Risk Managed Investing

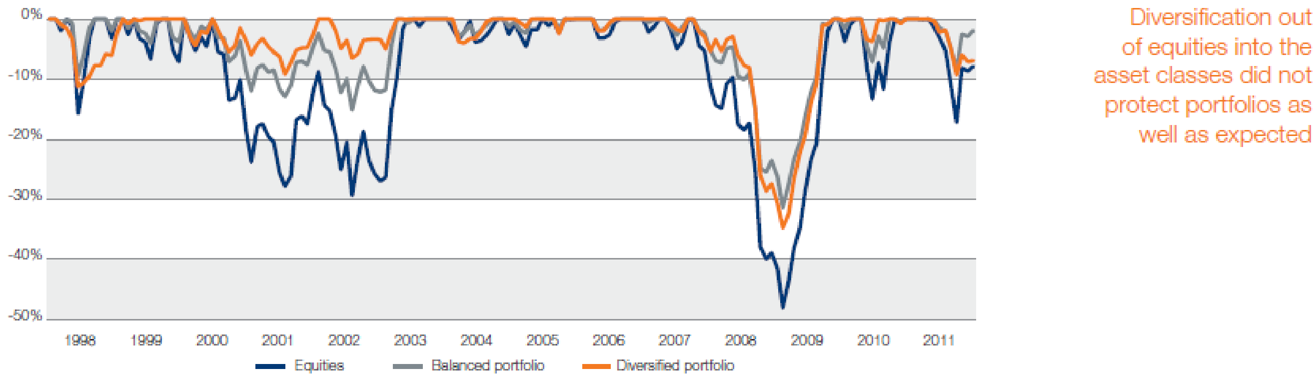
Strategies to <u>optimise</u> a portfolio by simultaneously increasing investment income and decreasing risk exposure.

Why consider risk managed investing?

Portfolio construction can reduce undesirable volatility and large negative stocks through including diversified non correlated assets

- Many portfolios are <u>no longer diversified non correlated</u> as a result of zero bound or negative interest rates
- Stock markets are 'late cycle' and expensive by most valuation metrics – major corrections typically happen over 6-12 months
- Historical drawdown for equities with traditional balance and diversified portfolio did not protect as well as expected

Figure 1: The historical drawdown for equities, a traditional balanced and a diversified portfolio



Source: Schroeders: Effective Downside risk management p7

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What is "best practice" for dynamic risk managed investing?

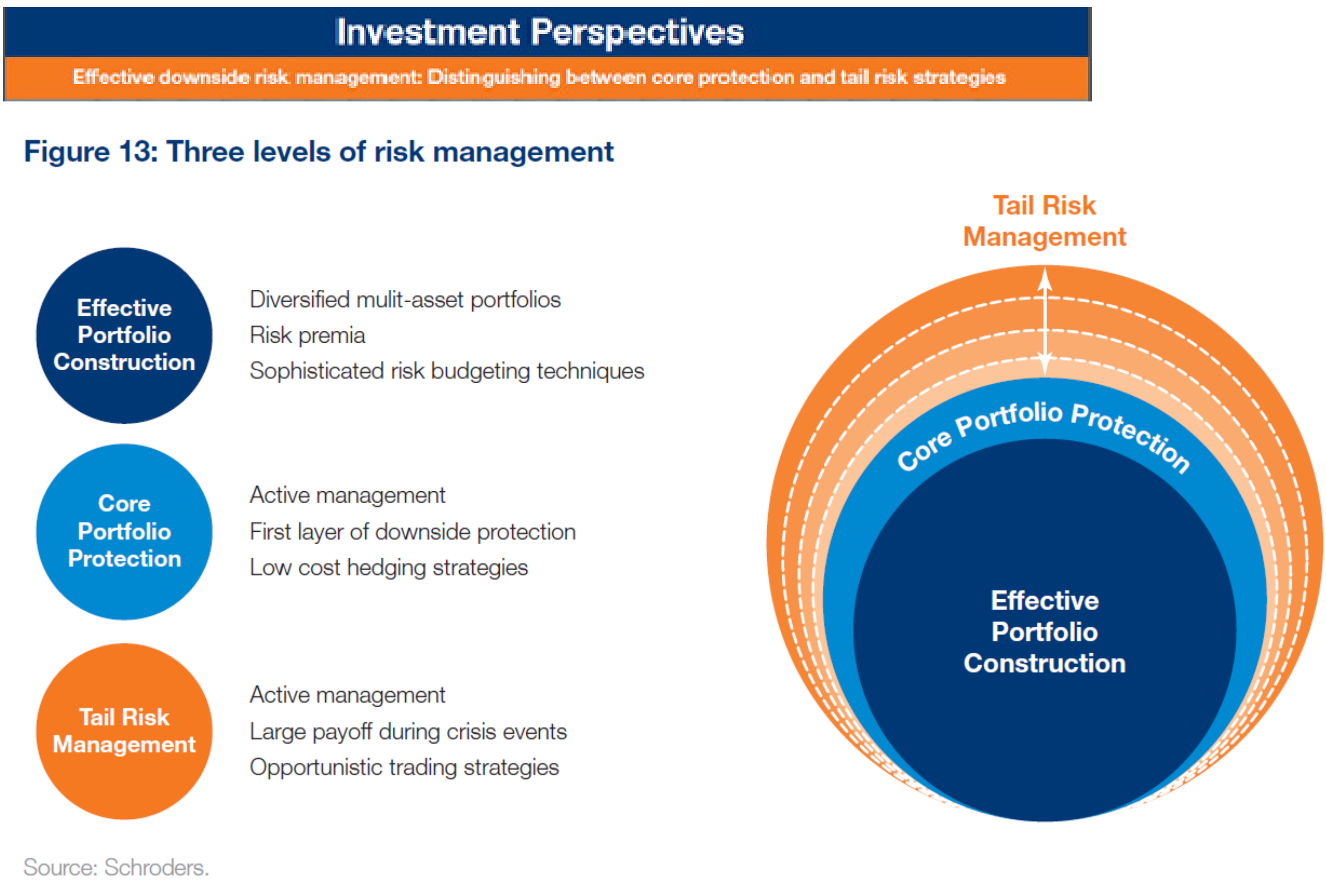
We have reviewed five global papers on dynamic risk managed protection overlays (refer end of this Paper) and two best practice key themes emerge:

