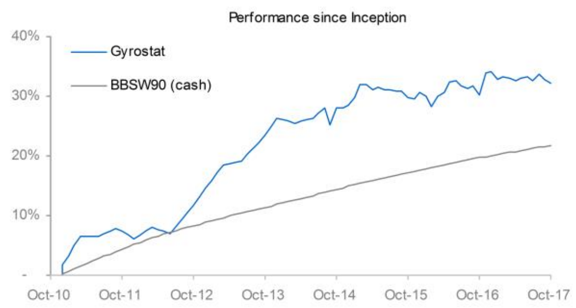
GYRATIONS

Insights into risk management of an equity portfolio for conservative investors

Gyrostat Capital Management Pty Ltd

November 2017

THIS MONTH



Gyrostat Absolute Return Income Equity Fund compounded returns are net of fees and include franking credits, cash (BBSW90) includes re-investment of interest.

Gyrostat Absolute Return Income Equity Fund buys and holds ASX 'Blue chip' shares with lowest cost protection <u>always</u> in place with upside. We are a conservative asset with the potential for capital growth in rising and falling markets. We have a 7 year track record of delivering our investment objectives.

- **Returns**: 6% - 8% pa in trending markets, greater than 8% pa in volatile markets, short term bond returns in stable markets
- **Income**: Minimum **cash rate + 3%** paid semi-annually (currently 4.7% p.a.) from dividends and franking credits
- **Protection:** No quarterly NAV draw-downs exceeding 2%

SIGNIFICANT ADVANCES IN RISK PROTECTION

Protect and grow capital with reliable income through the complete investment cycle

Expanding the investment menu

There have been significant advances in risk management for conservative investors, enabling them to protect and grow capital with reliable income through the complete investment cycle. This is achievable by combining the three approaches outlined below, and adjusting asset allocation now before volatility returns.

With protection always in place with upside, it is possible to ride out the storm and make money when other strategies don't.

The gap in today's market is a conservative asset that combines protection, returns and income. Capital growth is delivered when others don't – in trending and more volatile markets (including large 'one off' share price falls.)

Our feature article presents the views of Noble Prize winning economist Richard Thaler, and why he is nervous about stock markets and his misgivings about the low volatility and continued optimism amongst investors.

Previous Gyration feature articles (September 2017) have outlined how to prepare now to protect and benefit in changing markets. Our July 2017 feature article details how ASX options market can be utilised to reduce investment risk with the ASX the counterparty to the options contract. In June our feature article demonstrated the significant progress in investment risk management– possible from technological advances and deregulation.

In summary:

	Approach	Feature	Capital value	Benchmark
Level 1 **Diversify risk**	Asset allocation between 'conservative' and 'growth' assets	Diversification	Initial capital ± market moves	Model portfolio performance
Level 2 **Partial protection**	Protection sometimes in place using predictions	Additional 'growth' asset Predictive risk management - technology	Initial capital ± mitigated market moves	Equity index
Level 3 **Always in place protection**	Protection always in place with upside Absolute return - always minimal capital at risk	Additional 'conservative' asset Lowest cost bought put options - technology Active management options - deregulation	Initial capital + capital growth in trending and volatile markets (incl large falls)	BBSW
Short term bonds	Conservative asset (no capital growth)	Nil	Initial capital less defaults	BBSW

The investment performance of the approaches varies across the investment cycle. By combining the three and adjusting asset allocation now, it is possible to benefit with capital growth in volatile markets (including large 'one off' share price falls).

	Approach	Falling market (trending)	Volatile market (including 'one off' large falls)	Stable market	Rising market (trending)
Level 1 **Diversify risk**	Asset allocation 'conservative' and 'growth' assets	Unfavourable	Unfavourable – capital losses	Favourable	Favourable
Level 2 **Partial protection**	Protection sometimes in place using predictions	Unfavourable	Unpredictable – capital gains and losses	Favourable	Favourable (possibly mitigated)
Level 3 **Always in place protection**	Protection always in place absolute return Absolute return - always minimal capital at risk	Favourable (mitigated)	Very favourable – capital growth potential	Less favourable (lower returns)	Favourable (mitigated)

Our solution – stable and rising absolute returns with regular income

Our risk management approach has **protection always in place** with **absolute returns through the investment cycle.** With protection always in place we complement short term bonds and benchmarked against the BBSW90. Our expected returns vary with the stage of the investment cycle and benefit from trending and volatile markets, as this provides the opportunity to re-set protection levels and lowers the cost.

