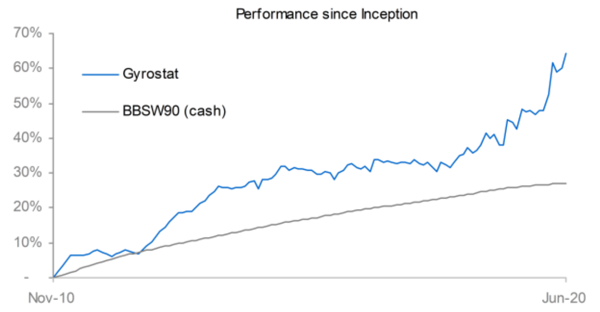
GYRATIONS

Volatility is our friend

Increasing income and returns from your 'highly defensive' assets

Gyrostat Capital Management Pty Ltd June 2020

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.

The Fund is designed for retiree income with protection, and to address sequencing risk (the risk of major market falls). The distinctive features are 'hard' protection always in place and a track record of returns increasing with market volatility.

Gyrostat has operated for 38 consecutive quarters within a 'hard' pre-defined risk parameter (no more than 3% capital at risk with our **maximum draw-down 2.2% in any circumstances**) always in place, delivering regular income by passing through ASX-20 dividends, and meeting returns guidance based upon market conditions (demonstrating increasing returns with market volatility). The Fund buys and holds ASX-20 and international assets with **lowest cost protection always in place** with upside. It is a 'highly - defensive' **conservative** asset allocation. Our investment objectives are:

- **Returns**: > 8% in volatile markets; 6% - 8% pa in trending markets, greater than 8% pa in volatile markets, BBSW + 3% in stable markets
- **Income**: Minimum **cash rate + 3%** paid quarterly (currently 3.2% p.a.) from dividends and franking credits; upgrading guidance with 'bumper' distribution of 6.0% p.a. for FY20
- **Protection:** No quarterly NAV draw-downs exceeding 3%; 'tail hedge' for gains large market falls

Why Gyrostat?

The unexpected happens.

Are you a:

- pre or post retiree wanting regular income.
- successful career or business executive who now prefers the *freedom* to focus on health, family and friends, passions, rather than fearing stock market falls.

Your life savings should give you the financial security to enable you to be:

Self reliant in an unsettled, highly unpredictable world - to take back control

Adaptable - knowing market crashes are a regular and hazardous feature of stock markets. Protect and make money when this happens.

Resilient - understanding that predicting the future in an uncertain world can threaten your future when predictions are wrong

Gyrostat is a defensive asset to fortify your portfolio in an uncertain world.

PORTFOLIO DESIGN

The two key global investment issues today are:

- Achieving a regular and stable income stream in a low interest rate environment with capital security – “defensive” assets.
- Elevated risk of major market corrections in a ‘late cycle’ environment of stock market volatility impacting capital returns – “growth” assets.

It is well recognised that traditional diversification approaches are not effective in preserving capital in ‘late cycle’ market conditions. In recent financial crises the value of stocks and bonds have moved together – as a consequence of historically low zero bound interest rates from record global indebtedness.

Diversified non-correlated assets

Instead, an approach that has been well recognised to work for all market conditions is to construct a portfolio with diversified non-correlated assets.

Ray Dalio is the founder, co-Chief Investment Officer and co-Chairman of Bridgewater Associates, which is a global macro investment firm, the world's largest hedge fund.

His brief explanation on portfolio construction is available at:

https://www.youtube.com/watch?v=Nu4lHaSh7D4&t=85s

If your portfolio suffered significant losses as at 31 March 2020 it is likely that your portfolio was not non-correlated between your ‘defensive’ and ‘growth’ assets. If you do not change the structure of your portfolio it is likely that similar losses will be experienced in future market corrections.

The rebound in stock markets now provides an opportunity to re-balance your portfolio to include defensive ‘non correlated’ assets which will benefit from any major market corrections.

