

## Feature article:- Equity income in retirement products

### Executive Summary

- Falling interest rates are highlighting the limited range of investments that deliver a regular and stable income stream with capital security.
- Equity protected funds provide a risk managed exposure to growth assets. There are many financial products being marketed on the basis of risk mitigation. However, protection at all times is rarely in place.
- Advances in investment risk management enable cost effective protection to always be in place for a 'hard' defined risk parameter (say no more than 3% capital at risk).
- The Gyrostat Absolute Return Income Equity Fund is a **conservative fund** with 'hard' protection always in place, a 9 year track record of no quarterly NAV draw-downs exceeding 3%, regular equity income, and returns always as per our guidance - increasing with volatility levels. (with tail hedge in place for large gains on large market falls).

### A framework for desired product features – Financial System Inquiry

Falling interest rates are highlighting the limited range of investments that deliver a regular and stable income stream with capital security. The lack of retirement income products was a conclusion reached by the Financial System Inquiry in 2014.

The Financial System Inquiry listed three desired features:-

1. High income: regular and stable income
2. Longevity: invest in growth assets with risk management feature
3. Flexibility: low cost, 'cooling off' period

Most 'income in retirement' asset classes don't invest in growth assets. This includes term deposits, annuities, endowment bonds, bond funds and hybrids.

Equity protected funds provide a risk managed exposure to growth assets. There are many financial products being marketed on the basis of risk mitigation. However, protection at all times is rarely in place.

Further details on objectives of superannuation, including industry background are available in the Gyrostat Capital Management submission on the objectives of superannuation.

[https://treasury.gov.au/sites/default/files/2019-03/C2016-010\\_Gyrostat\\_Capital\\_Management.pdf](https://treasury.gov.au/sites/default/files/2019-03/C2016-010_Gyrostat_Capital_Management.pdf)

## Investment risk management approaches

There are a variety of investment risk management approaches with the objective to meet the equity income needs of retirees and defend against losses in declining markets. A summary of the various approaches is contained in our Feature article of 13 December 2018.

Typically, the investment generates dividends from a diversified portfolio of Australian shares with an investment risk management overlay that aims to reduce the volatility of returns, in particular defending against losses in declining markets.

A brief summary of the approaches:

- Vary asset allocation between stocks and bonds (diversification)
- Buy underlying asset, write call options (Buy-write income funds)
- Long/short funds (market neutral, 130/30)

*Bennelong Absolute Equity Performance Fund<sup>1</sup>*

*Watermark Market Neutral Fund Limited<sup>2</sup>*

- Buy underlying asset, using predictive approach has the ability to sell futures contracts  
*Beta Shares Australian Dividend Harvester Fund (managed fund)<sup>3</sup>*  
*Beta Shares Managed Risk Australian Shares Fund<sup>4</sup>*  
*Plato Australian Shares Income Fund (Managed Risk)<sup>5</sup>*  
*Sanlam Private Wealth Australian Equity Fund<sup>6</sup>*

- Buy underlying assets, buy put options (sometimes) using predictive approaches

*Wealth Defenders Equity –protection strategies using puts, calls and futures<sup>7</sup>*

*Ironbark Denning Pryce Australian Tailored Income Fund<sup>8</sup>*

- Buy put options and cash (volatility as an asset class)

*Grant Samuels Triple3 Volatility Advantage Fund<sup>9</sup>*

- Buy underlying assets, buy put options (always in place 'hard' risk parameter)

*Gyrostat Absolute Return Income Equity Fund<sup>10</sup>*

Further details are contained in a Gyrostat feature article published 13 December 2018. This includes a more detailed explanation of our corporate expertise which includes a detailed industry overview of the various risk management approaches. ***Of all the approaches protection always in place is supported by Russell Investments and State Street (among others) - this is the approach adopted by Gyrostat.***

<https://www.gyrostat.com.au/news/feature-article-investment-risk-management-approaches/>

