# GYRATIONS

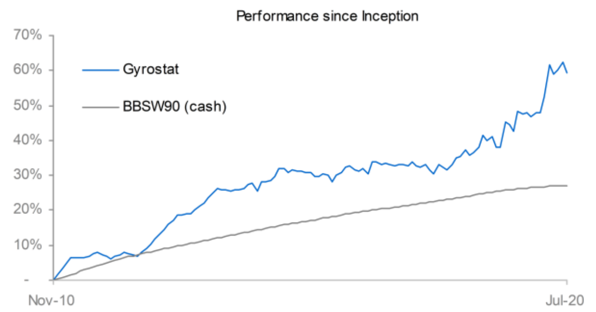
**Volatility is our friend – risk managed investing**

**(Retiree) equity income, risk managed, to protect and grow capital**

Gyrostat Capital Management Pty Ltd  August 2020

## 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.

**The unexpected happens**

**Gyrostat is a defensive asset to fortify your portfolio in an uncertain world**

# MANAGE UNCERTAINTY THROUGH PORTFOLIO DESIGN

- As no one can predict the outcomes in these highly uncertain times, you should plan for all eventualities. This is possible through portfolio construction.
- Gyrostat is a highly defensive fund to ***reduce portfolio risks, increase income and returns***.
- We are a defensive asset that reliably increases returns on market falls, whilst providing higher income generated from dividend pass through and profits from our risk management overlay.

**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 <u>now before volatility returns</u>.

- "Level 1" - diversifying risk- varying the allocation of 'conservative and 'growth' assets.
- "Level 2" - protection <u>sometimes</u> in place using a predictive risk management overlay. The benchmark for investment performance is typically an industry equity index. The variety of approaches includes:
  - Buy underlying asset, write call options (Buy-write income funds)
  - Long/short funds (market neutral, 130/30)
  - Buy underlying asset, using predictive approach has the ability to sell futures contracts
  - Buy underlying assets, buy put options (sometimes) using predictive approaches
  - Buy put options and hold cash (volatility as an asset class)

- "Level 3 - protection <u>always</u> in place, the **Gyrostat approach**. The benchmark for investment performance is 'absolute return' bank bill swap rate BBSW+. This produces an additional 'conservative' asset

The gap in today's market is a conservative asset that provides regular income and reliably increases in value in the case of market volatility (particularly large market falls). Capital growth is delivered when others don't – in trending and more volatile markets (including large 'one off' share price falls.)

In summary:

| | Approach | Feature | Capital value | Benchmark |
|---|---|---|---|---|
| **Level 1**<br><br>**Diversify risk** | Asset allocation between 'conservative' and 'growth' assets | Diversification | Initial capital ± market moves | Model portfolio performance |
| **Level 2**<br><br>**Partial protection** | Protection <u>sometimes in place</u> using predictions | Additional 'growth' asset<br><br>Predictive risk management - technology | Initial capital ± <u>mitigated</u> market moves | Equity index |

| | | | | |
|---|---|---|---|---|
| **Level 3**<br><br>**Always in place protection (Gyrostat)** | Protection always in place with upside<br><br>Absolute return - always minimal capital at risk | Additional 'conservative' asset<br><br>Lowest cost bought put options - technology<br><br>Active management options - deregulation | Initial capital + capital growth in trending and volatile markets (incl large falls) | 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**<br><br>**Diversify risk** | Asset allocation 'conservative' and 'growth' assets | Unfavourable | Unfavourable – capital losses | Favourable | Favourable |
| **Level 2**<br><br>**Partial protection** | Protection sometimes in place using predictions | Unfavourable | Unpredictable – capital gains and losses | Favourable | Favourable (possibly mitigated) |
| **Level 3**<br><br>**Always in place protection (Gyrostat)** | Protection always in place absolute return<br><br>Absolute return - always minimal capital at risk | Favourable (mitigated) | Very favourable – capital growth potential | Less favourable (lower returns) | Favourable (mitigated) |

Each level has a reduction in the downside variability of your initial capital. They each have complementary risk-return characteristics through the complete investment cycle.

Throughout the full investment cycle there are periods where investors are exposed to large investment losses. 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.

## *Why Gyrostat?*

There have been 10 years of Government retirement income reviews in Australia. The challenge is straightforward – how to generate sufficient income without taking on the risk of large losses in the value of your investment. Money is freedom. The various reviews have listed the criteria to satisfy: regular income, capital protection, no lock in periods for investors, transparent pricing, strong counterparty, invest in growth assets for capital gains, no credit default risks.

