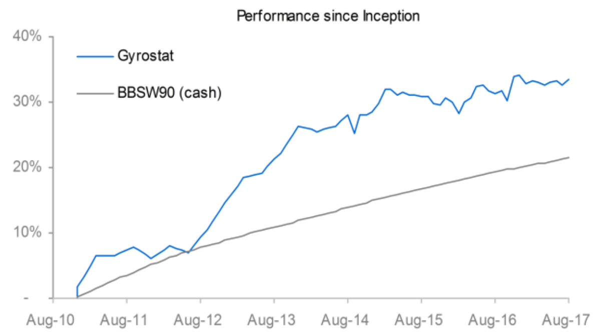
GYRATIONS

Insights into risk management of an equity portfolio for conservative investors

Gyrostat Capital Management Pty Ltd September 2017

THIS MONTH



Gyrostat Absolute Return Income Equity Fund compounded returns are net of fees and include franking credits, cash (BBSW90) includes re-investment of interest.

Gyrostat buys and holds ASX 'Blue chip' shares with lowest cost protection always in place with upside. With the progression of investment risk management, it is now possible to protect and benefit in changing markets. We have a 7 year track record of delivering our investment objectives.

- **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%

SIGNIFICANT ADVANCES IN RISK PROTECTION

Protect and grow capital with reliable income through the complete investment cycle

Expanding the investment menu

There have been significant advances in risk management for conservative investors, enabling them to protect and grow capital with reliable income through the complete investment cycle. This is achievable by combining the three approaches outlined below, and adjusting asset allocation now before volatility returns.

With protection always in place with upside, it is possible to ride out the storm and make money when other strategies don't.

The gap in today's market is a conservative asset that combines protection, returns and income. Capital growth is delivered when others don't – in trending and more volatile markets (including large 'one off' share price falls.)

Our feature article explains how the prepare now by increasing asset allocation to 'conservative' assets. Traditional conservative assets (cash, short term bonds, fixed term deposits) offer no capital growth potential. Our fund is a conservative asset that combines protection, returns and income.

Previous Gyration feature articles (July 2017) have outlined how ASX options market can be utilised to reduce investment risk with the ASX the counterparty to the options contract. In June our feature article demonstrated the significant progress in investment risk management– possible from technological advances and deregulation.

In summary:

	Approach	Feature	Capital value	Benchmark
Level 1 **Diversify risk**	Asset allocation between 'conservative' and 'growth' assets	Diversification	Initial capital ± market moves	Model portfolio performance
Level 2 **Partial protection**	Protection sometimes in place using predictions	Additional 'growth' asset Predictive risk management - technology	Initial capital ± mitigated market moves	Equity index
Level 3 **Always in place protection**	Protection always in place with upside Absolute return - always minimal capital at risk	Additional 'conservative' asset Lowest cost bought put options - technology Active management options - deregulation	Initial capital + capital growth in trending and volatile markets (incl large falls)	BBSW
Short term bonds	Conservative asset (no capital growth)	Nil	Initial capital less defaults	BBSW

The investment performance of the approaches varies across the investment cycle. By combining the three and adjusting asset allocation <u>now</u>, it is possible to benefit with capital growth in volatile markets (including large 'one off' share price falls).

	Approach	Falling market (trending)	Volatile market (including 'one off' large falls)	Stable market	Rising market (trending)
Level 1 **Diversify risk**	Asset allocation 'conservative' and 'growth' assets	Unfavourable	Unfavourable – capital losses	Favourable	Favourable
Level 2 **Partial protection**	Protection <u>sometimes in place</u> using predictions	Unfavourable	Unpredictable – capital gains and losses	Favourable	Favourable (possibly mitigated)
Level 3 **Always in place protection**	Protection <u>always</u> in place absolute return Absolute return - <u>always</u> minimal capital at risk	Favourable (mitigated)	Very favourable – capital growth potential	Less favourable (lower returns)	Favourable (mitigated)

Our solution – stable and rising <u>absolute</u> returns with regular income

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

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%

We have a track record of achieving these objectives every year since our inception in 2010.

Traditionally protecting your portfolio was expensive. Gyrostat has overcome this issue by actively managing ASX options, utilising proprietary software and taking advantage of reduced broker costs due to deregulation. We are always fully invested in blue chip high yielding shares and insure downside with lowest cost alternatives on the ASX.

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. Our Fund is of particular benefit to pre or post retirees who don't have the time required to overcome investment losses if large market falls.

Stock market corrections historically occur every 4 ½ to 5 ½ years. From 1929 to current, the range of falls and duration has been 25% to 90%, and duration of decline 22 to 160 weeks. The last correction occurred over 8 1/2 years ago. Our investment objective is capital growth in trending and more volatile markets, including large market falls.

