GYRATIONS

Volatility is our friend

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

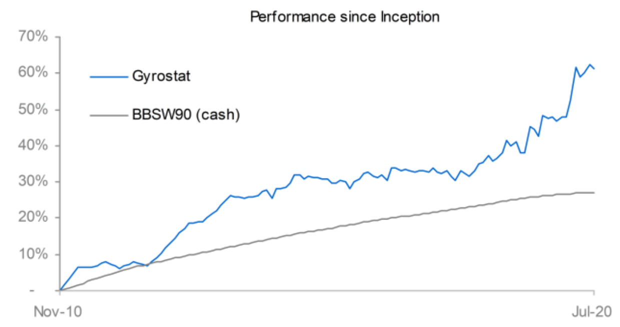
Gyrostat Capital Management Pty Ltd July 2020

THIS MONTH

Why Gyrostat? p 2
Portfolio design p 3
Diversified non correlated
Highly defensive reliable pay-offs
'Hard' protection not predicting
Outlook: p 8
Trojan Horse recovery?

Macroeconomic p 9

What we are reading p11



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

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.

Are you a:

- pre or post retiree wanting regular income with capital security at all times.
- successful career or business executive who now prefers the *freedom* to focus on health, family and friends, passions, rather than fearing stock market falls.

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 to a 'highly defensive' fund:

- lowers portfolio risk.
- increases income.
- improves returns through the investment cycle
- 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).

PORTFOLIO DESIGN

The two key global investment issues today are:

- Achieving a regular and stable income stream in a low interest rate environment with capital security – "defensive" assets.
- Elevated risk of major market corrections in a 'late cycle' environment of stock market volatility impacting capital returns – "growth" assets.

It is well recognised that traditional diversification approaches are not effective in preserving capital in 'late cycle' market conditions. In recent financial crises the value of stocks and bonds have moved together – as a consequence of historically low zero bound interest rates from record global indebtedness.

Diversified non-correlated assets

Instead, an approach that has been well recognised to work for all market conditions is to construct a portfolio with diversified non-correlated assets.

Ray Dalio is the founder, co-Chief Investment Officer and co-Chairman of Bridgewater Associates, which is a global macro investment firm, the world's largest hedge fund.

His brief explanation on portfolio construction is available at:

https://www.youtube.com/watch?v=Nu4lHaSh7D4&t=85s

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.

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 29 July 2020 the SP500 was at 3258. A re-set of the March 23 lows of 2237 would see **31.3% 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.

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

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

Market	High 19 Feb 2020	50% decline level	Market 29 July 2020	50% fall peak to trough scenario	March 23, 2020 lows	Re-test falls
SP500	3386	1693	3258	-48%	2237	-31%
Nasdaq	9817	4808	10542 *	-54%	6860	-35%
ASX200	7163	3581	6001	-40%	4546	-23%
Hang Seng	29056 *20 Jan	14528	24883	-42%	21696	-13%

* Nasdaq has exceeded 19 February 2020 previous high

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.

Contrasting other risk management approaches – growth asset overlay Vs defensive

There are a variety of investment risk management approaches with the objective to meet the equity income needs of retirees and defend against losses in declining markets. As distinct from other approaches Gyrostat is a 'highly defensive' conservative asset allocation with benchmark of BBSW + 3%.

Typically, the investment generates dividends from a diversified portfolio of Australian shares with an investment risk management overlay that aims to reduce the volatility of returns, in particular defending against losses in declining markets. Other approaches typically use an equity index in construction of their performance measurement objectives.

You can compare the effectiveness of these approaches by considering the maximum capital draw-downs and income received. Gyrostat has a maximum drawdown of -2.2% in any circumstances since our inception 10 years ago, and delivered a 'bumper' yield of 5.8% in FY 20.

A brief summary of the approaches is as follows:

- Vary asset allocation between stocks and bonds (diversification)
- 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)

- Buy underlying assets, buy put options (always in place 'hard' risk parameter) – **Gyrostat approach**

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

We always have extra downside protection in place to benefit from market falls. Previously we used to 'protect' – it is now 'protect and benefit'.

