GYRATIONS

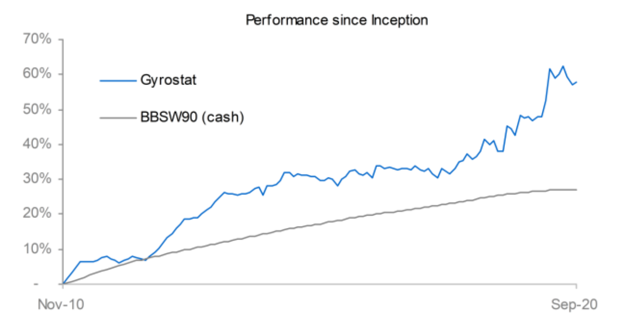
Volatility is our friend – risk managed investing

Portfolio construction: Reduce drawdown losses exposures, increase income

Gyrostat Capital Management Pty Ltd

September 2020

THIS MONTH



1 Feb 2020 to 31 March 2020: Gyrostat + 9.1% **ASX200 – 26.8%**

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

The unexpected happens – reduce unsettled nerves

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

- **Reliably increases in value on market falls**
- **Distributions are not fragile to dividend cuts**
- **Bumper distributions in more volatile markets**

MANAGE UNCERTAINTY THROUGH PORTFOLIO DESIGN

- Whilst no one can predict the outcomes in these highly uncertain times, you can plan for all eventualities. This is possible through portfolio construction that includes defensive diversified non correlated assets.
- Gyrostat is a highly defensive fund to ***reduce portfolio risks, increase income and returns***.
- We are a defensive asset that reliably increases returns on market falls, whilst providing higher income generated from dividend pass through and profits from our risk management overlay.

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 <u>now before volatility returns</u>.

- "Level 1" - diversifying risk- varying the allocation of 'conservative and 'growth' assets.
- "Level 2" - protection <u>sometimes</u> in place using a predictive risk management overlay. The benchmark for investment performance is typically an industry equity index. The variety of approaches includes:
  - 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)
- "Level 3 - protection <u>always</u> in place, the **Gyrostat approach**. The benchmark for investment performance is 'absolute return' bank bill swap rate BBSW+. This produces an additional 'conservative' asset

The gap in today's market is a defensive asset that provides regular income and reliably increases in value in the case of market volatility (particularly large market falls). A diversified non correlated Fund that delivers capital growth when others don't – in trending and more volatile markets (including large 'one off' share price falls.)

Gyrostat complements existing portfolios as a defensive allocation to reduce portfolio risk, increase income, and increase returns. We reliably increase in value on market falls with the extra protection always in place whilst providing higher income generated from dividend pass through and profits from our risk management overlay. Volatility is our friend.

Corporate presentation: (includes detailed industry comparisons)

http://www.gyrostat.com.au/news/gyrostat-corporate-presentation/

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 <u>sometimes in place</u> using predictions	Additional 'growth' asset Predictive risk management - technology	Initial capital ± <u>mitigated</u> market moves	Equity index
Level 3 **Always in place protection (Gyrostat)**	Protection <u>always</u> in place with upside Absolute return - <u>always</u> 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

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 (Gyrostat)**	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)

Each level has a reduction in the downside variability of your initial capital. They each have complementary risk-return characteristics through the complete investment cycle.

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.

Portfolio design - master uncertainty

The times are a changin' with interest rates low,
With late cycle markets risks continue to grow,

Diversify, diversify the cries they are loud,
But how to diversify with no income from cash?
Yet move it to shares and there could be a crash,
And dividends in future could further be slashed.

Add non correlated assets and all shall be well,
It goes up when markets fall when they ring the bell,
With regular quarterly income even if dividends are cut,
And protection always for when the going gets rough

When markets wash out, Gyrostat walks in
Uncertainty is our friend

PORTFOLIO CONSTRUCTION CHECKLIST

1. What are the capital losses drawdown exposures embedded in your portfolio?

You can consider how your portfolio performed from 1 February 2020 to 31 March 2020. In this 2 month period Gyrostat increased +9.1% with the ASX200 accumulation index falling – 26.8%.