RISK FRAMEWORK

The Gyrations risk model, depicted above, considers the implications of geopolitical, macro-economic, and company valuations on investor risk. The value of an investor's portfolio is impacted by political events, prevailing and forecast economic conditions and earnings expectations relative to current share values.

Geopolitical

- Election results change economic priorities and corporate earnings.
- Trade wars reduce economic growth and corporate earnings.
- Exchange rate devaluations lead to defaults of US denominated debts and capital flight thus impacting on corporate earnings.

Macro-economic

- Economic growth or decline determines corporate earnings.
- Debt defaults and resulting contagion effects reduce corporate earnings.
- Banking defaults can lead to liquidity issues for corporations.
- Inflation rate expectations impact on interest rates, with rising interest rates historically leading to lower market P/E levels.
- Central Bank changes to interest rate and quantitative easing policies impact on corporate earnings and P/E levels.

Company valuations

- Valuations driven from earnings and changes in overall P/E level.
- Human psychology tendency for herd or momentum behaviour.

Gyration will provide investors with a snapshot of these risks regularly. Traditional risk management approaches are exposed to capital losses with downside 'tail' risk and prediction risk with protection sometimes in place. Our risk management approach complements existing approaches by having protection always in place, and to benefit from trending and more volatile markets include large market falls. Such funds trade off some of the upside to insure against downside risk.

OUTLOOK

Our investment view is that 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 briefly spiked post US elections and Brexit but has again returned to near historic lows.

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

Our expectation is that volatility will increase, with "risk-on", "risk-off" investing occurring, only distantly related to fundamentals. Relying on market predictions, as is the traditional approach, with a 'straight line' pay-off leaves investors exposed to large capital losses.

The decision to 'solve' a debt crisis by printing tens of trillions of dollars more debt may have adverse longer term impact on financial stability, with adverse impacts for stock market valuations.

There are many potential triggers which may reveal system fragilities. Global debt as a percentage of GDP is at all time highs and the stock market has been rising for over 8 ½ years without a significant correction. Geopolitical developments are resulting in changes to macro-economic policies. Valuations are considered 'high' by historic standards.

Increased volatility is often experienced around key data releases relating to interest rates, growth, inflation rates, and key political events. These dates are detailed in this report, along with market pricing of likely outcomes where available.

An effective strategy for addressing sequencing risk ensures the consequences of such events do not materially adversely impact retirement lifestyle.

Gyrostat Absolute Return Income Equity Fund has a 'hockey stick pay off' investment profile, set to always participate in the upside with minimal capital at risk. With this investment profile investors can approach these markets with confidence.

GEOPOLITICAL

Key Political Events

There appear to be increasing tensions in the USA-Europe relationship as USA priorities change. Political instability is increasing with anti-establishment parties gaining traction. Many geopolitical commentators expect an increase in armed conflict within and between nations.

Key dates are:

Potential conflict with North Korea

24 September 2017: German elections

May 2018: Italian elections, potentially early elections

Trade

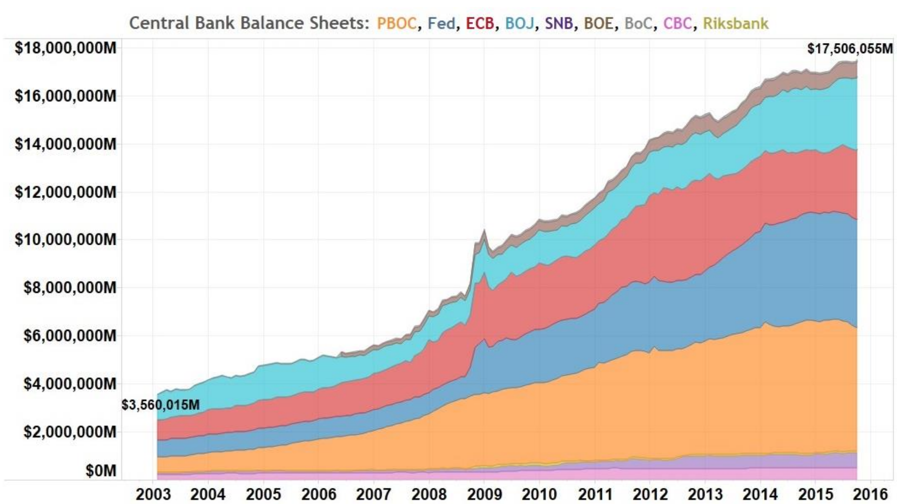
Trade wars can result from either currency devaluations or the introduction of trade barriers. This typically reduces overall economic growth, and subsequently company earnings. It can also cause capital flight, often the precursor to a debt crisis. There is increasing evidence of anti-globalisation activities.