To demonstrate, during 2020 the Australian banks fell around 50% and either substantially reduced or suspended dividends. Gyrostat has significant holdings in the Australian banks. With our approach we could sell the additional protection for profits and pass it through to you as a 'bumper' distribution, whilst growing your capital.

Many other investment approaches performed very poorly during this period.

OUTLOOK

The market conditions in July enabled us to enter additional positions for more elevated returns on any uplift in market volatility. Our investment Strategy allows up to 15% of the Fund's assets to be invested in international assets with positions in SP500, Nasdaq, Hang Seng, Nikkei, MSCI China, MSCI Developed and Emerging markets (amongst others).

Returns in July fell moderately consistent with our guidance for stable markets. Our returns for the 2019-20 financial year + 12.9%. At 15 July total returns since January 2018 are + 21.3%, and since inception + 61.7%. %.

The current market conditions (rising stock prices and moderate levels of implied volatility) provide the opportunity to extend the duration of our stock specific and index protection, and to increase our scale of 'left tail' positions to enhance returns in any subsequent market falls.

Our investment view is that stock market volatility will increase and that market lows will be re-tested.

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 the 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 all time highs and the stock market falls are significantly lower than those from a historical context.

Re-stated, the objective is to make ourselves impregnable to defeat in any circumstances, to take opportunities as they are presented by the market, to respond to whatever the external environment presents. This can be achieved by getting the investment structure right – in our case 2 dimensional pay-offs – not predicting.

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

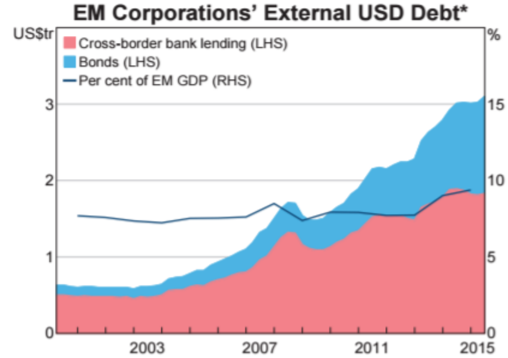
Debt – 'late stages' long term debt cycle

	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%

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

https://www.iif.com/

Graph 1
EM Corporations' External USD Debt*



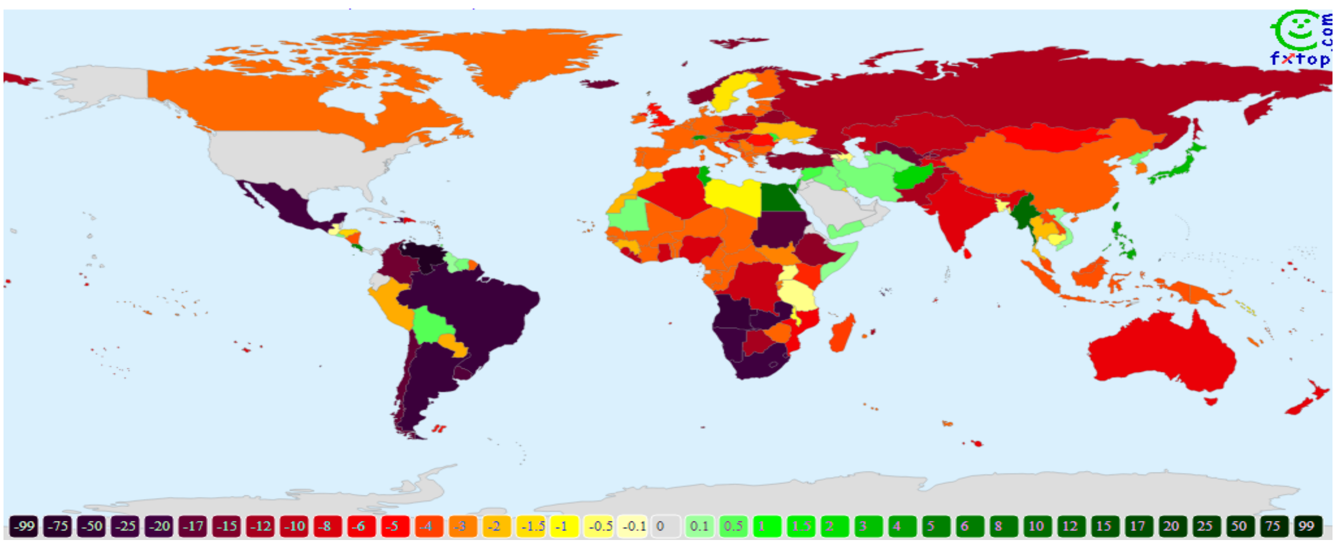
* Includes financials and government-owned corporations
Sources: BIS; Dealogic; IMF