Our investment objectives are:

- **Returns**: 6% - 8% pa in trending markets, greater than 8% pa in volatile markets, short term bond returns in stable markets
- **Income**: Minimum **cash rate + 3%** paid semi-annually (currently 4.7% p.a.) from dividends and franking credits
- **Protection:** No quarterly NAV draw-downs exceeding 2%

We have a track record of achieving these objectives every year since our inception in 2010.

Traditionally protecting your portfolio was expensive. Gyrostat has overcome this issue by actively managing ASX options, utilising proprietary software and taking advantage of reduced broker costs due to deregulation. We are always fully invested in blue chip high yielding shares and insure downside with lowest cost alternatives on the ASX.

Returns have more impact at some points in your investment 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. Our Fund is of particular benefit to pre or post retirees who don't have the time required to overcome investment losses if large market falls.

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 8 1/2 years ago. Our investment objective is capital growth in trending and more volatile markets, including large market falls.

RISK FRAMEWORK

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/tightening 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. Traditional risk management approaches are exposed to capital losses with downside 'tail' risk and prediction risk with protection sometimes in place. Our risk management approach complements existing approaches by having protection always in place, and to benefit from trending and more volatile markets include large market falls. Such funds trade off some of the upside to insure against downside risk.

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 historic highs. GDP growth remains below trend, interest rates are at historic 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 impact on financial stability, with adverse impacts for stock market valuations.

There are many potential triggers which may reveal system fragilities. Global debt as a percentage of GDP is at all time highs and the stock market has been rising for over 8 ½ years without a significant correction. Geopolitical developments are resulting in changes to macro-economic policies. Valuations are considered 'high' by historic 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 events do not materially adversely impact retirement lifestyle.

Gyrostat Absolute Return Income Equity 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

There appear to be increasing tensions in the USA-Europe relationship as USA priorities change. Political instability is increasing with anti-establishment parties gaining traction. Many geopolitical commentators expect an increase in armed conflict within and between nations.

Key dates are:

May 2018: Italian elections, potentially early elections

Trade

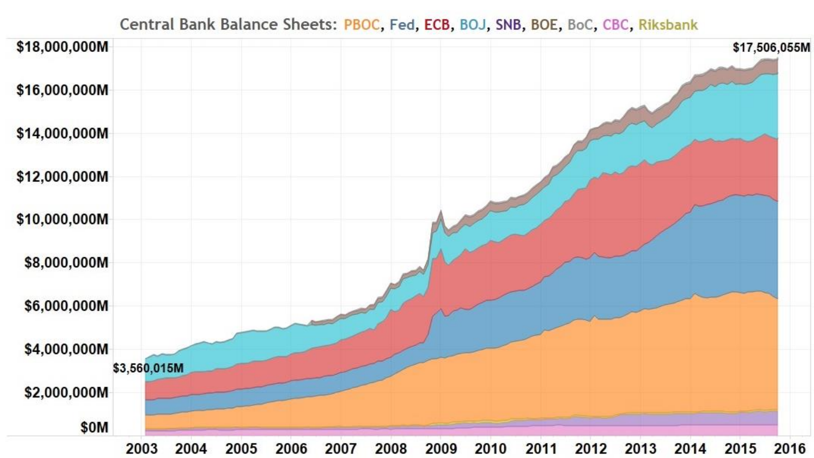
Trade wars can result from either currency devaluations or the introduction of trade barriers. This typically reduces overall economic growth, and subsequently company earnings. It can also cause capital flight, often the precursor to a debt crisis. There is increasing evidence of anti-globalisation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

The Trans-Pacific Partnership (TPP) trade agreement among twelve of the Pacific Rim countries will not be ratified. The North America Free Trade Agreement (NATFA) is subject to re-negotiation. There is the possibility of armed conflict with North Korea and increasing trade barriers between USA-China.

Central Banks

Central Banks decide monetary policy by determining the price of money (short term interest rates). With interest rates in many global 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.