The extent of peak to trough falls on SP500 since 1929 is shown below. With the market rebound since the lows of 23 March 2020 the SP500 has fallen 7.7%from the peak of 3386 (19 Feb 2020), significantly less than has been experienced in other corrections.

At 16 June 2020 the SP500 was at 3124. A re-set of the March 23 lows of 2237 would see 28.4% falls.

Our approach does not predict market movements. In portfolio construction one of the scenarios to consider is the consequences to your portfolio if the market was to repeat the previous peak to trough falls. For instance, a 50% fall would see the SP500 at 1693, a reduction of 46% from current levels.

SP500 index: 90 year historic chart. Peak to trough falls > 20, duration of falls, time to recover

Current market conditions and global uncertainty provide the opportunity to pro-actively address this risk in portfolio construction. This is particularly important for pre and post retirees exposed to sequencing risk.

Market	High 19 Feb 2020	50% decline level	Market 16 June 2020	50% fall peak to trough scenario	March 23, 2020 lows	Re-test falls
SP500	3386	1693	3124	-46%	2237	-28%
Nasdaq	9817	4808	9895 *	-51%	6860	-31%
ASX200	7163	3581	5942	-40%	4546	-23%
Hang Seng	29056 *20 Jan	14528	24344	-40%	21696	-11%

* Nasdaq has exceeded 19 February 2020 previous high

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.

Gyrostat positioning in your portfolio – 'highly defensive' reliable pay-offs

Our objective has remained unchanged since our inception in 2010. We are a 'highly defensive' fund, protecting wealth whilst delivering regular income, with a track record of returns increasing with market volatility.

We achieve this with our distinctive investment risk management approach which is to always have the lowest cost protection in place. We have operated for 38 consecutive quarters within a 'hard' pre-defined risk parameter always in place (no more than 3% capital at risk with a track record of maximum draw-down -2.2% in any quarter).

Our complete monthly return table since our inception in 2010 is detailed in the attached Monthly Performance Report. You will note that there have been no capital draw-downs exceeding -2.2% in any circumstances. The table demonstrates our Funds returns are not correlated with the stock market. Our best returns have been in rising and falling stock markets. Many funds are highly correlated to the market - that is they increase with market rises and decrease on market falls.

In order to offer our investors a broader range of non correlated assets with significant scale potential, we have expanded our international assets within the Fund to include SP500, Nasdaq, FANGS, Nikkei, Hang Seng, MSCI China, MSCI Developed and Developing markets.

We are an attractive defensive asset as most alternatives offer either a historically low rate of interest (some with credit default risk) or are illiquid. Gyrostat positions are highly liquid and externally valued marked to market by the relevant stock exchanges, who are also our counter-party for all trades.

Further background is provided in our recent Australian Financial Review article and Ausbiz interview:

http://www.gyrostat.com.au/news/ausbiz-interview/

https://www.gyrostat.com.au/assets/Uploads/2020-04-25-AFR-How-these-four-funds-beat-the-virus-crash...pdf

By **adding Gyrostat to portfolio** as a 'highly defensive' fund:

- lowers portfolio risk.
- increases income.
- improves returns through investment cycle
- enables model portfolio outperformance vs peers.

Gyrostat is **highly defensive** – 10 year track record maximum drawdown -2.2%

- reliable pay-off for general environment – not predicting.
- higher income and returns than other 'defensive' assets.
- addresses sequencing risk.

- highly liquid, transparent, counterparties stock exchange, no credit risk or duration risk
- track record of returns increasing with market volatility (both up and down).