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<sup>1</sup><https://www.aepfund.com.au/performance/>

<sup>2</sup> <http://wfunds.com.au/fund/watermark-market-neutral-trust/>

<sup>3</sup> <https://www.betashares.com.au/fund/australian-dividend-harvester-fund/#performance>

<sup>4</sup> <https://www.betashares.com.au/fund/managed-risk-australian-share-fund/#performance>

<sup>5</sup> <https://www.plato.com.au/retail-funds/fundprofiles/>

<sup>6</sup> <http://sanlamprivatewealth.com.au/sanlam-private-wealth-australian-equity-fund/>

<sup>7</sup> <http://wealthdefenderequities.com.au/Home/>

<sup>8</sup> <http://ironbarkam.com/performance/>

<sup>9</sup> <https://www.gsfm.com.au/our-funds/triple3-volatility-advantage-fund/>

<sup>10</sup> <http://www.gyrostat.com.au/investment/performance/>

## Investment risk management advances from technology and deregulation

Advances in investment risk management enable cost effective protection to always be in place for a 'hard' defined risk parameter (say no more than 3% capital at risk). Returns are designed to increase as volatility levels increase, as this provides more opportunities to lower protection costs.

The Gyrostat investment risk management approach utilises a unique set of investment software and process related intellectual property. Our strategy exploits the 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 enables our proprietary software systems to construct a volatility term structure and identify the 'least cost' call and put option alternatives available in the market at that time. There are many series to choose from. This is reflected in differing levels of 'implied volatility' across time periods and within a range of strike prices within the same time period. Gyrostat uses a variety of bought option and other strategies typically ranging from duration of 3-15 months, depending upon the prevailing option market conditions.

With market movements, the "options" component needs to be re-set or actively managed to ensure that the risk-return parameters meet the investment charter. This involves the buying or selling of options.

The key investment risk management features are:

- Protection is always in place to a specified absolute risk parameter (eg. no more than 3% at risk)
- Lower protection costs than existing approaches through option series selection and actively managing the options with market moves (enabled by technological advances and deregulation)
- For a given risk parameter, returns are maximised and re-set with market movements
- A financially strong counter-party - the ASX - for hedging activities
- Transparent mark to market valuations from ASX valuations

To minimise costs and maximise profits:

- Our proprietary software systems identify options series with the greatest profit potential for a defined cost, exploiting differing levels of implied volatility in the options market.
- "Active management" by buying or selling options with market movements.

At least 3 leading investment banks have adopted similar strategies for their clients in global markets:

**"Dynamic downside protection or option replication strategies provide access to a pay-off profile that has the potential to provide sufficient downside protection without removing too much upside potential. "**

[https://russellinvestments.com/-media/files/au/campaigns/cps/r\\_rpt\\_res\\_protection\\_v1ff\\_1402.pdf?la=en-au](https://russellinvestments.com/-media/files/au/campaigns/cps/r_rpt_res_protection_v1ff_1402.pdf?la=en-au)

**"Put options are often the first defense that comes to mind for investors. These are an explicit insurance contract, guaranteeing protection if market prices fall below the strike price."**

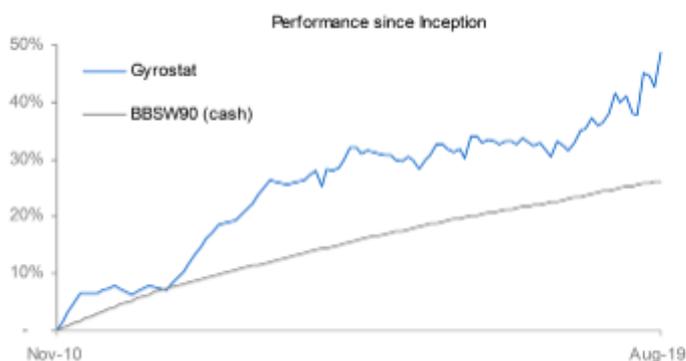
<https://www.ssga.com/na/us/institutional-investor/en/our-insights/publications/as-the-cycle-lengthens-investors-look-to-hedge-tail-risk-but-at-what-price.html>