Gyrostat satisfies all of these requirements.

Your life savings should give you the financial security to be:

> **Self reliant** in an unsettled, highly unpredictable world - to take back control
>
> **Adaptable** - knowing market crashes are a regular and hazardous feature of stock markets. Protect and make money when this happens.
>
> **Resilient** - understanding that predicting the future in an uncertain world can threaten your future when predictions are wrong

Gyrostat is a defensive asset to fortify your portfolio in an uncertain world.

The Fund is designed for retiree income with protection, and to address sequencing risk (the risk of major market falls). The distinctive features are 'hard' protection always in place and a track record of returns increasing with market volatility.

**Adding Gyrostat** as a 'highly defensive' fund:

- lowers portfolio risk.
- increases income (from dividend pass-through and profits from risk management overlay)
- improves returns through the investment cycle especially large moves both down and up
- enables model portfolio outperformance vs peers.

Gyrostat is **highly defensive** – 10 year track record maximum drawdown -2.2%

- reliable pay-off for general environment – not predicting.
- higher income and returns than other 'defensive' assets.
- addresses sequencing risk.
- highly liquid, transparent, counterparties stock exchange, no credit risk or duration risk
- track record of returns increasing with market volatility (both up and down).

http://www.gyrostat.com.au/news/inside-network-interview/

# OUTLOOK

The risk of significant losses is elevated in our view.

1. We expect a retest of the March lows –this would see the ASX down 23%. In 19 of 19 times where there has been 15 % falls, the market has always retested the lows.
2. Larger 40-50 % falls. Major corrections are a regular and hazardous feature of the investment cycle. Historically these typically occur within 8 years – we are now at 13 years, the longest period on record.

As no one can predict outcomes, you should plan for all eventualities.

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.

There are many potential triggers which may reveal system fragilities – valuations, geopolitical developments, macro, Covid 19, debt defaults.

Global debt as a percentage of GDP is at an all-time high and stock market falls are significantly lower than those experienced historically.

If your portfolio suffered significant losses as at 31 March 2020 it is likely that your portfolio was not non-correlated between your 'defensive' and 'growth' assets. If you do not change the structure of your portfolio it is likely that similar losses will be experienced in future market corrections.

The rebound in stock markets now provides an opportunity to re-balance your portfolio to include defensive 'non correlated' assets which will benefit from any major market corrections.

Gyrostat has low correlation with the market (approx 0.3)

The extent of peak to trough falls on SP500 since 1929 is shown below. With the market rebound since the lows of 23 March 2020 the SP500 has fallen 7.7%from the peak of 3386 (19 Feb 2020), significantly less than has been experienced in other corrections.

At 17 August 2020 the SP500 was at 3381. A re-set of the March 23 lows of 2237 would see **34% falls**.

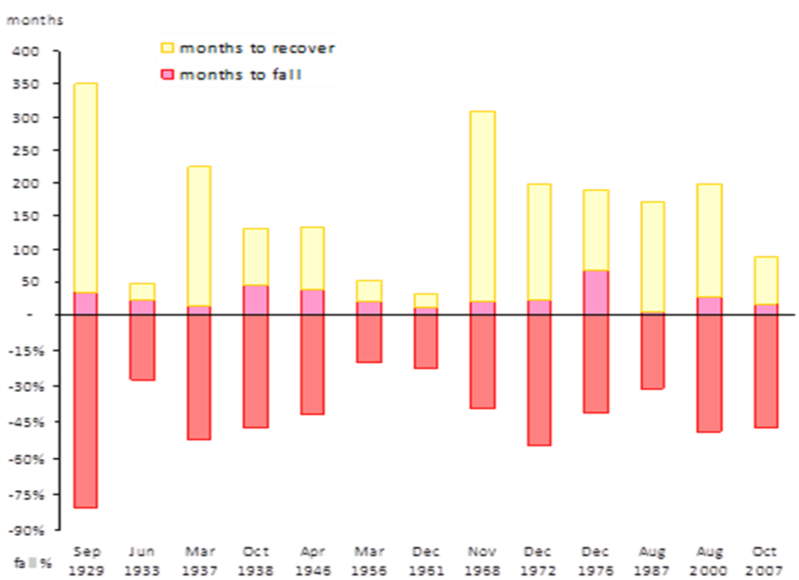
Our approach does not predict market movements. In portfolio construction one of the scenarios to consider is the consequences to your portfolio if the market was to repeat the previous peak to trough falls. For instance, a 50% fall would see the SP500 at 1693, a **reduction of 48%** from current levels.