Gyrostat **investment approach**:

- Approximately 20 assets including ASX20 stocks and S&P ASX 200 index, international (including SP500, Nasdaq, Hang Seng, MSCI Developed and Emerging markets).
- Each asset is protected at stock or index specific level with 2 dimensional pay off (either downside, neutral, or upside bias) with minimal capital always at risk.
- Returns increase with market volatility: Downside 'left' tail, upside 'right' tail, specific stocks and indexes with sector/country rotations

Can be **progressively added through the complete investment cycle** within established processes

- Pre and post retirees: At Statement of Advice review more conservative portfolio structure as move from growth to defensive assets with ageing
- Growth portfolios: Investors seek higher returns from their defensive assets
- Self directed investor currently has cash and seeks lower risk investments for income and returns

Gyrostat approach – 'hard protection always in place – not predicting

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.

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 protect downside with lowest cost alternatives on the ASX.

Advances in investment risk management enable cost effective protection to <u>always</u> 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.

To minimise costs and maximise profits:

- The Gyrostat 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.

Explaining our process

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/

Contrasting other risk management approaches – growth asset overlay Vs defensive

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. As distinct from other approaches Gyrostat is a 'highly defensive' conservative asset allocation with benchmark BBSW + 3%.

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. Other approaches typically use an equity index in construction of their performance measurement objectives.

A brief summary of the approaches is as follows:

- 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)
- Buy underlying asset, using predictive approach has the ability to sell futures contracts
- Buy underlying assets, buy put options (sometimes) using predictive approaches
- Buy put options and hold cash (volatility as an asset class)

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

OUTLOOK

The market conditions in May enabled us to enter additional positions for more elevated returns on any uplift in market volatility. Our investment Strategy allows up to 15% of the Fund's assets to be invested in international assets with positions in SP500, Nasdaq, Hang Seng, MSCI Developed and Emerging markets (amongst others).

Returns increased in May consistent with our guidance for trending markets. At June 15, 2020 the Fund has increased 2.7% for the month with the increasing levels of volatility.

The current market conditions (rising stock prices and moderate levels of implied volatility) provide the opportunity to extend the duration of our stock specific and index protection, and to increase our scale of 'left tail' positions to enhance returns in any subsequent market falls.

Our investment view is that stock market volatility will increase and that market lows will be re-tested.

The research published by CMG Wealth, highlighting the findings of Bryce Coward, CFA, states:

"… in 19 of 19 post-war instances of a 15% uninterrupted decline (excluding the current one), the stock market ended up re-testing the waterfall low in some fashion. Basically, markets tend to rally after "waterfall" declines. Until recently, test case #20 (Q4 2018) was the outlier. That low has now been re-tested."

https://www.cmgwealth.com/ri/on-my-radar-pandemic-cycles-recession-begins/

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.

There are many potential triggers which may reveal system fragilities – valuations, geopolitical developments, macro, Covid 19, debt defaults. Global debt as a percentage of GDP is at all time highs and the stock market falls are significantly lower than those from a historical context.

MACRO ECONOMIC

Debt

Global debt levels are at a record 322% of world GDP and rising (Institute of International Finance)

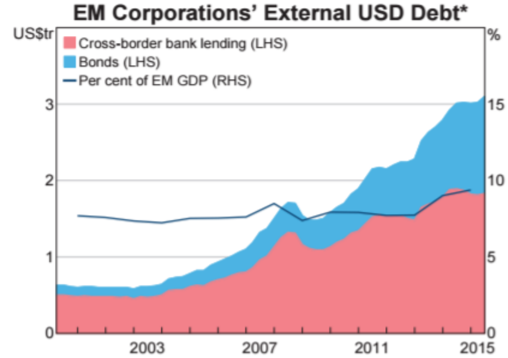
https://www.iif.com/

	Households	Non-Financial Corporates	Financial Corporates	Government	Total
US$ trillion					
1990	10	10	7	10	37
2000	17	24	24	21	86
2007	35	43	54	35	167
4Q2019	48	74	63	70	255
% of GDP					
1990	41%	41%	29%	41%	151%
2000	44%	72%	59%	55%	230%
2007	58%	76%	87%	58%	279%
4Q2019	60%	92%	81%	89%	322%