The USA Central Bank has provided guidance on modest quantitative tightening by not rolling over bond when they mature. This starts at $ 10 b per month, with guidance by the end of 2018 rising to $ 50 b per month.

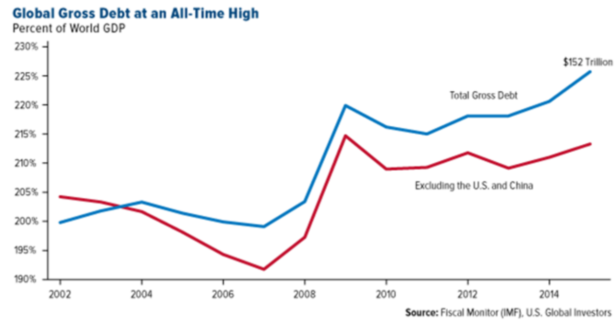


http://inflation.us/central-bank-balance-sheets/

MACRO ECONOMIC

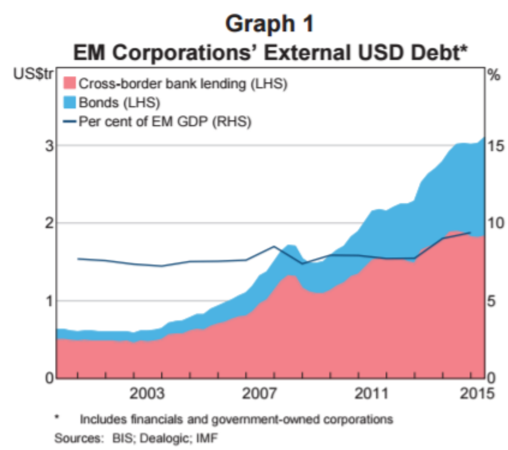
Debt

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



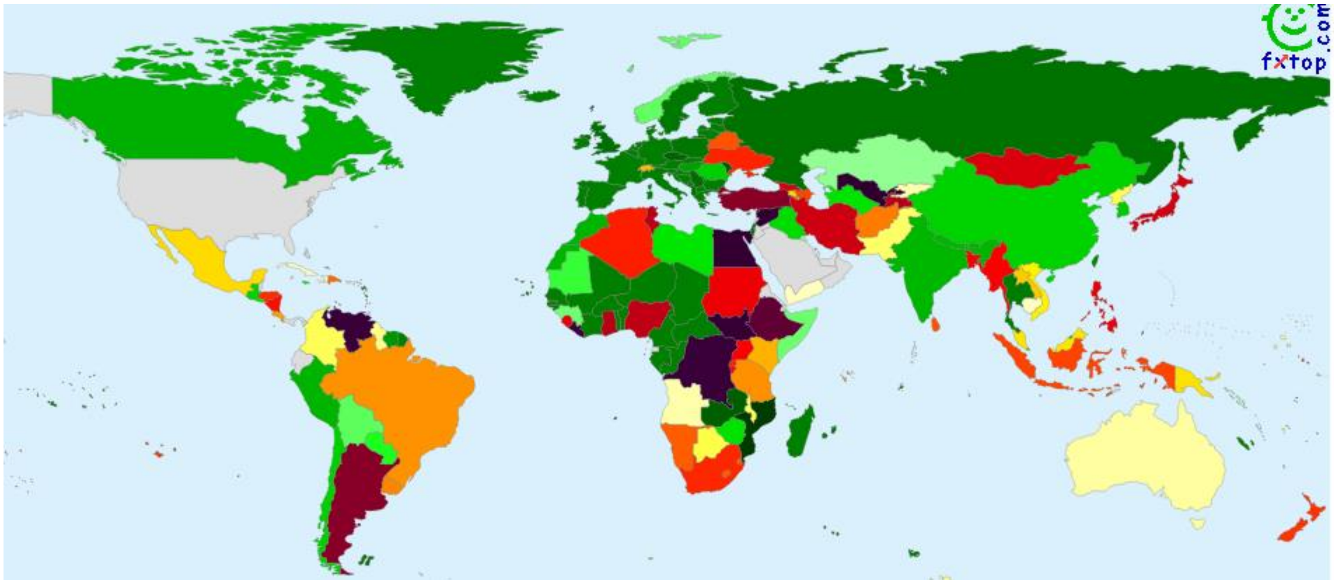
Gigantic Debt

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



GDP Growth- World

Despite historic low interest rates, global GDP has continued below trend levels. In April 2017 the IMF raised growth forecasts slightly. The USA expansion commenced in June 2009 and has now been in place for 99 months, the third longest expansion on record.

https://www.crestmontresearch.com/docs/Economy-Cycle-Dashboard.pdf

Key dates are:

November 3: US unemployment (monthly). Previous annualised 4.2% below consensus.

