"Do it yourself" equity protection - explanation and cost

The theoretical knowledge on how to "insure" your portfolio has been around since 1973 when Fisher Black and Myron Scholes published a paper, the basis for which a Nobel Prize in Economics was awarded fourteen 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.

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. It is like an insurance policy, but like all insurance it comes at a price.

The ASX offers investor education at their web-site for the "do it yourself" alternative.

http://www.asx.com.au/products/equity-options.htm
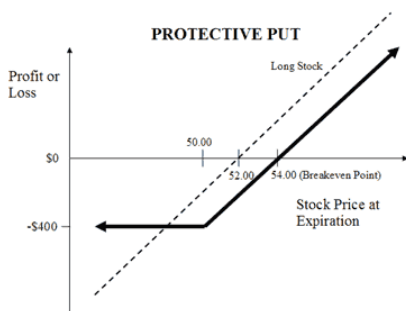
Protective Put Payoff Diagram

The level of implied volatility is one of the key determinants of the price of an option. This is the price of risk. At the market level this is reflected by the A-VIX

Understanding the A-VIX

The S&P/ASX 200 VIX (A-VIX) is a real-time volatility index that provides investors, financial media, researchers and economists with 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.

Since 2009 a chart of the A-VIX is shown below. The investor challenge is to 'convert' this to an annualized cost.

http://www.asx.com.au/products/sp-asx200-vix-index.htm
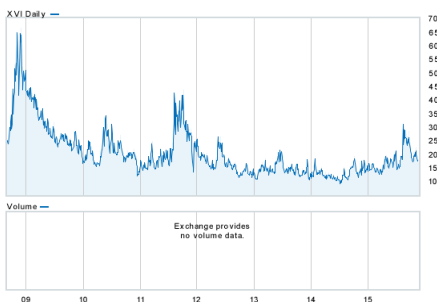
We have obtained live market prices with strike prices closest to 0%, 5% and 10% capital at risk. We have calculated the level of implied volatility and then extrapolated the option price to enable a comparison across the stocks and the index. These have been converted to an annualized cost based on holding the option position to expiry.

As at close of business Friday 8th[th] January the current market conditions are:

XJO Index

Capital at risk	Annualised Cost for 1 Month	Annualised Cost for 3 Months	Annualised Cost for 6 Months	Annualised Cost for 12 Months
0%	-47%	-21%	-13%	-9%
5%	-11%	-12%	-9%	-7%
10%	-3%	-7%	-6%	-5%

Stock specific select widely held stocks – by market capitalization

Commonwealth Bank of Australia

Capital at risk	Annualised Cost for 1 Month	Annualised Cost for 3 Months	Annualised Cost for 6 Months	Annualised Cost for 12 Months
0%	-30%	-17%	-10%	-8%
5%	-13%	-14%	-9%	-7%
10%	-5%	-8%	-6%	-5%

Westpac Banking Corporation

Capital at risk	Annualised Cost for 1 Month	Annualised Cost for 3 Months	Annualised Cost for 6 Months	Annualised Cost for 12 Months
0%	-41%	-20%	-15%	-10%
5%	-17%	-12%	-10%	-8%
10%	-8%	-7%	-7%	-6%

Australia and New Zealand Banking Group Limited

Capital at risk	Annualised Cost for 1 Month	Annualised Cost for 3 Months	Annualised Cost for 6 Months	Annualised Cost for 12 Months
0%	-48%	-22%	-16%	-11%
5%	-19%	-13%	-11%	-8%
10%	-9%	-8%	-8%	-7%

National Australia Bank Limited

Capital at risk	Annualised Cost for 1 Month	Annualised Cost for 3 Months	Annualised Cost for 6 Months	Annualised Cost for 12 Months
0%	-45%	-21%	-15%	-11%
5%	-17%	-13%	-11%	-8%
10%	-7%	-8%	-7%	-6%

BHP Billiton Limited

Capital at risk	Annualised Cost for 1 Month	Annualised Cost for 3 Months	Annualised Cost for 6 Months	Annualised Cost for 12 Months
0%	-72%	-39%	-22%	-14%
5%	-38%	-28%	-17%	-12%
10%	-19%	-20%	-13%	-10%

Telstra Corporation Limited

Capital at risk	Annualised Cost for 1 Month	Annualised Cost for 3 Months	Annualised Cost for 6 Months	Annualised Cost for 12 Months
0%	-34%	-24%	-13%	-9%
5%	-9%	-14%	-9%	-7%
10%	-3%	-6%	-5%	-5%

Wesfarmers Limited

Capital at risk	Annualised Cost for 1 Month	Annualised Cost for 3 Months	Annualised Cost for 6 Months	Annualised Cost for 12 Months
0%	-36%	-24%	-14%	-9%
5%	-11%	-15%	-9%	-7%
10%	-3%	-8%	-6%	-5%

Woolworths Limited

Capital at risk	Annualised Cost for 1 Month	Annualised Cost for 3 Months	Annualised Cost for 6 Months	Annualised Cost for 12 Months
0%	-46%	-29%	-27%	-11%
5%	-16%	-19%	-12%	-9%
10%	-7%	-12%	-9%	-8%

Protection always in place at an acceptable price

Active management of the ASX options is the key to lowering its cost.

In particular:

- There are differing levels of 'implied volatility' in the option market from differing maturities, or within the same maturity across a different range of strike prices. This has been observed by academics and market participants for many decades. Technology and software enables these to be identified in 'real time'.
- To further lower the cost of protection, you can receive premiums in return for limiting some of the upside. This is achieved by selling call options. Again, there are many series to choose from.
- With market movements, the "options" component can be actively managed. The trading reduces the cost. By actively managing, on market rises - locking in the gains with more protection; on market falls - sell some protection which is no longer required. Sophisticated software allows instant monitoring of a large number of price movements simultaneously.
- Transaction costs have fallen with deregulation. Deregulation allows funds managers and individuals to execute transactions at a low cost without the requirement to use a full service broker.

This is the approach taken by Gyrostat Capital Management. Gyrostat buys and holds blue-chip high yielding stocks and generates income from dividends and franking credits. The stocks are never sold – they are held for yield. We then use stock and index options publicly traded on ASX to hedge the risk of losing capital if the stock prices drop. The option positions are actively managed to restore the risk-return profile from market moves.

Gyrostat's key competitive advantage is the ability to have cost effective downside protection in place at all times, at a stock specific level.

Business Model "How it is done"

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

We participate in the upside if markets rise, and protect the downside when markets fall.

Further details available at www.gyrostat.com.au