US dollar-denominated borrowings by emerging market (EM) corporations have increased rapidly in recent years (non bank in excess of $ 11.4 trillion according to Bank of International Settlements in 2018), raising concerns about possible currency mismatch risk, debt defaults, and capital flight from those countries subject to currency devaluations.

https://www.bis.org/publ/work753.pdf

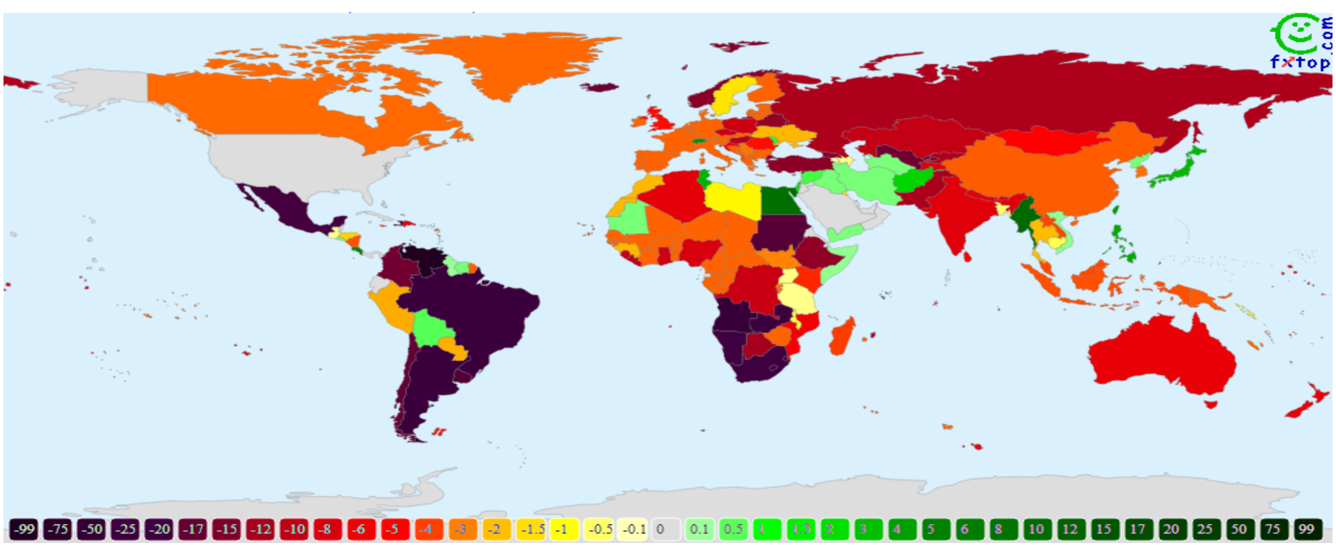
Graph 1
EM Corporations' External USD Debt*



* Includes financials and government-owned corporations
Sources: BIS; Dealogic; IMF

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



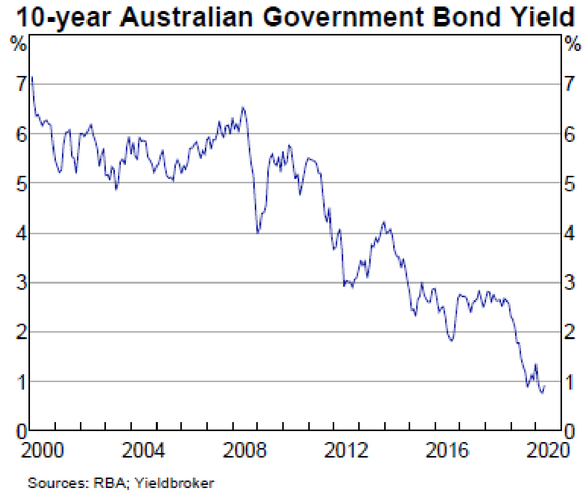
Bond yields

10 year bond rates are at historical lows, and expected to stay low for the next decade.