November 20: USA GDP growth (monthly). Previous annualised 3.0% above consensus.

December 6: Euro zone GDP growth (quarterly). Previous annualised 2.5% above consensus.

December 7: Australia GDP growth (quarterly). Previous annualised 1.8% at consensus.

January 2018: Australia unemployment (quarterly). Previous 5.5% below consensus.

January 2018: China GDP growth (quarterly). Previous 6.8% at consensus.

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

Inflation

Low inflation prolongs the elevated global debt levels by not growing nominal GDP. Inflation has recently increased in USA, has been stabilizing in Euro area, with the risk of deflation remaining in Japan. The inflation rate has recently seen modest increases in China.

Key dates are:

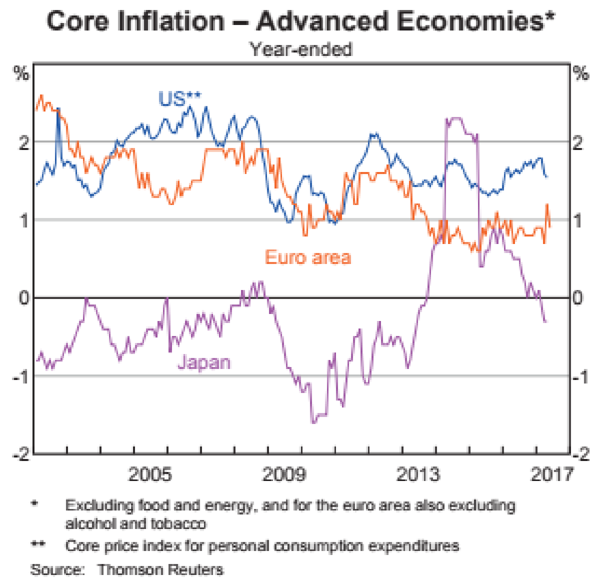
November 15: USA inflation rate (monthly). Previous 2.2% slightly below consensus.

November 16: EU inflation rate (monthly). Previous 1.4% slightly below consensus.

December 1: Japan inflation rate (monthly). Previous 0.7% at consensus.

December 9: China inflation (monthly). Previous 1.6% YoY at consensus.

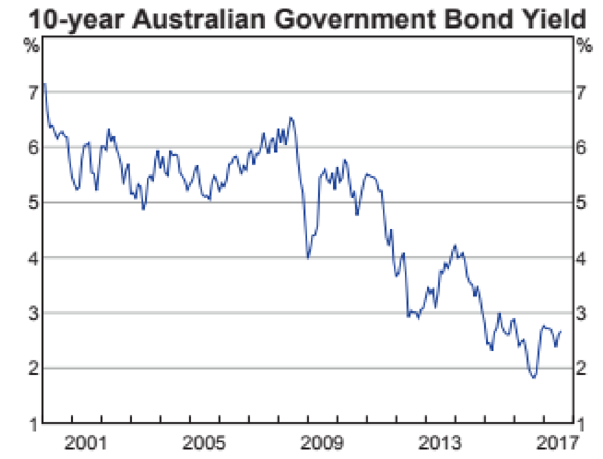
January 2018: Australia inflation rate (quarterly). Previous 1.8% below consensus.



