GYROSTAT
RISK MANAGED EQUITY FUNDS

Investment risk management – an <u>absolute</u> return alternative for retirees

Executive summary

- There have been significant advances in risk management approaches for conservative investors.
- These risk management approaches have different risk and return characteristics through the complete investment cycle.
    - "Phase 1" was the traditional risk management approach - varying the allocation of 'income' and 'growth' assets.
    - "Phase 2" introduced additional 'growth' asset risk management approaches with protection <u>sometimes</u> in place through a predictive risk management overlay.
    - "Phase 3", the Gyrostat approach, is a complement to Phase 2 approaches with protection <u>always</u> in place. We complement short term bonds as we deliver higher income and capital growth through the investment cycle (in trending and more volatile markets including large market falls).
- By combining the three phases conservative investors can protect and grow capital with reliable income through the investment cycle

The challenge for conservative investors

Blending traditional 'income' and 'growth' assets has produced a painful dilemma for conservative investors - "income" assets such as cash, term deposits and short term bonds provide insufficient income with no prospect for any capital growth. "Growth" assets, investing directly in blue chip shares, or equity funds, leave investors exposed to fluctuations in the value of invested capital.

There are 4 strategic trends that make it difficult to achieve the aims of conservative investors:

- Interest rates at historic lows with a quarter of the world with negative interest rates;
- Elevated stock market valuations by historic standards with global debt levels at historic highs;
- Ageing population as post-war baby boomers approach retirement;
- Geopolitical developments from election outcomes and changing macro economic policies.

Evolution of investment risk management

Throughout the full investment cycle there are periods where investors are exposed to large investment losses. Returns have more impact at some points in your investment lifecycle than at others. *Sequencing risk is the risk that markets fall near or early in retirement.* The wrong sequence of returns can have a big impact on your retirement portfolio. Negative investment returns early in retirement can be particularly damaging.

A major challenge confronting investors now is that stock market corrections historically occur every 4 ½ to 5 ½ years. Since 1929, the range of falls has been 25% to 90%, and duration of decline 22 to 160 weeks. The last correction occurred over 7 1/2 years ago.

Phase 1: Traditional approach asset allocation 'income' and 'growth' assets

The traditional risk management approach has been to vary the allocation of 'income' and 'growth' assets to reflect the lifecycle of the investor. In addition, there is a tactical allocation of growth assets for diversification of stocks.

Throughout the investment cycle, this approach has acknowledged deficiencies at times of substantial downside share price falls. In summary:

- **Non-correlated asset allocation** with both 'growth' and 'income' assets varied over the investors' lifecycle: produces portfolios with lower income (historical low interest rates) and substantial fluctuations in capital value. Reduced effectiveness in times of market stress.

- **Diversification of stocks**: exposed to the risk associated with investing in the markets generally (as distinct from stock specific) risks. Capital investment rises and falls with market cycles.

Phase 2: Risk management <u>sometimes</u> in place – downside tail and prediction risk

Investment risk management techniques have evolved in an attempt to address these acknowledged deficiencies. Of particular note are the following two approaches:

- **"Stop loss"** approach may not be effective in large market downside gaps, and requires prediction and the identification of 'exit' and 'entry' levels. Exposure to losses when predictions are wrong.

- **"Predictive" techniques:** protection sometimes, but not always in place using derivatives such as 'futures' and 'options' to adjust risk-return profiles. Exposes investors to large potential losses if protection not in place, or foregoes upside unless a 'hockey stick risk-return profile' in place.

These approaches offer additional protections from the asset allocation approach of Phase 1. Typically benchmarked against an equity index such as the ASX accumulation index as they are subject to <u>downside 'tail risk' and prediction risk</u>. These are considered an alternative 'growth' asset with fluctuations experienced in the value of investment capital (both up and down).

It is anticipated that these approaches will experience rapid uptake as the challenges faced by an increasing number of conservative investors from an ageing population expands the pool of investor funds from 'accumulation' to 'retirement' phase.

Phase 3: Risk management <u>always</u> in place – stable and rising <u>absolute</u> returns with capital growth in trending and more volatile markets including large market falls.

Our investment risk management approach has **protection <u>always</u> in place** with **<u>absolute returns</u> through the investment cycle.** With protection <u>always</u> in place we complement short term bonds and are benchmarked against the absolute return BBSW90. Our expected returns vary with the stage of the investment cycle and prefer trending and volatile markets as this provides the opportunity to re-set protection levels and lowers the costs.

Our investment objectives are:

- **Returns**: 6% - 8% pa in trending markets, greater than 8% pa in volatile markets, short term bond returns in stable markets
- **Income**: Minimum **cash rate + 3%** paid semi-annually (currently 4.7% p.a.) from dividends and franking credits
- **Protection:** No quarterly NAV draw-downs exceeding 2%

By adding our fund to a conservative portfolio we complement phase 1 and phase 2 approaches. In particular:-

i) Volatile markets provide more profit opportunities to participate in share price upside and protect on share price falls
ii) Gyrostat always has additional downside protection in place in case of large market falls

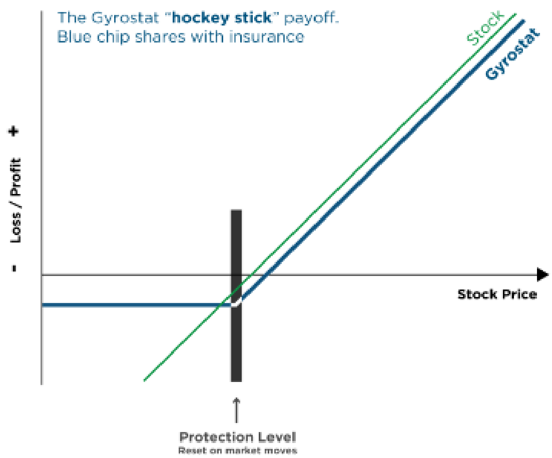
By combining these three phases conservative investors can protect and grow capital with reliable income through the complete investment cycle.

Our solution – the three step investment approach

Throughout the complete investment cycle our risk management approach has a risk-return profile which always has minimal capital at risk at the stock specific level with upside return potential. Each stock always has a protection level in place near the current stock price. This level is re-set as stock prices move to protect on share price downside and participate in upside.

Gyrostat investment approach

1. **<u>Buy</u> and hold blue chip shares with protection** on the Australian Stock Exchange.
2. **<u>Set</u> amount of protection -** to always participate in the upside with minimal capital at risk.
3. **<u>Reset</u> the protection level on market moves for risk-return profile to match stock view -** if the share price rises, increase protection level, on falls reduce protection level.



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