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

The Australian Government 30 year bond is priced at 1.757% (June 16, 2020)

http://www.worldgovernmentbonds.com/country/australia/



Cash Rate - Australia

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

The RBA cut cash rates to 0.25% in March 2020.

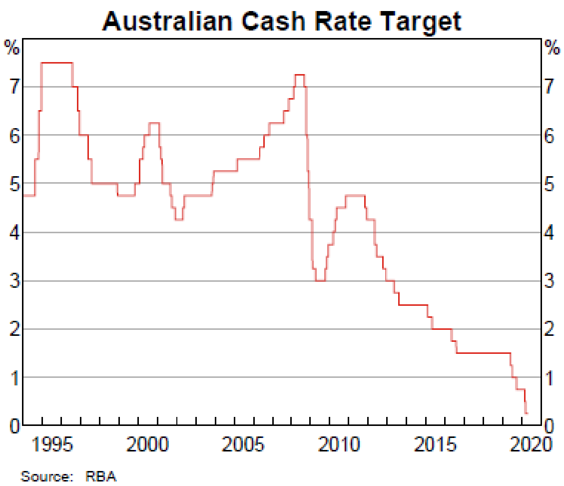
RBA meeting:

- July 7

https://www.rba.gov.au/schedules-events/calendar-2020.html

Market pricing of interest rate cut to 0.00% at June 2 meeting based on inter-bank cash rate futures: no change: 43%; fall 57%

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



Interest Rates and QE- International

Key dates are:

European Union decisions (now -0.5%)

- July 16, 2020

https://www.profitf.com/calendars/ecb-meeting-dates/

US Federal Reserve decisions (now 0.25%):

- July 28-29, 2020

https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm

Bank of England decisions (now 0.1%)

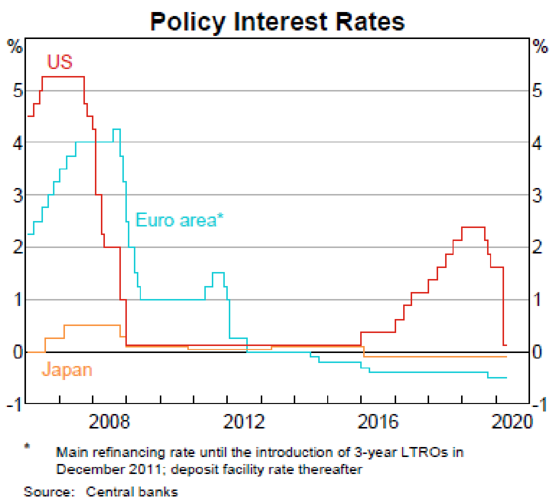
- August 6, 2020

https://www.bankofengland.co.uk/news/2019/september/monetary-policy-committee-dates-for-2020

Bank of Japan decisions (now -0.1%):

- July 14-15, 2020

https://www.boj.or.jp/en/mopo/mpmsche_minu/index.htm/



Retirees face financial ruin as coronavirus slashes share dividends

Retirees who have lived off a steady stream of share dividends have seen their income plunge as banks cancel payouts, and they face more financial pain in coming months when research shows more companies are likely to slash their distributions because of the coronavirus crisis.

Those who believe the damage wrought to their share portfolios means they now qualify for a part-pension have been having trouble dealing with a Centrelink system already struggling with waves of the freshly unemployed, the Association of Independent Retirees says.

Dividends have historically been responsible for about 60% of the income reaped from investing in the Australian sharemarket, according to research by Realindex, a division of First Sentier Investors.

Rents fall as landlords struggle to fill vacant properties during Australia's coronavirus crisis.
But, under pressure from the prudential regulator, three of the big four banks have deferred or slashed their previously lucrative dividends, and investors expect Australia's biggest bank, the Commonwealth, will follow suit after cutting the value of its assets by $1.5bn last week due to the pandemic.

