Mitigating sequencing risk through dynamic hedging

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Overview

Sequencing risk, or "sequence of returns risk", refers to the potential impact of the order and timing in which returns are received on the overall performance of an investment portfolio. When markets fluctuate more widely, the timing and order of returns are of more concern, particularly for investors that have liquidity needs from their portfolios.

One way to mitigate sequencing risk is to add non-correlated assets to the portfolio. By holding a mix of assets that have low or negative correlations with each other and with the stock market, an investor can reduce the volatility of their portfolio and smooth out their returns over time. For example, if some stocks decline in value, other non-correlated assets may increase in value or at least maintain their value, offsetting the losses.

Key points:

- Sequencing risk is very real and elevated
- Traditional (60:40) approaches are no longer as effective
- Solution is to add assets that are truly non-correlated to the portfolio
- Gyrostat is one such asset; shares always protected for non-correlated returns with lower volatility

Elevated sequencing risk

The short-term outlook is difficult to read, and so it makes sense to look at the bigger picture to better understand where markets and economies are heading. Billionaire investor Ray Dalio, founder of hedge fund giant Bridgewater Associates, recently argued[1] that the world is “on the brink of a period of great disorder” as we approach the end of a long-term debt cycle that started in the wake of World War II.

The five megatrends that Dalio says will end what he has called the “big cycle” can provide investors with a way of thinking about the uncertainties facing markets and economies.

1. The creation of enormous amounts of debt bought by central banks via their printing of money and buying the debt (i.e., monetizing debt)—in other words, the government financing itself in a big way by both borrowing a lot and printing a lot of money.
2. Big conflicts within countries (now most importantly the US) prompted by the largest wealth and values gaps in our lifetimes, which are leading to the emergence of populists of the left and the right who are fighting with each other.
3. Big conflicts between countries arising from the rise of countries (now most importantly China) that are becoming roughly powerful enough to be able to challenge the existing world powers (most importantly the US) and the world order (most importantly the American world order).
4. Acts of nature (droughts, floods, and pandemics)—i.e., climate change.
5. Technology changes—e.g., the First and Second Industrial Revolution, computing, and the internet, AI.

[1] https://lnkd.in/eXDdhNGj

On their own, each of Dalio's megatrends are important for investors to consider. But his key point is that at least four of the five are in play at the same time.

"When these forces come together in the magnitudes that we are now seeing, history has shown that it is likely that we experience seismic shifts in financial orders, domestic orders, and world orders," he says.

"In other words, there is little doubt in my mind that the existing world order is changing rapidly in challenging ways and that people who are living on the assumption that things will work in the orderly ways that they have gotten used to will be shocked and hurt by these changes to come."

Traditional approaches are no longer effective

From an investing standpoint, 2022 was a year like no other.

After the sharpest central bank interest rate cycle in many decades and quantitative tightening to contain inflation, 2022 ended with share market falls. Investors couldn't rely on bonds to cushion the losses of their riskier assets, as they had in past crises. In 2022 the 60:40 "diversified" portfolio didn't work.

The foundational 60/40 portfolio, where 60% is invested in stocks and 40% in bonds was the initial starting point for many portfolios. The balance of this 60/40 mix then adjusts based on an investor's time horizon, risk tolerance and financial goals, but its stock-bond combination is core to what is considered a "diversified" portfolio.

Typically, when growth assets, like stocks, sell off due to economic slowdowns, defensive assets like bonds appreciate. While stocks tend to suffer in a recession due to less economic growth, bonds can rally because the central banks typically cut interest rates to support the economy. When interest rates are cut, bond yields drop but bond prices go up. This provides a shock absorber in the portfolio, helping to cushion overall returns when stocks are falling.

Bonds may be a reliable diversifier when economic growth is slowing – but not necessarily when inflation is increasing. Why? Because when stocks decline due to rising inflation concerns, central banks may simultaneously have to raise interest rates to slow inflation. In the end, bonds may lose out as well, potentially exacerbating losses in a diversified 60/40

In summary there are circumstances where stocks and bonds are appreciably correlated and do not provide sufficient diversification to a portfolio.