Brexit negotiations protracted with potential European and UK economic instability. There is the possibility of trade conflict between USA-China. The North America Free Trade Agreement (NATFA) is subject to re-negotiation.

Central Banks

Central Banks decide monetary policy by determining the price of money (short term interest rates). With interest rates in many global jurisdictions at or below zero, an additional policy is used to vary the quantity of money (quantitative easing or 'printing' money). Central Banks have been buying longer term bonds and stocks with the QE proceeds. There are increasing concerns this has inflated 'asset prices' and not sufficiently stimulated economic growth. Liquidity of commercial banks can be addressed by a Central Bank, solvency can not.

The USA Central Bank has indicated it is considering quantitative tightening (selling longer term bonds and stocks).

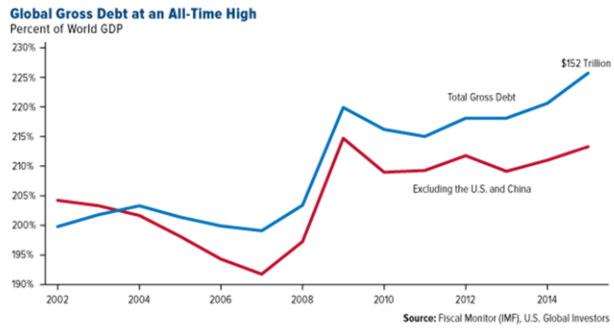


http://inflation.us/central-bank-balance-sheets/

MACRO ECONOMIC

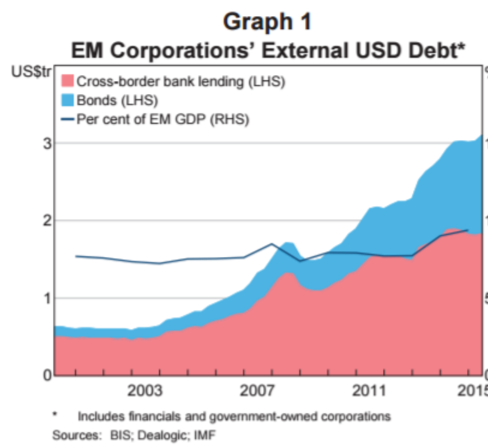
Debt

Global debt levels are at a record 225% of world GDP (IMF semi-annual fiscal monitor report October 2016)