Current market conditions and global uncertainty provide the opportunity to pro-actively address this risk through portfolio construction. This is particularly important for pre and post retirees exposed to sequencing risk.

| Market | High 19 Feb 2020 | 50% decline level | Market 17 August 2020 | 50% fall peak to trough scenario | March 23, 2020 lows | Re-test falls |
|---|---|---|---|---|---|---|
| **SP500** | 3386 | 1693 | 3381 | -50% | 2237 | -34% |
| **Nasdaq** | 9817 | 4808 | 11129 * | -57% | 6860 | -38% |
| **ASX200** | 7163 | 3581 | 6077 | -41% | 4546 | -25% |
| **Hang Seng** | 29056 *20 Jan | 14528 | 25347 | -42% | 21696 | -14% |

* Nasdaq has exceeded 19 February 2020 previous high

**SP500 index: 90 year historic chart. Peak to trough falls > 20, duration of falls, time to recover**




Returns have more impact at some points in your investment lifecycle than at others. <u>Sequencing risk is the risk that markets fall near or early in retirement.</u> 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.

## *What are the experts saying about the future?*

**US Federal Reserve:** Financial Stability Report May 2020

*"Asset prices remain vulnerable to significant price declines should the pandemic take an unexpected course, the economic fallout prove more adverse, or financial system strains reemerge." (p8)*

https://www.federalreserve.gov/publications/financial-stability-report.htm

**George Soros:** The crisis of a lifetime

*Only one thing is certain about the post-pandemic world: there is no way back to the globalized economy that preceded it. Everything else is up for grabs, including the rise of China, the fate of the United States, and the survival of the European Union.*

https://www.zerohedge.com/geopolitical/soros-has-faith-trump-will-destroy-himself-fears-weakened-xi-sees-existential-risk-eu

**Stan Druckenmiller:** Turns apocalyptic: Risk-Reward For Equities Is As Bad As I've Seen It In My Career"

*"The wild card here is the Fed can always step up their purchases, that the government stimulus programs won't be enough to overcome the economic problems, that it makes no sense for the market to jump so much when optimism emerges around certain drugs like remdesivir ("I don't see why anybody would change their behavior because there's a viral drug out there") and, most concerning, that "there's a good chance that we just cracked the credit bubble that's the result of free money."*

https://www.zerohedge.com/markets/druckenmiller-turns-apocalyptic-risk-reward-equities-bad-ive-seen-it-my-career

**ABC:** Australian investors, particularly retirees hurt from dividend payment cuts, risk of house price crash. Investors set to lose $10b in dividends as banks bunker down to weather coronavirus storm

*Up to $10 billion in income could be ripped out of the economy in the space of months as the major banks suspend or slash dividend payments in response to a massive rise in bad loans and the risk of a house price crash. However, the banks' actions are in line with the recommendations of regulators.*
*They are urging banks around the world to suspend dividends and use the money to provision against bad loans as households dealing with rising joblessness and businesses hit by lockdown measures struggle to make payments.*

https://www.abc.net.au/news/2020-05-14/investors-to-lose-10-billion-in-bank-dividends-from-coronavirus/12243836

**Bank of America**: divergence in opinions on market direction has never been greater

*With the S&P trading nearly 800 points - or a whopping 30% - above its March 23 lows, the divergence in opinions whether this is a new bull market or merely a massive - and the fastest ever - bear market rally ever, propped up by trillions in central bank liquidity and fiscal stimulus, has never been greater.*

*"With the current fallout from the complete shutdown of economic life in terms of disruptions in supply chains and collapse of aggregate demand, as well as the uncertainty on the post-lockdown path to recovery, new market bottoms are possible, although the unprecedented massive policy response could provide the backstop to a worsening case of deflationary spiral."*

https://www.zerohedge.com/markets/bear-market-rally-or-new-bull-bofa-has-answer-and-what-happens-next