**"In a bear market or a painful correction, astute investors in these mutual funds will find a refuge from the storm and a greater chance of substantial profits."**

<https://www.investopedia.com/articles/investing/020616/3-best-downside-protection-equity-mutual-funds.asp#ixzz55oXufVWr>

## Gyrostat Absolute Return Income Equity Fund

The Gyrostat Absolute Return Income Equity Fund buys and holds ASX 20 shares with lowest cost protection always in place with upside. The Funds objective is to deliver regular and stable equity income (by passing through ASX 20 dividends) at a minimum of the BBSW 90 + 3% with capital security and growth. Returns are designed to increase with volatility (including a tail always in place to benefit from large market falls.)



**Returns:** 8.2% pa (12M); cumulative 48% (>8 years)

**Income:** Minimum 4.2% pa (BBSW90 + 3%)

**Protection:** No quarterly draw-downs exceed 3%

Also includes 'tail hedge' for gains on large market falls

To assist with understanding our investment strategy please see the weblink to an explanatory video:

<http://www.gyrostat.com.au/news/gyrostat-absolute-return-income-fund-in-depth-guide/>

### Gyrostat Absolute Return Income Equity Fund - in depth guide

Current state of the market: "Incredible risks yet bullish trend persists"

Investment features:

- Protection always in place with upside (participate in the upside in rising market)
- Make money in changing markets (prefer more volatile conditions, especially if large 'one off' market falls)
- Proven strategy over 7 years – our innovation is the investment risk management of equities
- An Absolute return Income Equity fund is a conservative asset with the potential for capital growth in rising and falling markets

[Download PDF for more information](#)



### External review – McGregor Asset Consulting

McGregor Asset Consulting have completed their review of the Gyrostat Absolute Return Income Equity Fund. They have concluded:

"McGregor Asset Consulting has developed a solid level of confidence in the manager's ability to successfully execute on their investment strategy. They have a long history, spanning more than 8 years, and have performed as expected during the various market conditions, in particular volatile markets, where the Fund has protected capital and delivered solid absolute returns. This is the environment where the Fund is expected to perform, and has been the case, providing diversification benefits to long-only equity funds."

"Its correlation with the Australian equity market is low, averaging 0.3 while its performance has been particularly effective in delivering strong absolute returns during volatile and falling equity markets."

"To our knowledge, there are no other **conservative funds** available in Australia/Asia with 'hard' protection always in place and a 9 year track record of no quarterly NAV draw-downs exceeding 3%, regular equity income, and demonstrated returns increasing with volatility levels. (with tail hedge in place for large gains on large market falls)."

## **Gyrostat Absolute Return Income Equity Fund**

### **Frequency Asked Questions**

#### **1. Investors**

##### ***How will your fund improve my lifestyle?***

With historically low interest rates expected for many years, many 'conservative' assets are generating very low returns (such as cash, term deposits, short term bonds).

Gyrostat has for 34 consecutive quarters operated within a 'hard' defined risk parameter (no more than 3% capital at risk) always in place, delivered regular income by passing through ASX20 dividends, and met returns guidance based upon market conditions (demonstrating increasing returns with market volatility.)

We offer the ability to increase your portfolio returns without the risks associated with investing more in unprotected 'growth' assets which exposes your capital to major losses in stock market corrections.

Most analysts anticipate 'late cycle' market conditions with rising volatility levels and elevated risk of major market corrections. Most major corrections occur within 8 years, we are now at year 12, with the longest on record since 1929 being 13 years.

This is important to all investors – for those in accumulation phase it enables a higher return from your conservative assets, whilst for retirees it offers a stable equity income stream with peace of mind from protection always in place.