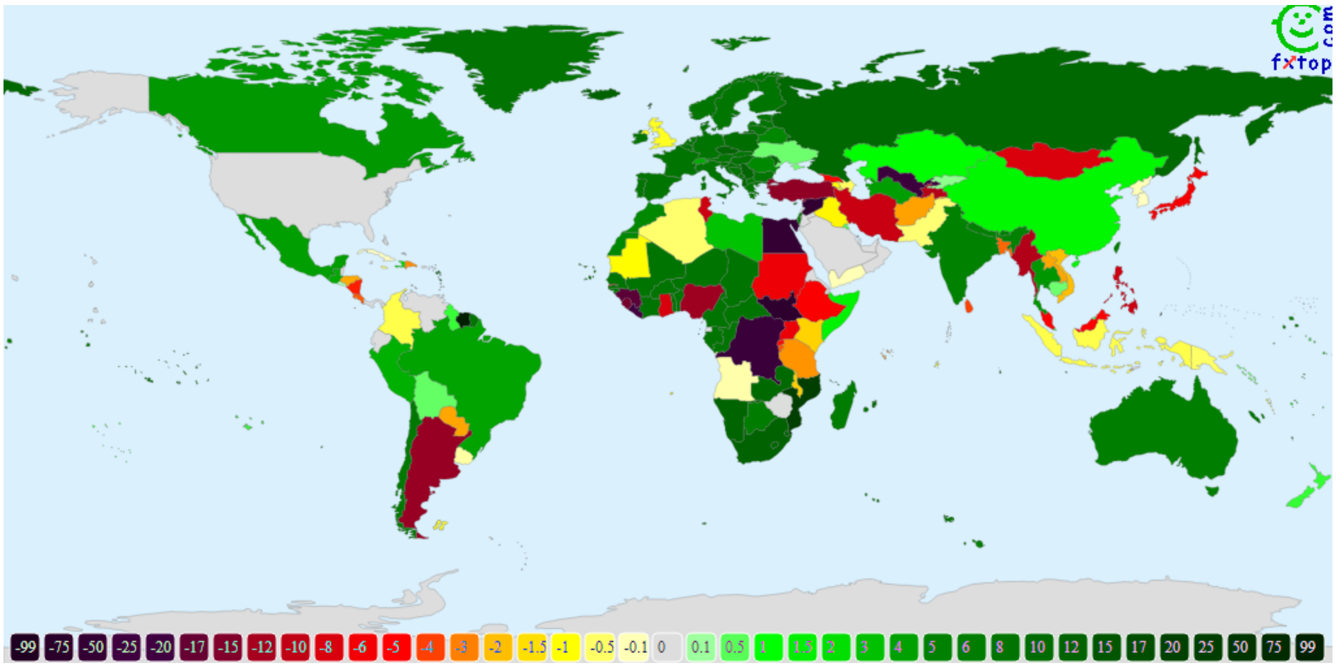
Gigantic Debt

US dollar-denominated borrowings by emerging market (EM) corporations have increased rapidly in recent years (currently in excess of $ 15 trillion), raising concerns about possible currency mismatch risk, debt defaults, and capital flight from those countries subject to currency devaluations.



http://www.rba.gov.au/publications/bulletin/2015/dec/pdf/bu-1215-6.pdf

Over the past 12 months, movements of currencies relative to the US dollar are shown below. In green is shown those countries with increases, in purple and red those with devaluations. A rising US dollar increases the risk of debt defaults and capital flight in those countries with unhedged borrowings and domestically generated revenues. http://fxtop.com/en/forex-map.php



GDP Growth- World

Despite historic low interest rates, global GDP has continued below trend levels. In April 2017 the IMF raised growth forecasts slightly. The USA expansion commenced in June 2009 and has now been in place for 98 months, the third longest expansion on record.

https://www.crestmontresearch.com/docs/Economy-Cycle-Dashboard.pdf

Key dates are:

September 1: US unemployment (monthly). Previous 4.3% at consensus.

September 6: Australia GDP growth (quarterly). Previous annualised 1.7% above consensus.

September 28: USA GDP growth (monthly). Previous annualised 2.6%, at consensus.

October 19 Australia unemployment (quarterly). Previous 5.6% at consensus.

October 20 China GDP growth (quarterly). Previous 6.9% slightly above consensus.

October 31: Euro zone GDP growth (quarterly). Previous annualised 2.2% above consensus.

http://www.tradingeconomics.com/calendar?g=world

Inflation

Low inflation prolongs the elevated global debt levels by not growing nominal GDP. Inflation has recently increased in USA with most recent data below consensus, has been stabilizing in Euro area, with the risk of deflation remaining in Japan. The inflation rate has recently been stable in China.

Key dates are:

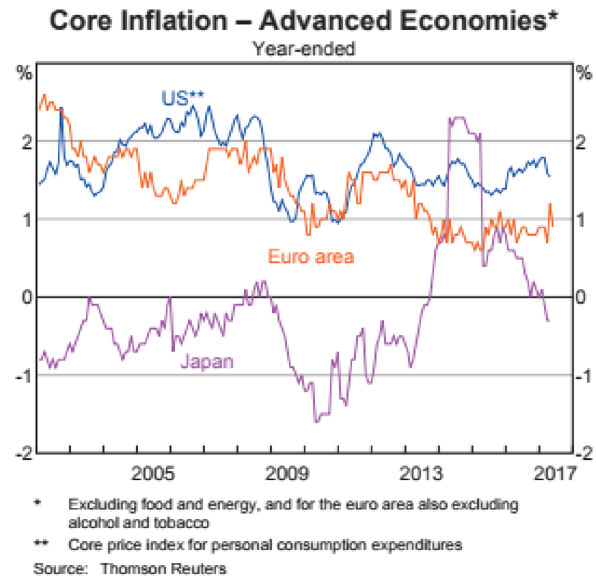
September 9 China inflation (monthly). Previous 1.4% YoY slightly below consensus.

September 14: USA inflation rate (monthly). Previous 1.7% slightly below consensus.

September 29: EU inflation rate (monthly). Previous 1.3% at consensus.

September 30: Japan inflation rate (monthly). Previous 0.4% at consensus.

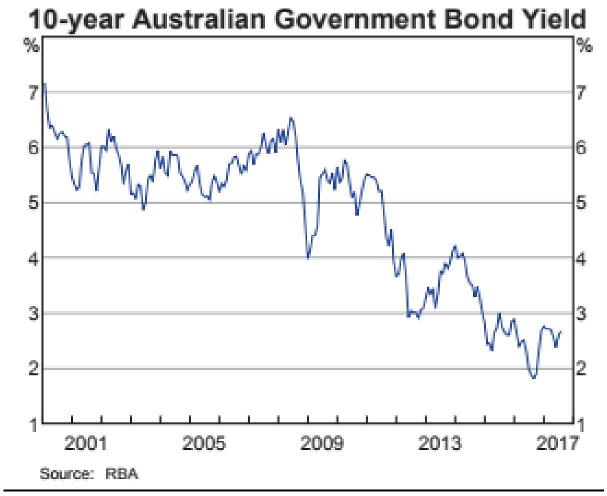
October 25: Australia inflation rate (quarterly). Previous 1.9% below consensus.



