Dynamic hedging can solve the retirement income product dilemma

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<u>The problem</u>: ***A lack of retirement income products which protect and grow capital through the complete investment cycle***

There have been more than 10 years of Government retirement income reviews in Australia to encourage the development of retiree income products with downside protection.

The Financial System Enquiry, commissioned by the Australian Government concluded in their final report in 2014:

"The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees."

As recently as 23 June 2022 speaking at the Trans-Tasman Business Circle event APRA chair Wayne Byres said the superannuation sector is not equipped to deal with the current "significant demographic shift".

"An ever-growing number of members shift each year from the accumulation to the retirement phase, only to encounter a lack of accessible financial advice or suitable products to help manage their nest eggs for potentially decades to come."

In plain speech, this means retiree investors are exposed to significant losses of their capital with stock market falls, which is a regular and hazardous feature of the market. This can be measured by the maximum drawdown losses during the period of the investment, a commonly quoted statistic for all fund managers.

<u>What is needed:</u> ***Retirement income product specifications – the criteria to be satisfied***

The various reviews have listed the criteria to be satisfied as follows: regular income, capital protection and growth, no lock in periods for investors, transparent pricing, address sequencing risk (major market falls reducing capital value), longevity risk (capital to grow through the complete investment cycle), strong counterparty and no credit default risks.

This 'template' of reviews has garnered significant industry comment and provides a template for retirement income product and innovation managers.

We believe that Gyrostat Risk Managed Equity Fund Class A satisfies all these requirements.

"Blue chip shares with protection for retiree income, 12 M +12.28%, 11 year track record of no quarterly downside losses > 3%, volatility is our friend with capital gains in rising and falling markets."

***The solution*: Dynamic hedging – technology to the rescue**

In 2011 global asset manager Russell Research concluded dynamic hedging provides downside protection offers at a reasonable price. It's an approach that is also being used by leading global asset managers. Gyrostat benchmarks against these managers, as outlined in our review published in June 2021. Gyrostat commenced operations in December 2010.

2021-06-11-Risk-Managed-Investing-Supporting-Pack-v1b.pdf

A summary of the risk management approaches is as follows:

- *Vary asset allocation between stocks and bonds (diversification)*
- *Buy underlying assets, write call options (Buy-write income funds)*
- *Long/short funds (market neutral, 130/30)*
- *Buy underlying assets, using a predictive approach to sell futures contracts at some times*
- *Buy underlying assets, buy put options at selected times using predictive approaches*
- *Buy put options and hold cash (volatility as an asset class)*
- *Dynamic risk managed protection overlays (dynamic hedging)*

In plain speech, when Gyrostat utilises dynamic hedging of every $ 1 invested, approximately 95c buys the stock, and around 5c the lowest cost protection. As the market price moves, the "gyrostat" is brought back into balance to restore this 95:5 recipe. This means if the stock falls, the value of protection goes up – the protection has done its job and a portion is sold for cash. On stock rises, the value of protection falls and more is acquired.

The aim is to achieve a stable and rising capital value, with income from the blue chip stock dividends and capital protection provided by entering option positions using a portion of the cashflow from dividends. In Australia, these are typically ASX20 stocks that also attach 'franking credits', offering additional benefits to retiree investors on zero or low marginal tax rates.

To implement this strategy requires sophisticated proprietary software systems. The key is to immediately identify the differences in the pricing of options (which academics have noted for decades have different levels of implied volatility) to identify the lowest cost protection in the market at that time. It was necessary for Gyrostat to build sophisticated systems which feed in live pricing from the stock exchange, immediately interpret the live data to identify the lowest cost protection and recommend the trades to make. Initially a 'hard risk' tolerance or limit on capital loss of no more than 2% per quarter was set, which was increased to 3% in March 2019.

Gyrostat has consistently delivered income to investors (quarterly with bumper payment in 4th quarter in strong return years) and has a track record of over eleven years with no quarterly drawdown greater than the pre-defined 3% limit. It has been designed to reliably increase in value on major market falls – a valuable offset to losses experienced in other parts of the retiree investors portfolio during stock market falls.

Gyrostat have partnered with Damien Hatfield and Tim Cheung and their team at Mantis in 2020 as distribution partner. *"Our class A fund offers "blue chip shares with protection, for retiree income", with class B a levered version (higher risk tolerance, higher expected return)".*