2. How many assets in your portfolio reliably increase in value on market falls (ie: non correlated diversified assets)?

In more traditional investment climates you could move to defensive assets as interest rates rose and 'lock in' a reliable income stream. Interest rates used to rise towards the end of the investment cycles, and would fall to stimulate the economy (typically after stock market falls.) This is no longer possible as an investment strategy given 'zero bound' interest rates, a result of 'late cycle' market conditions in the longer term debt cycle (approximately a 70-90 year cycle).

This is why there is the need to product innovation to address the problems with some existing portfolio structures.

3. Based upon investor feedback, what product refinements have you introduced over the past few years to address current portfolio problems?

Extra lowest cost protection in always in place to 'protect and benefit' from market falls – the consequence is there will be more variability in month to month NAV with anticipated overall higher returns in more volatile markets. This extra protection also provides an additional source of income in the events dividends are cut from the greater stock price movement. (for instance Australian bank dividend cuts in 2020 saw Gyrostat deliver a bumper distribution.)

The protection piece has also been applied to international markets, particularly the SP500 and Nasdaq technology to increase in value on market falls as this is a key component of most portfolios.

Summary: You can do nothing or you can do something to address major market falls – it is yourself and your family that ultimately are responsible for the decisions that are taken. Re-balance to defensive assets on market rallies (like now) has been a tried and tested method of achieving longer term investment objectives.

Our biggest regrets are often our inactions, not our actions, particularly where the consequences of failing to act threaten your lifestyle as is the case with major market falls. **Major market falls are a regular and hazardous feature of the investment cycle. Most corrections of > 30-50% occur within 6-12 months and typically within an 8 years cycle. We are now at year 13 which is the longest since 1929.**

WHY GYROSTAT?

There have been 10 years of Government retirement income reviews in Australia. The challenge is straightforward – how to generate sufficient income without taking on the risk of large losses in the value of your investment. Money is freedom. The various reviews have listed the criteria to satisfy: regular income, capital protection, no lock in periods for investors, transparent pricing, strong counterparty, invest in growth assets for capital gains, no credit default risks.

Gyrostat satisfies all of these requirements.

Your life savings should give you the financial security 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.

Adding Gyrostat as a 'highly defensive' fund:

- lowers portfolio risk.
- increases income (from dividend pass-through and profits from risk management overlay)
- improves returns through the investment cycle especially large moves both down and up
- enables model portfolio outperformance vs peers.

Gyrostat is **highly defensive** – 10 year track record maximum drawdown -2.5%

- 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).

http://www.gyrostat.com.au/news/inside-network-interview/

OUTLOOK

The risk of significant losses is elevated in our view.

1. **We expect a retest of the March lows** –this would see the ASX down 23%. In 19 of 19 times where there has been 15 % falls, the market has always retested the lows.
2. **Larger 40-50 % falls**. Major corrections are a regular and hazardous feature of the investment cycle. **Historically these typically occur within 8 years – we are now at 13 years, the longest period on record.**

Whilst no one can predict outcomes, you can plan for all eventualities.

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, election results, pauses in quantitative easing by Central Bank or perceptions of insufficient fiscal stimulus for Governments.

Global debt as a percentage of GDP is at an all-time high and stock market falls are significantly lower than those experienced historically.

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. <u>If you do not change the structure of your portfolio it is likely that similar losses will be experienced in future market corrections.</u>

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.

Throughout its 10 year history Gyrostat has low or negative correlation with the market.

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 18 September 2020 the SP500 was at 3319. A re-set of the March 23 lows of 2237 would see **33% falls**.