Bond yields

10 year bond rates are also typically used as an indicator of inflation expectations. Rates have risen over the past quarter, but remain near historical lows. These rates can move rapidly, and cause rapid changes in bond prices.

http://www.bloomberg.com/markets/rates-bonds



Cash Rate - Australia

Interest rates are at historical lows and anticipated to stay low for an extended period.

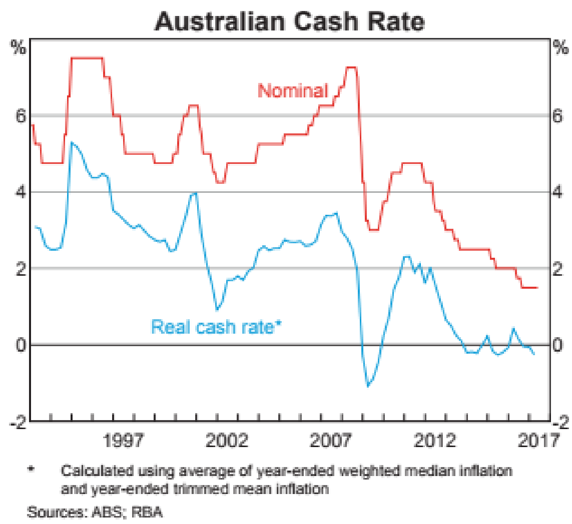
The RBA cut cash rates to 1.50% on 2 August 2016

RBA meetings:

- September 5
- October 3

Market pricing of interest rate cut to 1.75% at August meeting based on inter-bank cash rate futures: no rise: 100%; rise 0%

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



Interest Rates and QE- International

Key dates are:

US Federal Reserve decisions (now 1.00%-1.25%):

- September 21
- November 2

Bank of Japan decisions (now -0.1%):

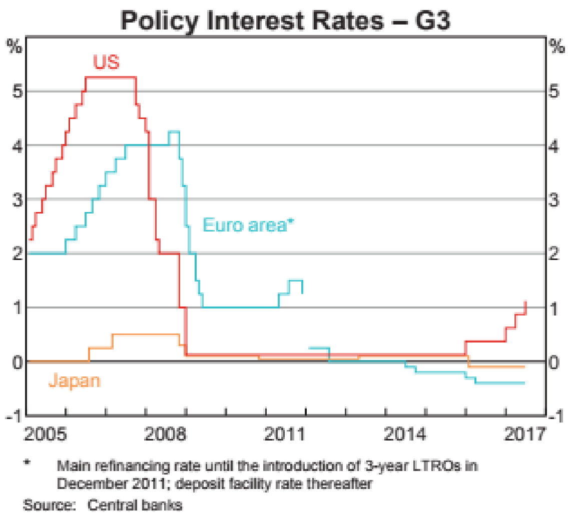
- September 21
- October 31

European Union decisions (now 0.0%):

- September 7
- October 26

Bank of England decisions (now 0.25%)

- September 14
- November 2



COMPANY VALUATIONS

Company Earnings

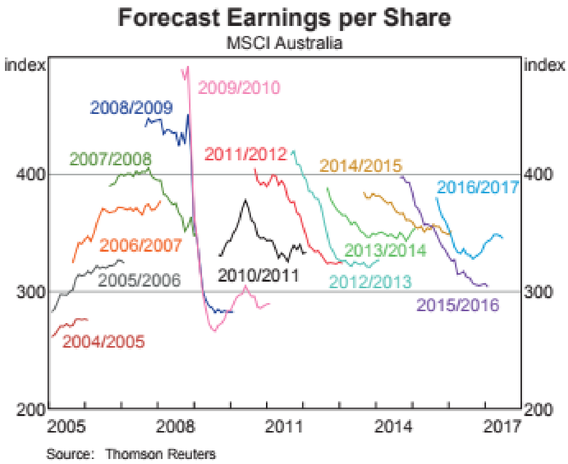
Corporate earnings expectations are influenced by macro economic and company specific factors. Substantial changes in market valuations often occur as investors adjust for new data, particularly where it differs from the 'consensus' view.