#### **2. Advisers**

##### ***What are the key attributes of investment performance?***

We track the number of re-sets where the asset value has varied +/- 2%, and also the number of gaps at market open exceeding 2%. Our returns have increased the greater the market volatility.

We have a non-linear pay off profile always in place that is 2 dimensional (as distinct from the traditional 1 dimensional payoff).

The shape of the pay off profile is re-set with market moves to match the investment view on each particular stock.

### **3. Asset consultants**

#### ***How are you generating alpha in your Fund and why does the Sharpe ratio increase with market volatility?***

If you graph our investment performance with returns on the horizontal axis, and standard deviation on the vertical axis, you can see a 9 year history of extremely low standard deviation. This is because there is a 'hard' protection always in place.

It has been long observed that the implied volatility in options varies within the same time period (volatility smile) and over differing time periods (volatility duration).

Our proprietary investment systems have direct feeds to the ASX exchange and instantaneously identify the lowest cost protection available. We have a 3 step process to buy the underlying asset, set the level of protection, and re-set with market moves (whilst meeting our taxation net delta requirements.)

### **4. Multi managers**

#### ***Why should we add your Fund as distinct from other risk managed investment approaches?***

The correlation of our investment returns to market moves is approximately 0.3 (from recently completed McGregor Consulting Report.).

In addition, with a 'tail hedge' always in place, we anticipate large gains on large market falls.

Implied volatility levels in the options market are nearing historic lows – this provides the opportunity to benefit from volatility spikes as they occur.

### **5. Distribution partners**

#### ***What are your business expansion plans?***

We currently operate under a wholesale information memorandum. We are in discussions or on the approved product list of a number of wholesale groups.

It is our intention to offer a retail offering on product disclosure statement, with our fund available on investment platforms. We are offering discounted management fees in return for pre-commitments and will then appoint a Responsible Entity (quotations received and all is in place to be implemented.)

## **6. Family offices/industry super funds**

### ***Do you operate under investment mandate, and can you protect our existing assets without triggering capital gains tax liabilities?***

Yes. With markets at or near historic highs, and protection costs near historic lows (with low implied volatility levels) the protection only component of our strategy is offered under mandate. We offer a solution that does not trigger the capital gains tax associated with selling the underlying asset.

Our proprietary systems identify the lowest cost protection available for a defined period of time at a 'hard' defined risk tolerance (for instance, no more than 5% at risk.) We actively manage the portfolio within defined parameters set within the mandate (to raise the protection level at a defined cost, lower protection levels for minimum cash receipt, and extend duration for a pre-defined cost.)

## **7. Product developers/structured product groups**

### ***Can we engage Gyrostat to develop products specific to our geographic market at a risk-tolerance we define?***

Yes. Our approach is available on any asset with a liquid options market. We operate through the relevant stock exchange (rather than over the counter) for counter party and market determined option pricing.

We have for instance back-tested our approach at a 'hard' 5% monthly/10% quarterly risk tolerance for all major markets. We have operations in the Hong Kong market with this parameter.

We propose our partner own the Fund and meets local regulatory and distribution needs, with an investment management agreement to Gyrostat Capital Management.

Naming rights would be with our partner. The markets we have back-tested include Hong Kong, China, Canada and major European markets.

## **8. Philanthropic**

### ***Why should donors invest with Gyrostat?***

For donors the cash component of our distribution can be directed to their nominated charity. The investor maintains the franking credits and any changes in capital value.

Gyrostat will rebate half our management fee directly to the nominated charity.

## **9. Partners**

The Financial System Inquiry noted the absence of product for equity income in retirement. Our objective is to more fully commercialize our existing fund (capacity estimates at A\$ 2 b ++ ) as an 'alternative defensive' asset.

We then propose to launch additional funds as an 'alternative – growth' and with geographic expansion.

We will expand our investment expertise (including our sophisticated proprietary investment systems available through technological advancements).

The Financial System Inquiry envisaged closer alliances between boutique managers and larger established wealth groups (including life insurance companies and foreign players in the Australian market.