# MACRO ECONOMIC

## Debt – 'late stages' long term debt cycle

Global debt levels are at a record 322% of world GDP and rising (Institute of International Finance)

https://www.iif.com/

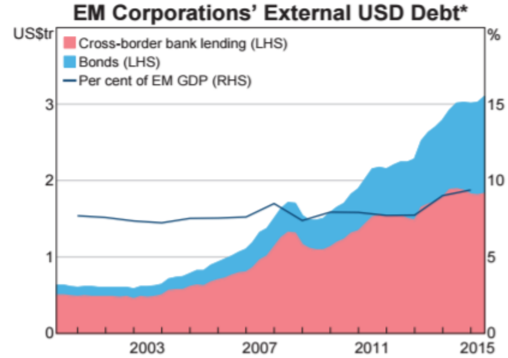
| | Households | Non-Financial Corporates | Financial Corporates | Government | Total |
|---|---|---|---|---|---|
| US$ trillion | | | | | |
| 1990 | 10 | 10 | 7 | 10 | 37 |
| 2000 | 17 | 24 | 24 | 21 | 86 |
| 2007 | 35 | 43 | 54 | 35 | 167 |
| 4Q2019 | 48 | 74 | 63 | 70 | 255 |
| % of GDP | | | | | |
| 1990 | 41% | 41% | 29% | 41% | 151% |
| 2000 | 44% | 72% | 59% | 55% | 230% |
| 2007 | 58% | 76% | 87% | 58% | 279% |
| 4Q2019 | 60% | 92% | 81% | 89% | 322% |

US dollar-denominated borrowings by emerging market (EM) corporations have increased rapidly in recent years (non bank in excess of $ 11.4 trillion according to Bank of International Settlements in 2018), raising concerns about possible currency mismatch risk, debt defaults, and capital flight from those countries subject to currency devaluations.