The next quarterly earnings season commences in November 2017. Details of upcoming Australian company earnings announcements are available at:

http://www.morningstar.com.au/Stocks/CorpCalendar

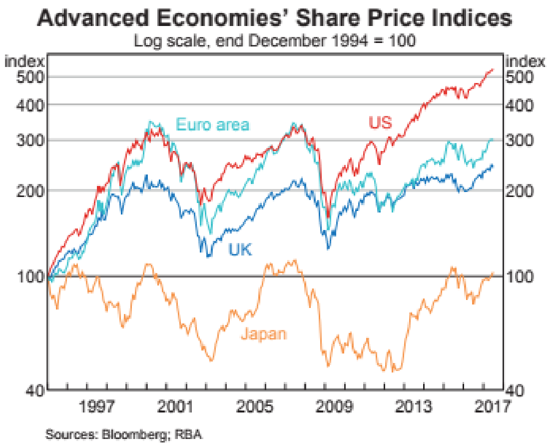
Listed companies also have continuous disclosure requirements to advise the market of any material changes in the companies projected earnings, particularly where they vary from the market consensus.

The graph opposite shows the changes in forecast earnings for the shown years. Over recent years, earnings estimates have been downgraded as time has progressed. Recently earnings estimates have increased slightly.

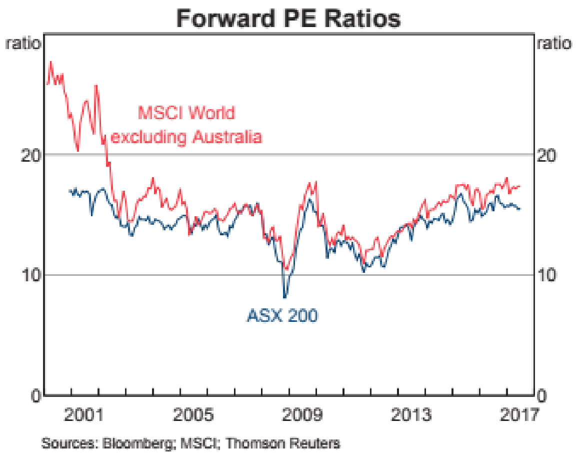


Share prices

Globally share prices have rallied strongly since 2009 market lows with the US market rising nearly 200%.



Price Earnings Ratios

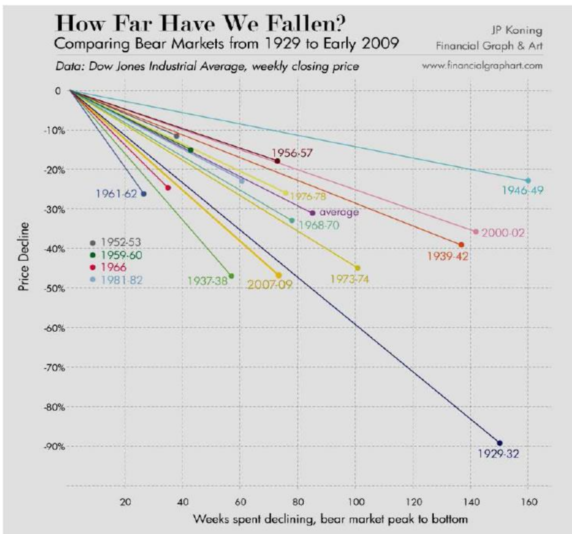


The price/earnings ratio is often used as a metric for stock market valuations.

A historical context of market levels using normalized earnings since 1900 as calculated by Crestmont Research.

http://www.crestmontresearch.com/docs/Stock-PE-Report.pdf

Stock Market Corrections



Stock market corrections historically occur every 4 ½ to 5 ½ years. From 1929 to current, the range of falls and duration has been 25% to 90%, and duration of decline 22 to 160 weeks. The last correction occurred over 8 1/2 years ago

http://www.marketoracle.co.uk/images/2009/Mar/fallen.jpg

Prepare now to protect and benefit in changing markets

Executive summary

- Geopolitical and macro developments indicate volatility is likely to rise from historically low levels.
- To prepare, conservative asset allocations are typically increased.
- Traditional conservative assets (cash, short term bonds, fixed term deposits) offer no capital growth potential.
- Our fund is a conservative asset that combines protection, returns and income.
    - *Protection* always in place with minimal capital at risk at all times,
    - *Capital growth* in trending and volatile markets including large 'one off' share price falls,
    - *Regular income* from blue chip dividends and franking credits.
- Delivers best outcomes when others don't – in volatile markets. Target of annual capital returns 6.5 % to 8 % in trending markets, short term bond returns in stable markets, but most of all, returns of greater than 8 % in volatile conditions.
- We buy and hold ASX20 blue chip shares with lowest cost protection always in place with upside from innovative risk management.
- Of particular benefit to pre or post retirees who don't have the time required to overcome investment losses if large market falls.

Gyrostat Absolute Return Income Equity Fund
A 'conservative' asset combining protection, returns and regular income

The changing investment landscape

Our view is that recent developments are more likely to see the stock market revert to a more volatile phase.