- Structure protection between 'core' and 'tail' protection
- Use Dynamic Downside Protection, not buy and hold protection

(a) Structure protection between 'core' and 'tail' protection

<u>Core protection</u> is designed for <u>normal market conditions</u> and provides a positive payoff in moderate corrections.

<u>Tail risk</u> hedges are designed to provide significant gains during <u>extreme market corrections</u>.



Source: Schroeders: Effective Downside risk management p12

(b) Use Dynamic Downside Protection, not buy and hold protection

Protection updated with market moves → for cost effective protection always in place


White Paper

Risk Management Overlay Strategies

Changing the Way Investors Think About Hedging Using the S&P 500® Index and CBOE Exchange Traded Options

March 2015

Jointly presented by:

CBOE EXECUTE SUCCESS

NEXUS RISK MANAGEMENT

S&P DOW JONES INDICES McGRAW HILL FINANCIAL

This paper presents a new way for investors to think about hedging and examines an approach to providing effective downside protection by reshaping the risk distribution based on performance objectives using a new class of risk management overlay ("RMO") strategies.

Momentum and conditioning: a dynamic approach to managing protection

"Experience shows that the systematic purchase of put protection can be costly (as discussed earlier) and that a tactical approach might prove more beneficial. However, as we demonstrate below, the time available to make a profit through tactical option management can be very short in a crisis. Investing in a put option on the S&P500 in January 2011 may initially have appeared a wise choice given the volatility over the year. However, history showed that active management was required either to reset the option in the first quarter, then again in June-July or opportunistically to take profit during the turmoil of the 3rd quarter, as shown in Figure 19. If the buyer did not take some or all of these actions, the portfolio would have absorbed the full expense of the premium expense since the S&P500 finished the year flat."

Source: Schroeders: Effective Downside risk management p17

A dynamic option replication strategy provides investors with the ability to harvest greater upside potential whilst still providing an ongoing level of downside protection."

Source: Russell Research: Dynamic Downside Protection (March 2014) p7

"Through a dynamic option replication strategy there is the ability to participate in a much larger part of the potential upside thus reducing the opportunity cost of implementing a downside protection strategy."

Source: Russell Research: Dynamic Downside Protection (March 2014) p8

"Dynamic downside protection … provide access to a payoff profile that has the potential to provide sufficient downside protection without removing too much upside potential."

