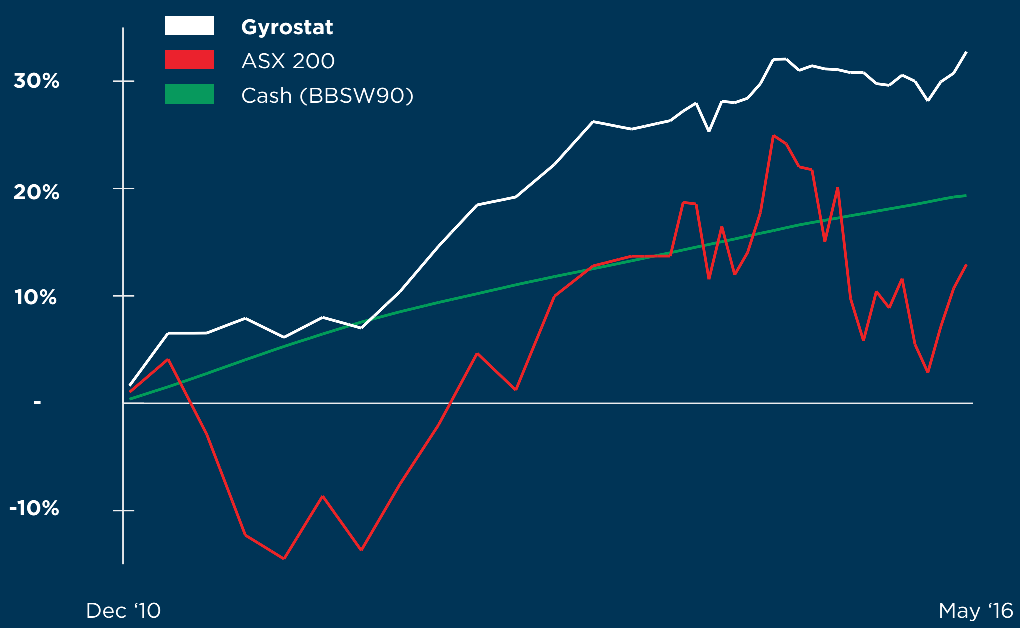
GYROSTAT
RISK MANAGED EQUITY FUNDS

"GYRATIONS"

Insights into risk management of an equity portfolio

Key data releases with market pricing of outcomes

31 May 2016



Gyrations – insights into risk management of an equity portfolio

By Craig Racine, Managing Director and Chief Investment Officer, Gyrostat Capital Management

- We detail investor sentiment and key upcoming data released with market pricing of outcomes.
- Our investment view is that interest rates will stay low for an extended period, and stock market volatility will increase. During 2012-2016 the level of volatility was low by historical standards. Our expectation is that volatility will increase, leading to "risk-on", "risk-off" investing market characteristics only distantly related to fundamentals.
- The "traditional" approach to investing directly in blue chip high yielding shares, or conventional income funds, leave investors fragile and exposed to falls in the value of investments. Falling interest rates and rising market volatility are ideal market conditions for risk managed equity income funds with a "hockey stick" payoff always in place. The more volatility, the more opportunities there are to capture upside and re-balance the portfolio.

Outlook

Our investment view is that interest rates will stay low for an extended period, and stock market volatility will increase. During 2012-2016 the level of volatility was low. Historically volatility has remained low for periods of 4 years - 1992-1996, 2002-2006, and 2012-2016. Volatility has started to increase and is likely to continue.

These are dangerous times for traditional investment approaches with global total debt outstanding as a percentage of GDP at historical highs. GDP growth remains below trend, interest rates are at historical lows, and central banks are implementing unconventional monetary policies.

Increased volatility is often experienced around key data releases relating to interest rates, growth, inflation rates, and key political events. These dates are detailed, along with market pricing of likely outcomes where available. We present data from futures markets, credit default swaps, and online betting odds.

Our expectation is that volatility will increase, with "risk-on", "risk-off" investing occurring only distantly related to fundamentals. Investors should approach these markets with confidence with a 'hockey stick pay off' profile set to always participate in the upside with minimal capital at risk.

