares for income' with capital stability

The missing link in today's market

The missing link in today's market is a long term dividend product where there are some underlying protections against market risk. This would address the natural aversion to share market volatility and its impact on investment capital.

The major beneficiaries of such a product are conservative investors including pre and post retirees (to address sequencing risk), industry associations, philanthropic and charities, individuals and family offices (for intergeneration wealth transfer).

These investors seek a solution for stable and rising returns with regular income. Blending traditional 'income' and 'growth' assets has produced a painful dilemma for conservative investment planning - invest in 'income' assets like cash and term deposits and you receive insufficient income; invest in blue chip high yielding shares and you are subject to market fluctuations in the value of your investment capital.

There are 4 strategic trends that make it difficult to achieve the aims of conservative investors:

- Low interest rates at historic lows with a quarter of the world in negative interest rates;
- Elevated stock market valuations by historical standards with global debt levels at historic highs with;
- Ageing population as post-war baby boomers approach retirement;
- Geopolitical developments from election outcomes and changing macro economic policies.

The limited investment menu available today

At present there are no investment solutions that provide both 'income' and 'growth' to deliver stable and rising returns with regular income. Most "income" alternatives don't invest in growth assets and offer no prospects for capital growth.

David Murray, the chairman of the Financial System Inquiry, concluded:

> " … the retirement phase of superannuation is underdeveloped and provides limited choice for managing risk"
>
> *David Murray, Chair of The Financial System Inquiry*

Similar conclusions can be drawn for all conservative investors.

The asset classes commonly used to generate conservative income are:

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

Most are 'income' assets with no prospect of capital growth. An investment in equities – income focused owns underlying growth assets. However, the traditional risk management techniques have acknowledged deficiencies.

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, or foregoes upside unless a 'hockey stick risk-return profile' in place.

Funds that apply derivatives based strategies 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 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.

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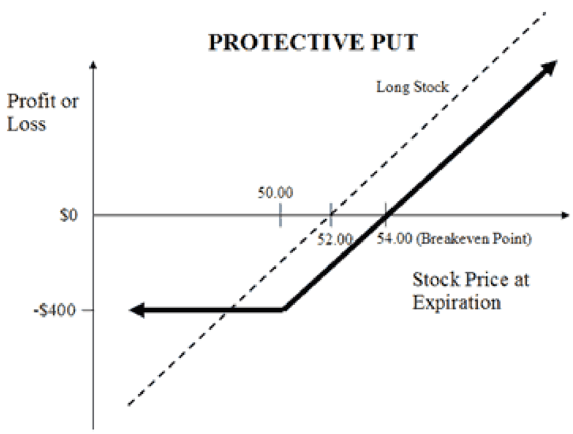
Technology enables the future

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.”

The theoretical knowledge on how to “insure” your portfolio has been around since 1973 when Fisher Black and Myron Scholes published a paper, the basis for which a Nobel Prize in Economics was awarded fourteen years later. Their work created one of the most important concepts in modern financial theory, the mathematical model for pricing derivative investment instruments, including options.

A put option gives you the right to sell a stock at a pre-defined price for a pre-defined period of time. It is like an insurance policy, but like all insurance it comes at a price.



Protective Put Payoff Diagram

The ASX offers investor education at their web site, including a specific section "Equity Options from SMSFs". (http://www.asx.com.au/products/equity-options/eto-for-smsf.htm)

The historical issue that always protecting your portfolio is expensive is addressed through the management of ASX options, made possible through advances in technology and deregulation. Technology enables our software systems to identify the lowest cost insurance (ASX bought put) alternatives. On market moves we re-set the insurance level, made possible by lower fees from deregulation.

Management of the ASX options is the key to lowering its cost. 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.

When evaluating risk managed 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

The Gyrostat risk managed equity funds approach

Given the apparent gap in the market, Gyrostat has developed a risk managed equity fund specifically designed to deliver stable and rising returns with regular income.

The **investment objectives are:**

- **Returns with protection**: 60-70% ASX20 accumulation index over a rolling 3 year period with no quarterly downside exceeding 2%,
- **Income**: Minimum BBSW90 + 3% (currently 4.7% pa) from dividends and franking credits, paid semi annually
- **Track record**: 6 year track record of delivering our investment objectives

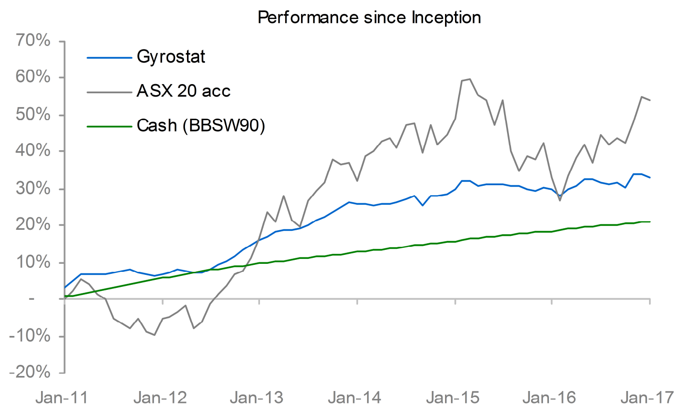
Since our inception we have captured 64% of the ASX20 accumulation index upside with no quarterly downside ever exceeding 2%

We participate in share price upside, protect on market falls, and benefit from increasing levels of volatility.

Risk managed equity funds have both "cash plus" and "protected equity" characteristics.

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. Our **innovative risk management approach has <u>at all times</u> 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.**

Gyrostat's key competitive advantage is the ability to always be fully invested with a risk-return profile at all times to participate in share price upside with minimal capital at risk, at the stock specific level.



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