Source: Russell Research: Dynamic Downside Protection (March 2014) p19


Russell Research

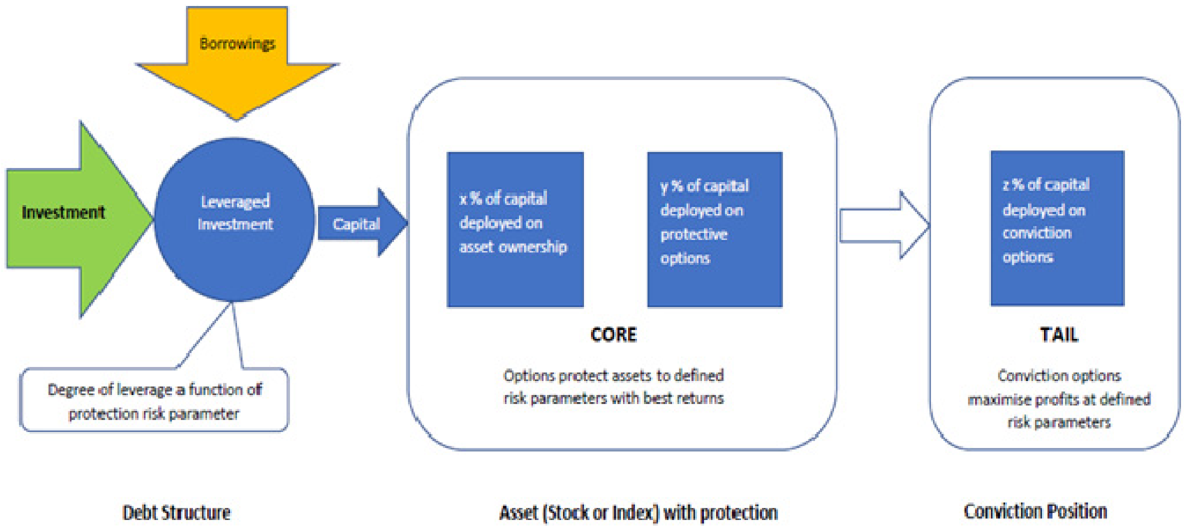
Title: Dynamic Downside Protection

Intelligent, efficient and evolving implementation in action

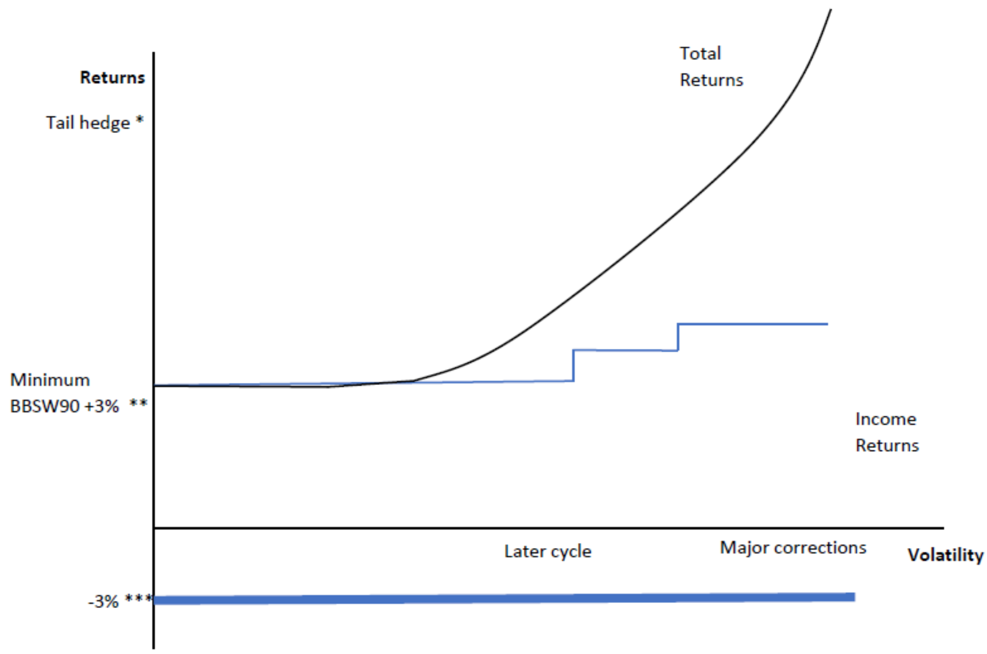
How does Gyrostat implement "best practice" dynamic risk managed investing?

Gyrostat manages both "core" and "tail" dynamically – <u>not buy and hold</u>.

Gyrostat Investment Risk Return Variables



Risk Managed Investing combines returns, income, and protection always



* Tail hedge always in place for large gains on large market falls
** Funded by pass through of ASX20 dividends
*** Hard risk parameter, no quarterly capital drawdowns exceed 3%

Investment opportunities:

Solutions for:

Equity income reliably increases with volatility, absolute return

- Gyrostat Absolute Return Income Equity Class A
- Gyrostat Leveraged Absolute Return Income Equity Class B

Australian and international equities, benchmarked against index

- Gyrostat Risk Managed Australian Equity Class C
- Gyrostat Risk Managed Hong Kong Equity Class D
- Gyrostat Risk Managed Global Equity Class E

Class A investment approach and track record

Gyrostat Absolute Return Income Equity Class A

- **10 year track record no quarterly downsides exceed -3%, downside tail always in place (predefined risk tolerance)**
- **Reliable income even increasing with market volatility**
- **Returns increase with volatility (track record)**

1 Feb 2020 to 31 March 2020: Gyrostat + 9.1% ASX200 – 26.8%

Attachments:-

Schroeders: Effective Downside risk management: Distinguishing between core protection and tail risk strategies

White Paper: Risk Management Overlay Strategies – Changing the Way Investors Think About Hedging CBOE, S&P Dow Jones, Nexus Risk Management (March 2015)

Russell Research: Dynamic Downside Protection (March 2014)

White Paper: Risk Management Overlay Strategies, Changing the Ways Investors Think About Hedging NEPC (March 2015)

BNP Paribas: Equity Risk Overlays (May 2020)