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



Source: RBA

Cash Rate - Australia

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

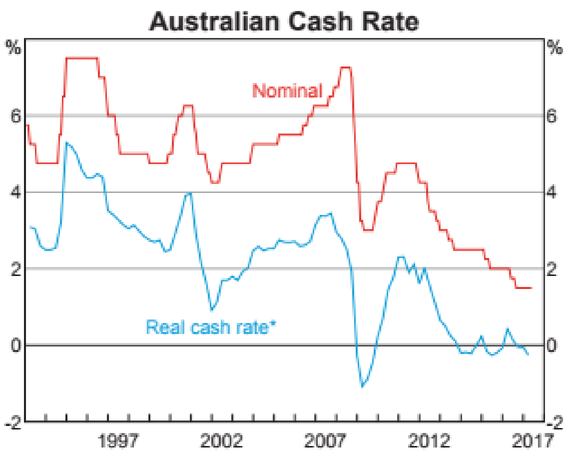
The RBA cut cash rates to 1.50% on 2 August 2016

RBA meetings:

- November 7
- December 5

Market pricing of interest rate cut to 1.75% at October meeting based on inter-bank cash rate futures: no rise: 100%; rise 0%

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



* Calculated using average of year-ended weighted median inflation and year-ended trimmed mean inflation

Sources: ABS; RBA

Interest Rates and QE- International

Key dates are:

European Union decisions (now 0.0%):

- December 14

US Federal Reserve decisions (now 1.00%-1.25%):

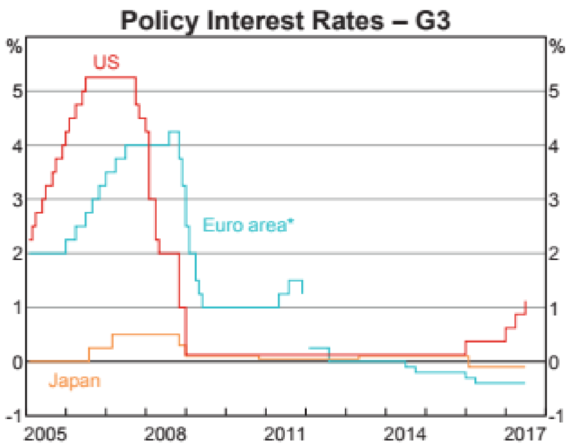
- December 14

Bank of England decisions (now 0.25%)

- December 14

Bank of Japan decisions (now -0.1%):

- December 21



* Main refinancing rate until the introduction of 3-year LTROs in December 2011; deposit facility rate thereafter

Source: Central banks

COMPANY VALUATIONS

Company Earnings

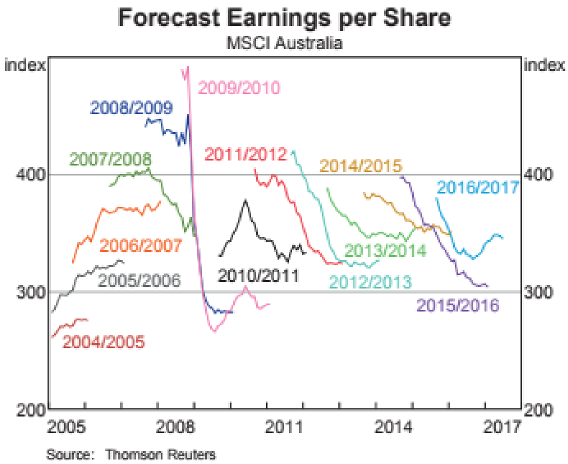
Corporate earnings expectations are influenced by macro economic and company specific factors. Substantial changes in market valuations often occur as investors adjust for new data, particularly where it differs from the 'consensus' view.

The next quarterly earnings season commences in November 2017. Details of upcoming Australian company earnings announcements are available at:

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

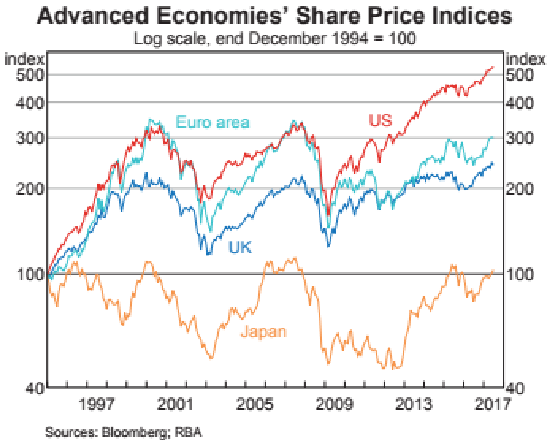
Listed companies also have continuous disclosure requirements to advise the market of any material changes in the companies projected earnings, particularly where they vary from the market consensus.