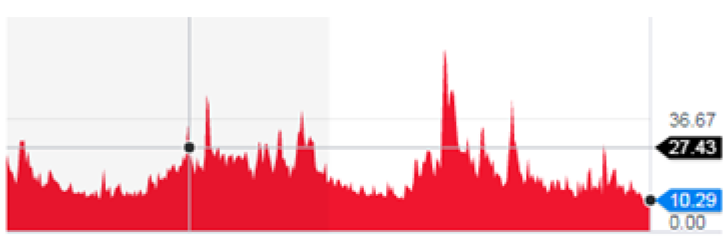
A summary of current views, and likely developments, is as follows:

	Current view	**Likely development**
Geopolitical	More uncertainty but markets can cope with change	Trade barriers, tariff increases, conflict
Macro economic	Slow but stable growth with recent upgrades Central Banks can control volatility	Recession risks – history of Republican Presidents in recession in second year of term; currently third longest economic expansion in US history Quantitative tightening (unwinding QE) and rising interest rates
Valuations	Historically expensive, recent narrow bound share prices	Increasing volatility from historically low levels with elevated risks of market correction

Investor sentiment historically changes between stable and more volatile conditions. Stable periods typically last for a period of 4-5 years (1991 – 1996), (2003 – 2007), (2012 – current).

Volatility has a tendency to elevate for an extended period of time, sometimes to more extreme levels.

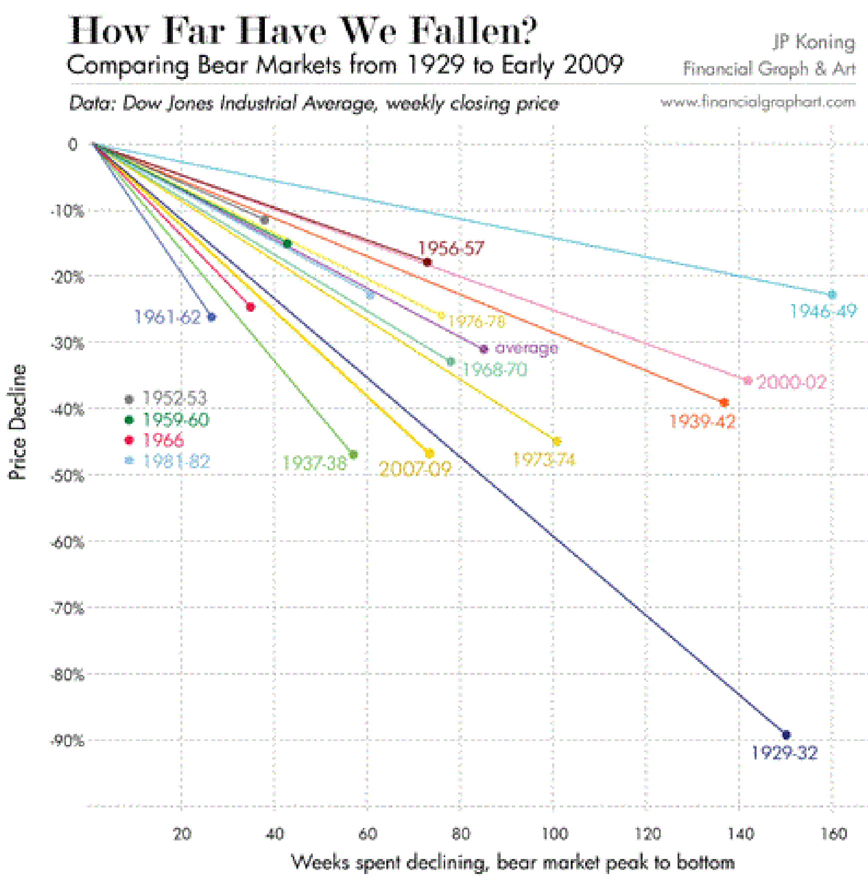
History of changing investment paradigms
VIX Index 1980 to 2017



Changing market are often accompanied by significant stock market corrections.

With significant stock market corrections, you don't have the time required to overcome significant loss if you are a pre or post retiree.

A major challenge now confronting investors 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 8 1/2 years ago.