Volatility S&P500 (VIX) 1990 – 2016

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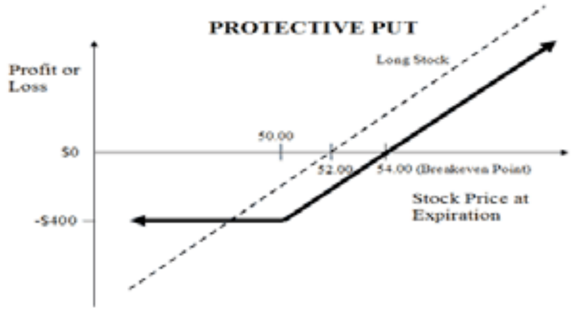
Traditional investment approaches have a "straight line" pay-off. In contrast, risk managed equity funds always have a "hockey stick" profile to participate in the upside with minimal capital at risk.

On market moves we re-set the insurance level. If the share price rises, we buy more to 'lock in' the gains – on falls we sell some that is no longer required.

A put option gives you the right to sell a stock at a pre-defined price for a pre-defined period of time. You don't have to sell the stock; you can sell the protection back into the market and receive the cash.



Protective Put Payoff Diagram

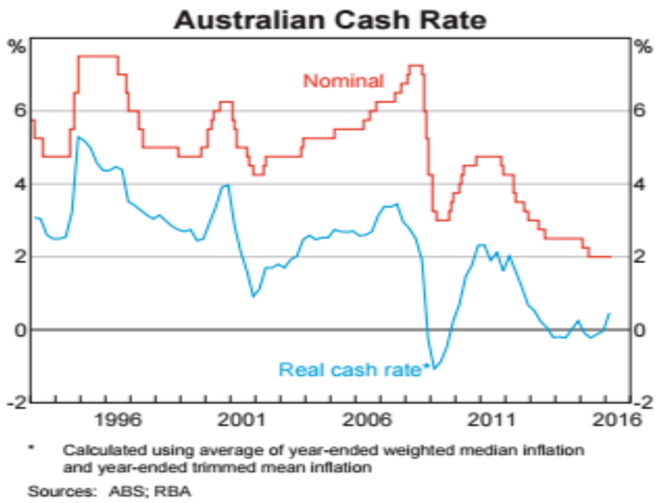
Australian volatility A-VIX 2012-2016

Understanding the A-VIX

The S&P/ASX 200 VIX (A-VIX) is a real-time volatility index provides an insight into investor sentiment and expected levels of market volatility. The index tracks S&P/ASX 200 index option prices as a means of monitoring anticipated levels of near-term volatility in the Australian equity market.

The level of implied volatility has been rising, but is still low by historical standards.

Cash Rate - Australia



- The RBA cut cash rates to 1.75% on 3 May 2016
- Upcoming RBA meetings:
  - **June 7**
  - July 5
  - August 2
- Market pricing of interest rate cut to 1.5% at June meeting based on inter-bank cash rate futures
- No cut: 90%   Cut 10%

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

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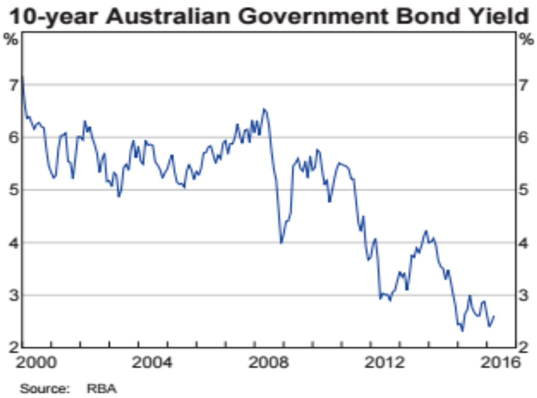
Bond Yield - Australia