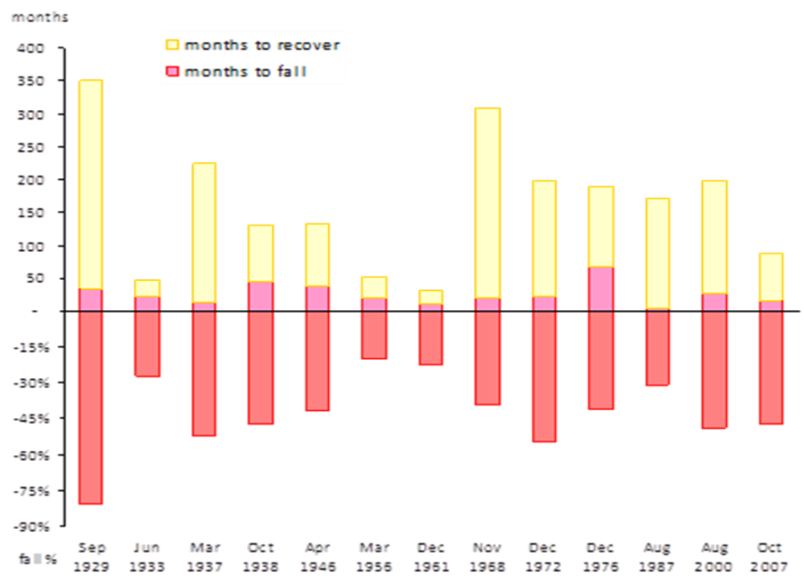
Our approach does not predict market movements. In portfolio construction one of the scenarios to consider is the consequences to your portfolio if the market was to repeat the previous peak to trough falls. For instance, a 50% fall would see the SP500 at 1693, a **reduction of 49%** from current levels.

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

Market	High 19 Feb 2020	50% decline level	Market 18 September 2020	50% fall peak to trough scenario	March 23, 2020 lows	Re-test falls
SP500	3386	1693	3319	-49%	2237	-33%
Nasdaq	9817	4808	10793 *	-55%	6860	-36%
ASX200	7163	3581	5864	-39%	4546	-22%
Hang Seng	29056 *20 Jan	14528	24454	-41%	21696	-11%

* Nasdaq has exceeded 19 February 2020 previous high

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

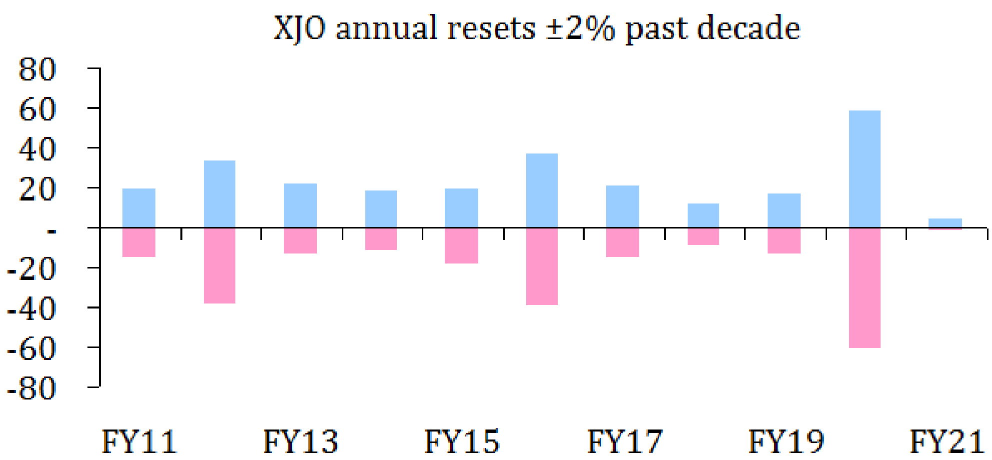


Returns have more impact at some points in your investment lifecycle than at others. <u>Sequencing risk is the risk that markets fall near or early in retirement.</u> The wrong sequence of returns can have a big impact on your retirement portfolio. Negative investment returns early in retirement can 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.