Solution is to add assets that are truly non-correlated to the portfolio

Rather than the traditional 60:40 portfolio some more proactive investors are also incorporating a range of 'alternative' assets that meet the specific needs of their conservative investor base. By constructing an investment portfolio holding a mix of assets that have low or negative correlations with each other and with the stock market, an investor can reduce the volatility of their portfolio and smooth out their returns over time. For example, if stocks decline in value, non-correlated assets may increase in value or at least maintain their value, offsetting the losses.

Ray Dalio gives a brief explanation on portfolio construction at:
https://www.youtube.com/watch?v=Nu4lHaSh7D4&t=85s

Gyrostat - always protected, non-correlated with the market with lower volatility

Gyrostat Risk Managed Equity Fund uses dynamic hedging to manage the trade-off between returns, income, and protection levels (risk). Our approach is focused on a pre-defined quarterly 'hard' risk parameter, and then to maximise returns and income within that constraint. A secondary consideration is the source of returns, in particular the level of correlation with the market. From established finance theory adding non correlated assets is of significant value to the overall portfolio, so the Gyrostat approach has been to generate returns in rising and falling markets, which increase with volatility.

AT A GLANCE

- Class B Units +26.23% are the top performing and Class A Units + 18.90% are the 4th top performing absolute return funds in Australia over the 12 months to 31 March 2023 according to FE Analytics[2].
- Shares always protected: Absolute returns and income with protection always in place (dynamic hedging) adjusted with market moves (not set and forget).
- Non correlated returns in rising and falling markets with low volatility.
- Class A Units: 12 years of no quarterly losses > 3% (pre-defined 'hard' limit) with downside 'tail' always in place for gains on large market falls to address sequencing risk- for conservative and moderate portfolios.
- Class B Units: Leveraged with focuses on greater returns and less risk protection – for growth and high growth portfolios.
- Regular quarterly income: Class A Units BBSW3M + 3% (currently 6.6% pa; Class B Units BBSW3M +6% (currently 9.6% pa).
- Daily liquidity and no locks ins.
- Track record of returns increasing with market volatility ('changing' markets since Jan 2022).
- SQM Research 4 stars, Superior, High Investment Grade Rating.
- Forward guidance returns FY2023-24 at top of range based upon continuing market volatility.

In simple terms, when Gyrostat utilises dynamic hedging, of every $ 1 invested, approximately 95c buys the stock, and around 5c the lowest cost option 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 the option 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.

Since our inception in December 2010 Gyrostat Class A Units have a track record of no quarterly downside exceeding our quarterly pre-defined loss limit of 3%. The performance of the Gyrostat Absolute Return Income Equity Fund Class A Units since inception compared with the worst 5 quarterly returns from the ASX accumulation index were:

Period	ASX accumulation return	Gyrostat Class A return
Apr - Jun 2022	-11.90%	8.70%
Jan - Mar 2020	-23.10%	9.22%
Oct - Dec 2018	-8.24%	4.18%
Jul - Sep 2015	-6.58%	-0.26%
Jul - Sep 2011	-8.17%	1.29%

[2] FE Analytics Report generated 13 April 2023 comparing the 12-month performance of the 71 funds constituting the Australian Managed Investments Absolute Return Sector

FURTHER INFORMATION

Corporate presentation:

http://www.gyrostat.com.au/assets/Uploads/2022-03-31-Gyrostat-Presentation-Class-A-and-B-Final.pdf

Global benchmarking: Dynamic hedging risk management for sequencing risk

http://www.gyrostat.com.au/assets/Uploads/2023-02-09-Dynamic-Hedging-Article-final.pdf
http://www.gyrostat.com.au/assets/Uploads/2022-06-28-Article-Dynamic-Hedging-v1f-final-approved.pdf
https://www.gyrostat.com.au/assets/Uploads/2021-06-11-Risk-Managed-Investing-Supporting-Pack-v1b.pdf

Performance reports:

http://www.gyrostat.com.au/assets/Download/List/Document/2023-03-31-GYROSTAT-Class-A-Final.pdf
http://www.gyrostat.com.au/assets/Download/List/Document/2023-03-31-GYROSTAT-Class-B-Final.pdf

Disclaimer

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