The Australian Prudential Regulation Authority has also called on insurers and other institutions it regulates to cut or defer dividends.

And Realindex's research also shows that analysts expect companies in sectors including energy, transport and consumer services will also cut their payouts to shareholders as the economic effects of shutting down whole industries to crimp the spread of the virus become clear.

Wayne Strandquist, the president of Air, said retirees who invested in commercial or residential property were also taking a hit due to tumbling rents.

"They're struggling to find a reliable source of income," he said.

"They might have a lot of assets on paper but they're not making anything."

He said that before the crisis self-funded retirees were attracted to bank stocks because they paid high dividends that were fully franked, meaning tax had already been paid at the corporate rate of 30%.

Because of this tax benefit bank stocks paid effective returns of 10% to 11%, rates that were "impossible to get elsewhere", Strandquist said.

He said bank stocks seemed particularly attractive at a time when term deposit rates were at record lows.

"There were a number of commentators saying, 'Don't put your money in the bank, buy shares in the bank,'" he said.

"They treated it almost as an annuity."

He said retirees now feared for the returns from other high-yield stocks, especially in the infrastructure sector, that they had treated as an alternative to buying bonds.

"A lot of the bond proxies, Sydney Airport, Transurban, they've been smashed," he said.

He said retirees who thought the fall in their assets due to a sharemarket rout that wiped about 30% from stock prices meant they would be eligible for a part-pension were having difficulty dealing with Centrelink.

Some were put off by the queues of “hundreds and hundreds” of people outside Centrelink offices, he said.

“What 75-year-old would want to deal with that?” he said.

“From go to whoa it takes months to inventory all their assets, talk to their accountants, and then there’s a delay in processing from Centrelink.

“The pension can’t make up for the 40% drop in dividends they’ve seen.”

The executive chairman of fund manager Ausbil, Paul Xiradis, said travel, casinos, retail shopping and energy companies were at the highest risk of needing to cut dividends.

“With a medium risk of reduced dividends are companies in the financials (ex-banks), metals, discretionary health care and building industries,” he said.

“We consider food retailing, telecommunications, pharmaceuticals (especially CSL), agriculture, technology, regulated utilities, iron ore and gold producers to have a relatively low risk of dividend reductions.”

Realindex’s head of investments, David Walsh, said there was no doubt dividends across the market would be lower in the future, dragging down overall returns.

“The impact will be noticeable,” he said.

He said dwindling dividends had also forced Realindex and other big-end-of-town investors to think about how they valued companies.

“It’s certainly going to have an impact on how investment managers – and we – work,” he said.

Ben Butler
The Guardian
Sun 24 May 2020
https://www.theguardian.com/business/2020/may/22/retirees-face-financial-ruin-as-coronavirus-slashes-share-dividends

WHAT WE ARE READING

On my radar: A wave of bankruptcies ahead – valuation parameters

https://www.cmgwealth.com/ri/on-my-radar-a-wave-of-bankruptcies-ahead/

What comes after the deepest economic crisis since the Great depression?

https://www.zerohedge.com/economics/what-comes-after-deepest-economic-crisis-great-depression

Gyrostat feature article: Portfolio structure and uncertainty

http://www.gyrostat.com.au/news/feature-article-portfolio-structure-and-uncertainty/

Carmen Reinhart: The curious case of missing defaults
https://www.project-syndicate.org/commentary/missing-emerging-market-debt-defaults-by-carmen-reinhart-2017-11

Stephen Roach: Project Syndicate – The Crisis of 2020 published 23 December 2019
https://www.project-syndicate.org/commentary/high-economic-vulnerablility-risk-of-major-shock-by-stephen-s-roach-2019-12?barrier=accesspaylog

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 Absolute Return Income Equity Fund – in depth guide with video
http://www.gyrostat.com.au/news/gyrostat-absolute-return-income-fund-in-depth-guide/

Further details at: www.gyrostat.com.au