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. Recently earnings estimates have increased slightly.



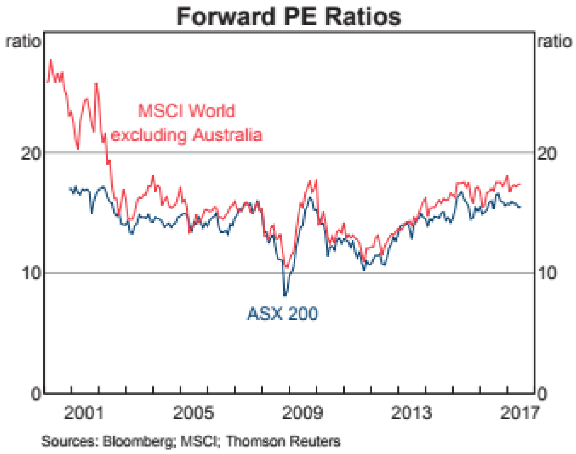
Share prices

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

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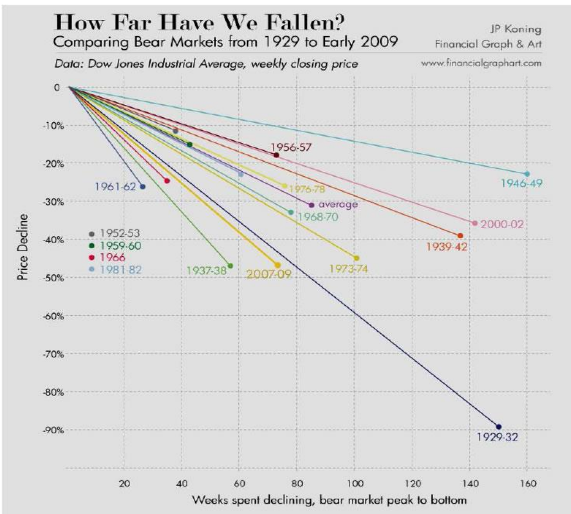
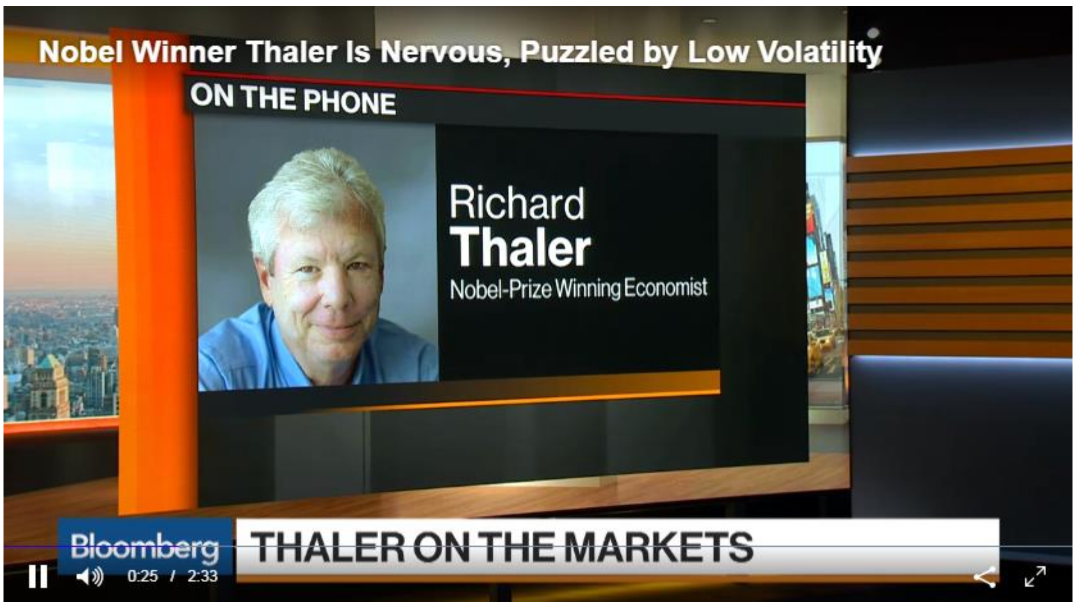


http://www.marketoracle.co.uk/images/2009/Mar/fallen.jpg

Nobel Economist Thaler Says He's Nervous About Stock Market

by Jeanna Smialek
10 October 2017



(Bloomberg) A buoyant and complacent stock market is worrying Richard H. Thaler, the University of Chicago professor who this week won the Nobel Prize in economics.