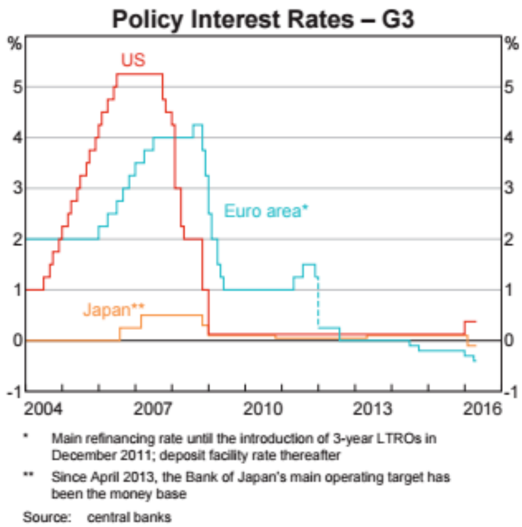
- The Australian Government 10 year bond rate on 16 May 2016 fell to 141 year lows.

Interest Rates – International

- Upcoming US Federal Reserve decision:
  - Jun 16 (also Chair speech Jun 6)
  - Jul 28
  - Sep 22

- Upcoming Bank of Japan decision:
  - Jun 16
  - Jul 29
  - Sep 21

- Upcoming European Union decision:
  - Jun 2
  - Jul 21
  - Sep 8



GDP Growth– World

GDP growth remains below trend, see IMF April world outlook "Too slow for too long."

June 1: Australia GDP growth. Previous annualised 3.0% exceeding expectations. Highest since 3Q2012.

June 3: US payrolls. Previous 160,000 below consensus 202,000.

June 14: US retail sales. Previous + 1.3% YoY to March above consensus.

June 16: Australia employment change.

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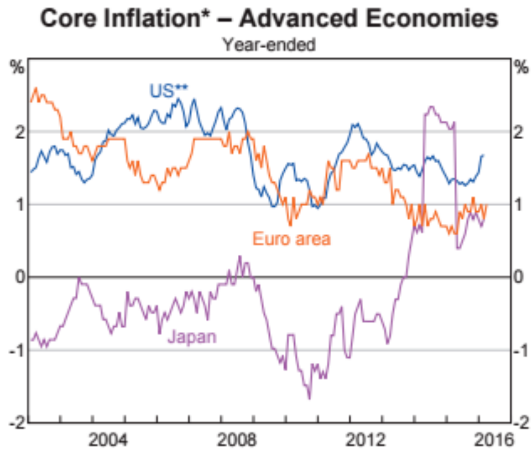
Inflation

Jun 9: China inflation. Previous 2.3% YoY to April slightly below consensus.

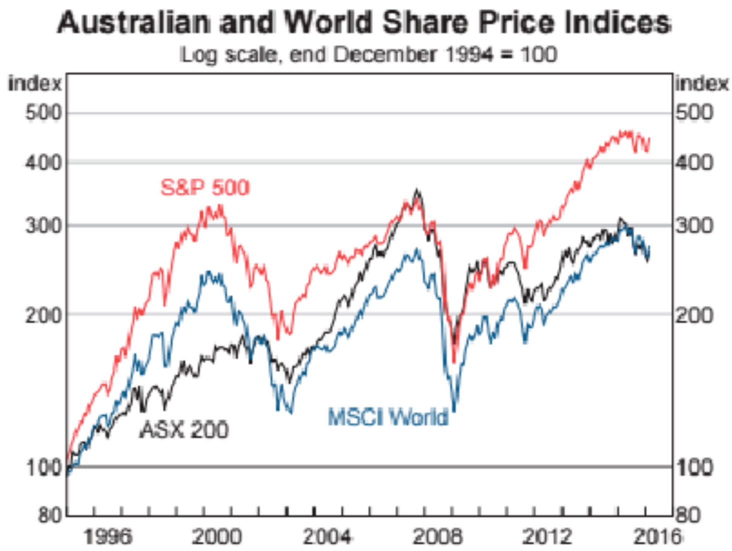
June 16: USA core inflation rate. Previous 2.1% in line with consensus.

July 22: Australia inflation rate. Previous 1.3% below consensus.