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

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

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



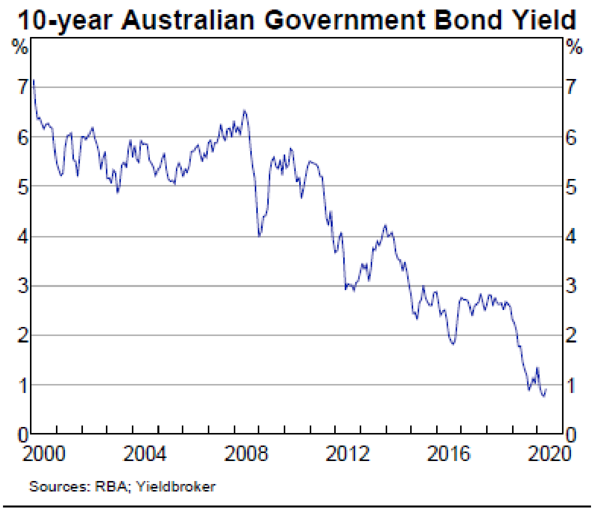
Bond yields

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 1.757% (June 16, 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.

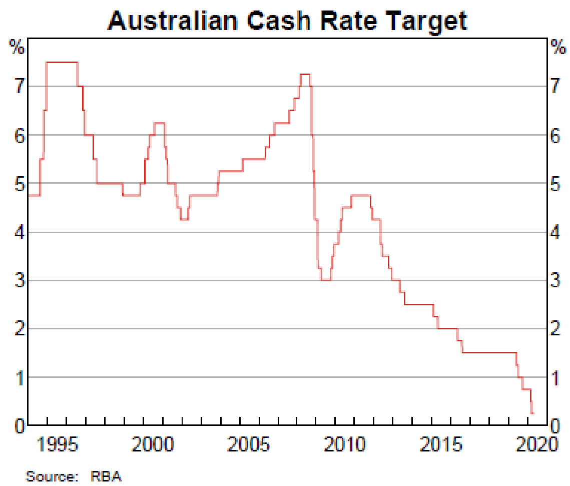
RBA meeting:

- July 7

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

Market pricing of interest rate cut to 0.00% at June 2 meeting based on inter-bank cash rate futures: no change: 43%; fall 57%

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%)

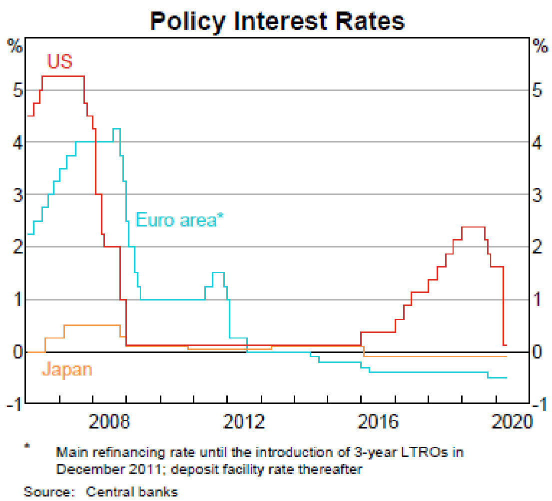
- August 6, 2020

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: A wave of bankruptcies ahead – valuation parameters

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

What comes after the deepest economic crisis since the Great depression?

https://www.zerohedge.com/economics/what-comes-after-deepest-economic-crisis-great-depression

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

Stephen Roach: Project Syndicate – The Crisis of 2020 published 23 December 2019
https://www.project-syndicate.org/commentary/high-economic-vulnerablility-risk-of-major-shock-by-stephen-s-roach-2019-12?barrier=accesspaylog

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/

Further details at: www.gyrostat.com.au