"We seem to be living in the riskiest moment of our lives, and yet the stock market seems to be napping," Thaler said, speaking by phone on Bloomberg TV. "I admit to not understanding it."

The S&P 500 index has been reaching repeated records since President Donald Trump's election last November amid steady growth in the U.S. economy and labor market, as well as expectations for lower taxes, though policy action in Washington has been limited. Thaler, who has made a career of studying irrational and temptation-driven actions among economic actors and won the Nobel for such contributions to behavioral economics, expressed misgivings about the low volatility and continued optimism among investors.

"I don't know about you, but I'm nervous, and it seems like when investors are nervous, they're prone to being spooked," Thaler said, "Nothing seems to spook the market" and if the gains are based on tax-reform expectations, "surely investors should have lost confidence that that was going to happen."

The economist said that he didn't know "where anyone would get confidence" that tax reform is going to happen.
"The Republican leadership does not seem to be interested in anything remotely bipartisan, and they need unanimity within their caucus, which they don't have," Thaler said. "And the president's strategy of systematically insulting the votes he needs doesn't seem to be optimizing anything I can think of, but maybe he's a deeper thinker than me."

That followed another jab earlier Tuesday on Bloomberg Radio, when Thaler said of Trump: "His ratio of certitude to knowledge is nearing record highs." Thaler also took a swipe at Brexit, saying that Britain's vote last year to leave the European Union was based on disenchantment.

"I don't think that the leave votes were based on any implicit spreadsheet running in people's heads it was just like, 'I'm angry, and I'm voting no,"' he told Bloomberg TV's Vonnie Quinn and Mark Barton. Of the Brexit process, he said: "It doesn't seem to be headed in any productive direction."

Bloomberg

https://www.bloomberg.com/news/videos/2017-10-10/nobel-winner-thaler-is-nervous-about-low-volatility-video

Gyrostat Absolute Return Income Equity Fund

Investment Objectives

Combines returns, income and protection for investors wanting minimal capital at risk at all times

RETURNS

6%-8% in trending markets, greater than **8%** in changing markets, short term bond returns in stable markets.

INCOME

Minimum cash rate **+ 3%** paid semi-annually (currently 4.7% p.a.) from dividends and franking credits.

PROTECTION

No quarterly NAV draw-downs exceeding **2%**

Gyrostat buys and holds ASX 'Blue chip' shares with lowest cost protection always in place with upside. With the progression of investment risk management, it is now possible to protect and benefit in changing markets. We have a 7 year track record of delivering our investment objectives.

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- **Income:** Minimum **cash rate + 3%** paid semi-annually (currently 4.7% p.a.) from dividends and franking credits
- **Protection:** No quarterly NAV draw-downs exceeding 2%

The fund is suitable as a 'conservative' asset offering capital growth for all portfolios. It is of particular benefit to pre or post retirees who don't have the time required to overcome investment losses if large market falls.

All portfolios

As a 'conservative' asset allocation, complements a portfolio - makes money when others don't

Retirees

Confronts sequencing risk (large market falls), and longevity risk (capital growth potential)

Intergenerational wealth transfer

Protect and benefit in changing markets

Industry associations, philanthropic and charities

Higher income than cash and short term bonds with stable and rising capital value

WHAT WE ARE READING

Carmen Reinhart: The curious case of missing defauls
https://www.project-syndicate.org/commentary/missing-emerging-market-debt-defaults-by-carmen-reinhart-2017-11

Steve Blumenthal: On My Radar: The Great Central Bank unwind
https://www.cmgwealth.com/ri/radar-great-central-bank-unwind/

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

"Global Debt Bomb" history of sovereign defaults: Reinhart and Rogoff
https://www.forbes.com/forbes/2010/0208/debt-recession-worldwide-finances-global-debt-bomb.html

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

Gyrostat Absolute Return Income Equity Fund – in depth guide with video
http://www.gyrostat.com.au/news/gyrostat-absolute-return-income-fund-in-depth-guide/

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