* Excluding food and energy, and for the euro area also excluding alcohol and tobacco
** Core price index for personal consumption expenditures
Source: Thomson Reuters

Share Indices



Sources: Bloomberg; MSCI; RBA

Bear markets historically occur every 4 ½ to 5 ½ years

The graph shows price declines since 1929 (range 25% to 90%, average 38%) and duration of decline (22 to 160 weeks)

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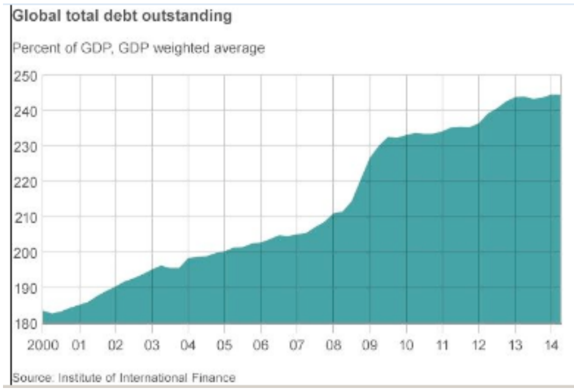
Global Debt



Global total debt outstanding as a % of GDP has grown from 180% in 2000 to over 240%, and is at historical highs.

This increases the fragility to market sell-offs.

Macro events

June 23: Britain EU vote.

- Stay $ 1.18 Exit $ 4.50

July 2: Australian Federal election

- Coalition $ 1.30 ALP $ 3.60

November 8: USA Presidential election

- Democrats/Clinton: $ 1.50
- Republicans/Trump: $ 3.00

* Pricing based on online betting odds

Credit Default Swaps

A credit defaults swap (CDS) transfers credit risk from the buyer to seller in return for a premium. The market price of the premiums varies with perception of risk of default.

- China 5 year sovereign bonds.
    - 125 basis points (up 2 basis points past 1 month)
- United Kingdom 5 year sovereign bonds
    - 35 basis points (down 3 basis points past month)

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Retirement planning **Craig Racine**

End of seven-year rule brings a new ball game

For the first time in the history of the ASX, the All Ordinaries Index is lower than it was seven years ago. The seven-year rule used to be a persuasive sales pitch for financial planners. Now it is gone.

Times have changed. Global debt has increased by $57 trillion since 2007 and interest rates are at record low levels. Rental yields are heading in the same direction. Sharemarket volatility around the world adds to the uncertainties facing retirees.

Australia escaped the worst of the global financial crisis, but the record 25-year run of prosperity and growth seems set to end soon. The economic tremors in China and Europe add more uncertainty. This all spells trouble for retirement planning as the peak of the baby boom bulge moves past 65. In Paris last month, OECD secretary-general Angel Gurria warned about the risks created by current conditions.

He said: "Increasingly pension funds and life insurers are feeling the pressure to chase yield themselves, and to pursue higher risk investment strategies that could ultimately undermine their solvency. This not only poses financial sector risks, but potentially jeopardises the secure retirement of our citizens."

Reserve Bank of Australia governor Glenn Stevens recently questioned how an adequate flow of income could be generated for the retired "in a world where nominal returns on low-risk assets are so low".

David Murray, the chairman of the Financial System Inquiry, added more doubt when he said recently that "the retirement phase of superannuation is undeveloped and provides limited choice for managing risk in retirement". Put simply, the traditional approaches of buying high yielding stocks or buying stocks and selling call options are fragile and exposed.

Most attention on the financial planning industry recently has been, quite rightly, on the graft and corruption exposed by Fairfax Media in some of our biggest institutions. But the wider, long-term question is how the industry will produce income for its clients and manage the new risks. One answer is to deploy two other great movements of the past 25 years – technology and deregulation.

Deregulation allows fund managers and individuals to make unlimited numbers of transactions at low cost without the requirement to use a full service broker or other third party. And sophisticated software allows instant monitoring of large numbers of price movements simultaneously.

The deployment of these two weapons allows a form of insurance with downside protection always in place through the use of put and call options to lock in the sale price of the shares, no matter how low the share price may go.

The theoretical knowledge for this approach has been around since 1973 when Fisher Black and Myron Scholes published a paper that was the basis for a Nobel prize in economics awarded 14 years later. Their work created one of the most important concepts in modern financial theory, the mathematical model for pricing derivative investment instruments, including options. Recent software developments have opened the way for new ways to apply the model with deeper levels of sophistication and speed.