Prepare now to protect and benefit in changing markets

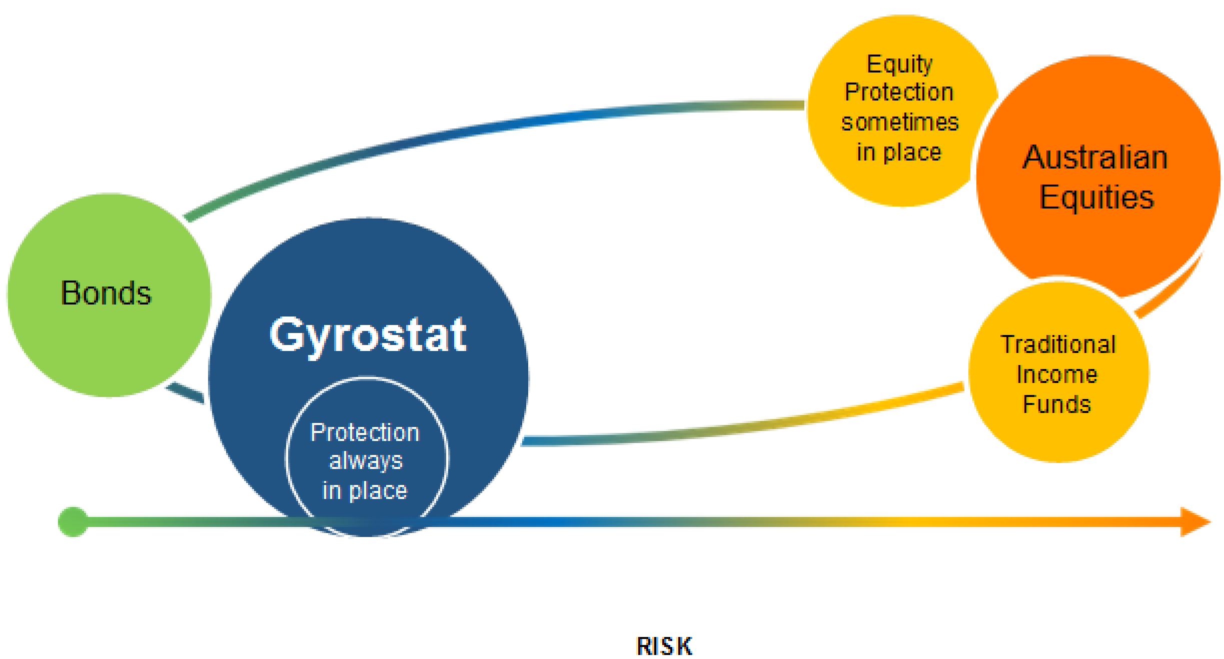
To prepare for these market changes, conservative asset allocations are typically increased.

Traditional conservative assets (cash, short term bonds, fixed term deposits) offer no capital growth potential.

Our fund is a conservative asset that combines protection, returns and income.

- Protection always in place with minimal capital at risk at all times,
- Capital growth in trending and volatile markets including large 'one off' share price falls,
- Regular income from blue chip dividends and franking credits.

By allocating to a conservative asset including Gyrostat, investors can protect and benefit in changing markets.



Gyrostat delivers best outcomes when others don't – in volatile markets. Our investment objectives are:

Gyrostat Absolute Return Income Equity Fund

Investment Objectives

Combines returns, income and protection for investors wanting minimal capital at risk at all times

RETURNS

6%-8% in trending markets, greater than **8%** in changing 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%**

Gyrostat buys and holds ASX 'Blue chip' shares with lowest cost protection always in place with upside. With the progression of investment risk management, it is now possible to protect and benefit in changing markets. We have a 7 year track record of delivering our investment objectives.

- **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%

The fund is suitable as a 'conservative' asset offering capital growth for all portfolios. It is of particular benefit to pre or post retirees who don't have the time required to overcome investment losses if large market falls.

All portfolios

As a 'conservative' asset allocation, complements a portfolio - makes money when others don't

Retirees

Confronts sequencing risk (large market falls), and longevity risk (capital growth potential)

Intergenerational wealth transfer

Protect and benefit in changing markets

Industry associations, philanthropic and charities

Higher income than cash and short term bonds with stable and rising capital value

WHAT WE ARE READING

Mohamed A El-Erain: The lost lessons of the financial crisis
https://www.project-syndicate.org/commentary/lost-lessons-of-the-financial-crisis-by-mohamed-a--el-erian-2017-08

Steve Blumenthal: On My Radar: Near tern looks good, long term looks scary (Ray Dalio)
https://www.cmgwealth.com/ri/radar-near-term-looks-good-long-term-looks-scary/

SMSF Association innovative retirement income products
http://trustees.smsfassociation.com/wp-content/uploads/2016/07/Innovative-retirement-income-products.pdf

"Global Debt Bomb" history of sovereign defaults: Reinhart and Rogoff
https://www.forbes.com/forbes/2010/0208/debt-recession-worldwide-finances-global-debt-bomb.html

Stock market valuations through the lenses of history
http://www.crestmontresearch.com/docs/Stock-PE-Report.pdf

Gyrostat feature article: Absolute return income equity fund ASX20 'Blue chip' shares
http://www.gyrostat.com.au/news/feature-article-absolute-return-income-fund-asx20-blue-chip-shares/

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