https://www.bis.org/publ/work753.pdf

**Graph 1**

**EM Corporations' External USD Debt***

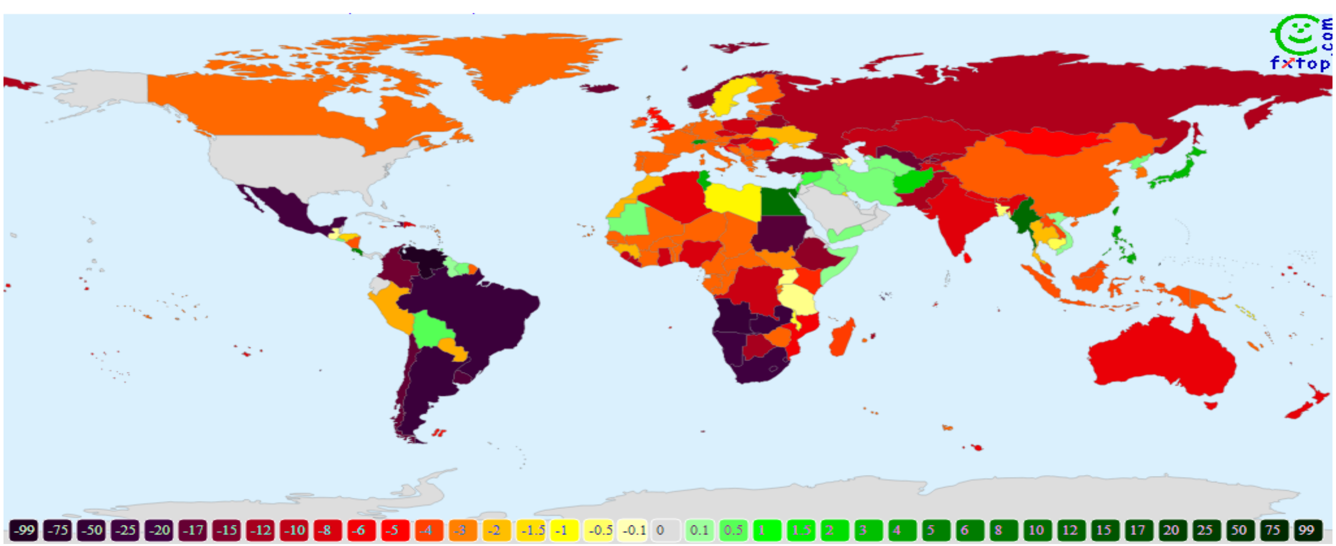



* Includes financials and government-owned corporations

Sources: BIS; Dealogic; IMF

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



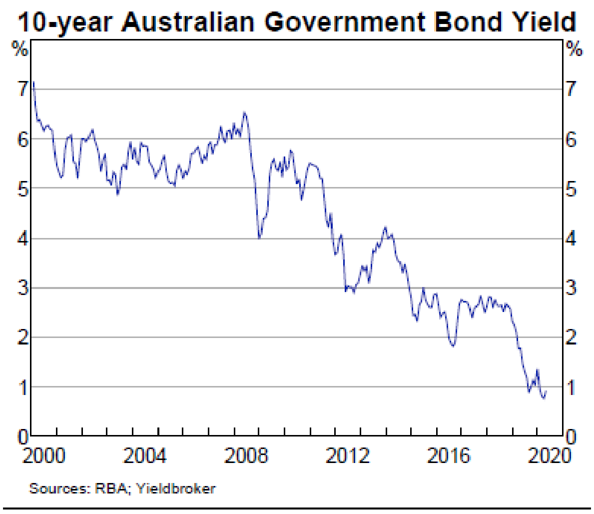
## Bond yields

10 year bond rates are at historical lows, and expected to stay low for the next decade.

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

The Australian Government 30 year bond is priced at 1.8% (August 17, 2020)

http://www.worldgovernmentbonds.com/country/australia/




## Cash Rate - Australia

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

The RBA cut cash rates to 0.25% in March 2020.

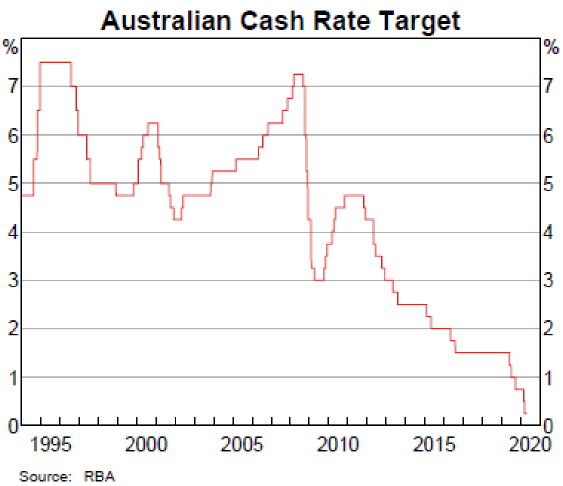
RBA meeting:

- September 1, 2020

https://www.rba.gov.au/schedules-events/calendar-2020.html

Market pricing of interest rate cut to 0.00% at September 1 meeting based on inter-bank cash rate futures: no change: 48%; fall 52%

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




## Interest Rates and QE- International

**Key dates are:**

European Union decisions (now -0.5%)

- September 10, 2020

https://www.profitf.com/calendars/ecb-meeting-dates/

US Federal Reserve decisions (now 0.25%):

- September 15-16, 2020

https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm

Bank of England decisions (now 0.1%)

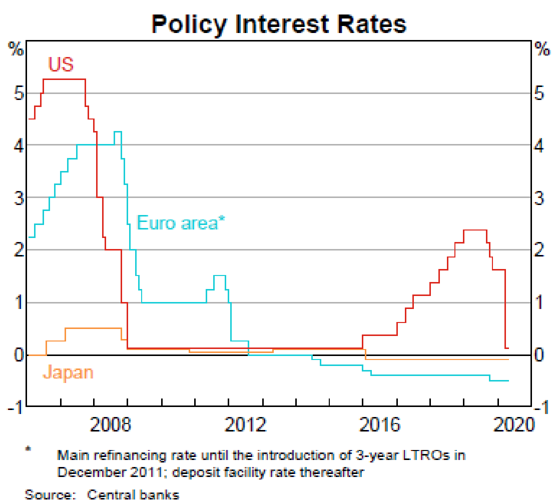
- September 17, 2020

https://www.bankofengland.co.uk/news/2019/september/monetary-policy-committee-dates-for-2020

Bank of Japan decisions (now -0.1%):

- September 16-17, 2020

https://www.boj.or.jp/en/mopo/mpmsche_minu/index.htm/



# WHAT WE ARE READING

On my radar: The pandemic and debt with parameters

https://www.cmgwealth.com/ri/on-my-radar-the-pandemic-and-debt/

On my radar: A wave of bankruptcies ahead – valuation parameters

https://www.cmgwealth.com/ri/on-my-radar-a-wave-of-bankruptcies-ahead/

Gyrostat feature article: Portfolio structure and uncertainty

http://www.gyrostat.com.au/news/feature-article-portfolio-structure-and-uncertainty/

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

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

Further details at: www.gyrostat.com.au

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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.