Most fund managers will be searching for ways to adapt to the new market paradigms to deliver better returns in a sluggish investment environment. This introduces another risk for investors who may be at the mercy of unintended consequences of new investment products.

Some exotic products will be exposed as fatally flawed. A recent example is bank hybrids, which were supposed to be a cross between the safety of cash and the risk of shares, with a yield somewhere in between. Unfortunately, some investors have found that hybrids are capable not only of producing the best of both worlds, but also the worst.

Investors and trustees of self-managed superannuation funds need to get used to the marketing by financial planners of more novel products aimed at producing higher returns than the old formulas. Investors should look for strategies with a proven track record. Those asked to participate in novel approaches should check for safeguards, including a straightforward business model with minimal capital at risk at all times and a financially strong counterparty such as the ASX for hedging activities, be cautious about leverage within a fund, ensure instruments are traded on an exchange which provides transparency and ask questions about whether the offering is robust in all market conditions.

Craig Racine is managing director of Gyrostat Capital Management.

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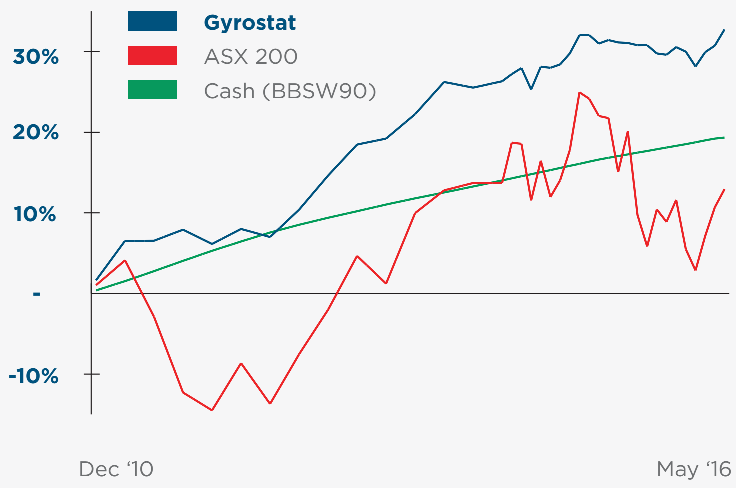
If your objective is to generate a higher level of income than cash and term deposits, whilst always protecting and growing your capital investment...

...OUR FUND CAN HELP.

Risk managed equity income fund

- Minimum distribution cash rate plus 3% (currently 5.3%)
- Growing your investment on market rises or large 'one off' falls
- Protecting your investment when markets fall
- Compounded returns of 33% since inception
- 21 consecutive quarters of no losses exceeding 2%



WE BUY AND HOLD BLUE CHIP STOCKS AND PASS ON THE FRANKED DIVIDEND.

We simultaneously enter the Australian Securities Exchange ("ASX") options market to hedge risk.

We are always fully invested with minimal capital at risk.

Our Track Record of Returns:

Period	Gyrostat	ASX 200	BBSW 3M
31 Mar 2012	6.1%	-6.7%	4.9%
31 Mar 2013	7.6%	2.0%	4.3%
31 Mar 2014	7.1%	4.0%	3.8%
31 Mar 2015	6.7%	5.2%	3.6%
31 Mar 2016	5.1%	1.3%	3.3%

* compunded annualised returns since inception

Business Model - "How we invest"

Unit Trust

Investors purchase units in "Gyrostat Capital Stability Income Fund".

The fund net income is dividends and franking credits less expenses and the cost of protection.

Stock Market ASX

The fund simultaneously buys stock and enters ASX options market

Stocks are "buy and hold" to generate dividends and franking credits

Options Market ASX

For hedging risk only we use calls and put options to grow your investment when markets rise, and protect your investment when markets fall.

Daily management to restore risk-return profile from market movements

Technology & Deregulation

Software continuously monitors price movements to identify "least cost" alternatives to restore risk-return pay-off from market moves.

Deregulation enables low cost transactions

Further details available at:
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