GYROSTAT
RISK MANAGED EQUITY FUNDS

Insuring your investments – how the ASX options market works

Executive summary

- Similar in purpose to buying insurance on your house or car, you can ensure you don't lose significant amounts of your investment capital on the ASX.
- Buying protection for your shares is termed a put option. When buying put options you pay a premium to lock in a value for shares you own at the agreed value or exercise price.
- Options can be used to either reduce risk (hedge -not risky) or to speculate (can be risky). Options are sometimes considered risky and overlooked.
- When you buy protection to hedge risk (the Gyrostat approach) it is the ASX who is the counter party.
- The ASX imposes collateral requirements on the seller of the option. The ASX had over $ 6 billion collateral from market participants at 30 June 2016

Protecting your investment capital

The first question is what protection is available?

ASX Options are available over the top 71 shares in the market as well as the ASX 200 index (XJO). These can be exchange traded or over the counter. http://www.asx.com.au/services/clearing/asx-equity-flex-clear.htm

When buying put options you pay a premium to lock in a value for shares you own at the agreed value or exercise price. If a company's shares fall significantly in value, you simply exercise your option to redeem at the contract exercise price.

With options the person selling is obligated to buy the shares from you at the pre-determined price.

The pricing dynamics in the world of options market mean if you purchase 12 months protection it costs more than the 6 month equivalent as the seller is taking on more risk.

Similarly if you are seeking to protect shares, the price at which your protection kicks-in will have an effect on the premium you pay. A protection level around or higher than the prevailing share price will cost more than selecting a protection level below the prevailing share price.

The ASX offers investor education at their web site, including a specific section “Equity Options from SMSFs”. http://www.asx.com.au/education/investor-update-newsletter/201405-sleep-easy-investments.htm

The mechanics of the ASX options markets

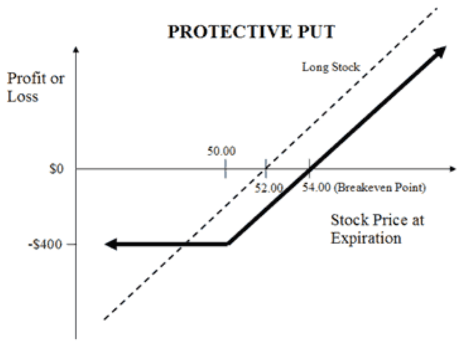
A put option gives you the right to sell a stock at a pre-defined price for a pre-defined period of time. It is like an insurance policy, and like all insurance it comes at a price or premium.

Options can be used to either hedge risk (the buyer of the option - not risky) or to speculate (the seller of the option - can be risky). They are traded on the ASX and you place an order through a broker, just as investors do with shares.

Option strategy	Risk	Return
Buy put option	Limited to 'premium' cost	Uncapped
Sell put option	Uncapped	Limited to 'premium' received

Let's consider the workings of the market through an example. You own shares and decide to pay a premium to buy a put option to lock in the sale price of your shares for the life of the option, no matter how low the share price may be. As the buyer of the option, a so called "protective put" that you have at risk is the put option premium you have paid.

Buy option – hedge risk



Protective Put Payoff Diagram

If the stock does fall, the other party must "honour" the insurance contract. As counterparty the ASX is liable for the settlement of these derivative contracts traded between its clearing participants, and is supported by collateral received from clearing participants.

The seller of the put option, or insurance policy, is required at the close of business each day to lodge collateral to show they can "honour" the contract. If the share price falls that day, they are required to lodge additional collateral.

Lowering the cost of protection

Active 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'. In effect, some insurance policies are cheaper than others.

- 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.

Progression of investment risk management

The continued development of the ASX options market has contributed to the significant progression in risk management approaches now available to conservative investors.

These risk management approaches have different risk and return characteristics through the complete investment cycle.

- "Phase 1" was the traditional risk management approach - varying the allocation of 'income' and 'growth' assets.

- "Phase 2" introduced additional 'growth' asset risk management approaches with protection <u>sometimes</u> in place through a predictive risk management overlay. Benchmarked to equity index.

- "Phase 3", the Gyrostat approach, is a complement to Phase 2 approaches with protection <u>always</u> in place. We complement short term bonds as we deliver higher income and capital growth through the investment cycle (in trending and more volatile markets including large market falls). Benchmarked to BBSW.

By combining the three, conservative investors can protect and grow capital with reliable income through the investment cycle

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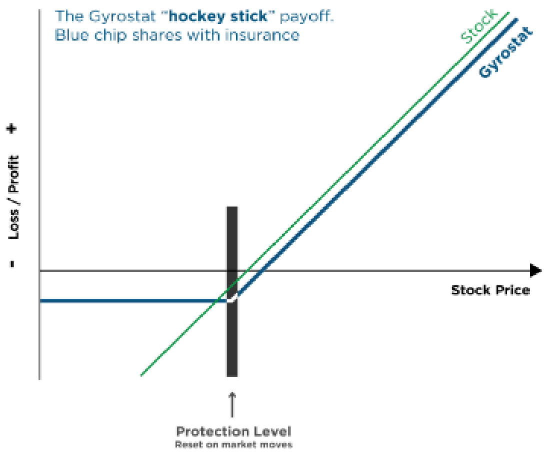
Our solution – the three step investment approach

Throughout the complete investment cycle our risk management approach has a risk-return profile which always has minimal capital at risk at the stock specific level with upside return potential. Each stock always has a protection level in place near the current stock price. This level is re-set as stock prices move to protect on share price downside and participate in upside.

Super impose a 'hockey stick' pay off at all times on a share price chart, moving the protection level on market moves.

Gyrostat investment approach

1. **Buy and hold blue chip shares with protection** on the Australian Stock Exchange.
2. **Set amount of protection -** to always participate in the upside with minimal capital at risk.
3. **Reset the protection level on market moves for risk-return profile to match stock view -** if the share price rises, increase protection level, on falls reduce protection level.



Disclaimer

This information is general advice only and does not take into account your particular circumstances, your personal investment or financial planning objectives, your investment knowledge, needs and requirements, including taxation implications that may result from investing in the Fund.

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Investors should download and review the Information Memorandum available at www.gyrostat.com.au before making an investment in the Fund.

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