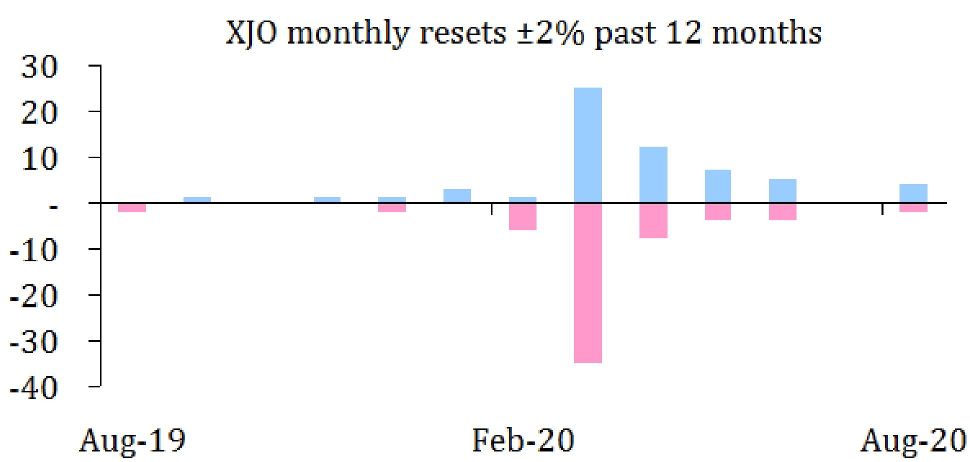
VOLATILITY BY THE NUMBERS

An objective measure of the historic level of market volatility is the number of times an asset has moved in price by increments of 2% during a monthly period.

Over a 10 year view the number of upside and downside re-sets in increments of 2% for the ASX200 has been:-



Since May 2020 there has been a substantial reduction in realized volatility, despite the general perception. For instance, in August 2020 the ASX200 rallied greater than 2% 4 times and fell by -2% twice.



Gyrostat returns have been designed to increase with volatility levels, as was demonstrated by our + 9.1% returns in February and March 2020 Vs market falls of – 26.8%

WHAT ARE THE EXPERTS SAYING ABOUT THE FUTURE?

US Federal Reserve: Financial Stability Report May 2020

"Asset prices remain vulnerable to significant price declines should the pandemic take an unexpected course, the economic fallout prove more adverse, or financial system strains reemerge." (p8)

https://www.federalreserve.gov/publications/financial-stability-report.htm

George Soros: The crisis of a lifetime

Only one thing is certain about the post-pandemic world: there is no way back to the globalized economy that preceded it. Everything else is up for grabs, including the rise of China, the fate of the United States, and the survival of the European Union.

https://www.zerohedge.com/geopolitical/soros-has-faith-trump-will-destroy-himself-fears-weakened-xi-sees-existential-risk-eu

On My Radar – A Few Ideas on Risk Management

There are times when risk management makes perfect sense. That's generally when valuations are high and forward return potential is low. There are other times when it's safer to keep your foot on the accelerator. That's when valuations are low and forward return potential is high.

So, more risk management when the risk is highest and perhaps less when risk is lowest (let 'em run). With this thinking in mind, let's look at a few different processes to get a feel for how rules-based trend following works

https://www.cmgwealth.com/ri/on-my-radar-a-few-ideas-around-risk-management/

S&P 500 10-year Returns Based on Shiller P/E (10-Year Earnings):

Let's look at the Shiller price-to-earnings (P/E) ratio. It currenly reads 30.69 as of Friday, September 18, 2020. You can see the 1929 level, 1966 (bull market top), and 2000 tech bubble top. Look how low it got in 2009 (I wrote then, "It's So Bad It's Good.").

MACRO ECONOMIC

Debt – ‘late stages’ long term debt cycle

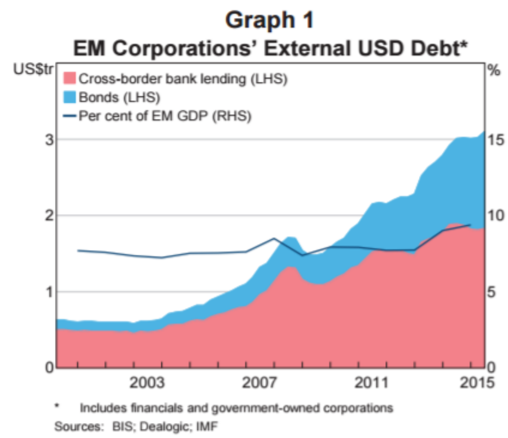
Global debt levels are at a record 322% of world GDP and rising (Institute of International Finance)

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%

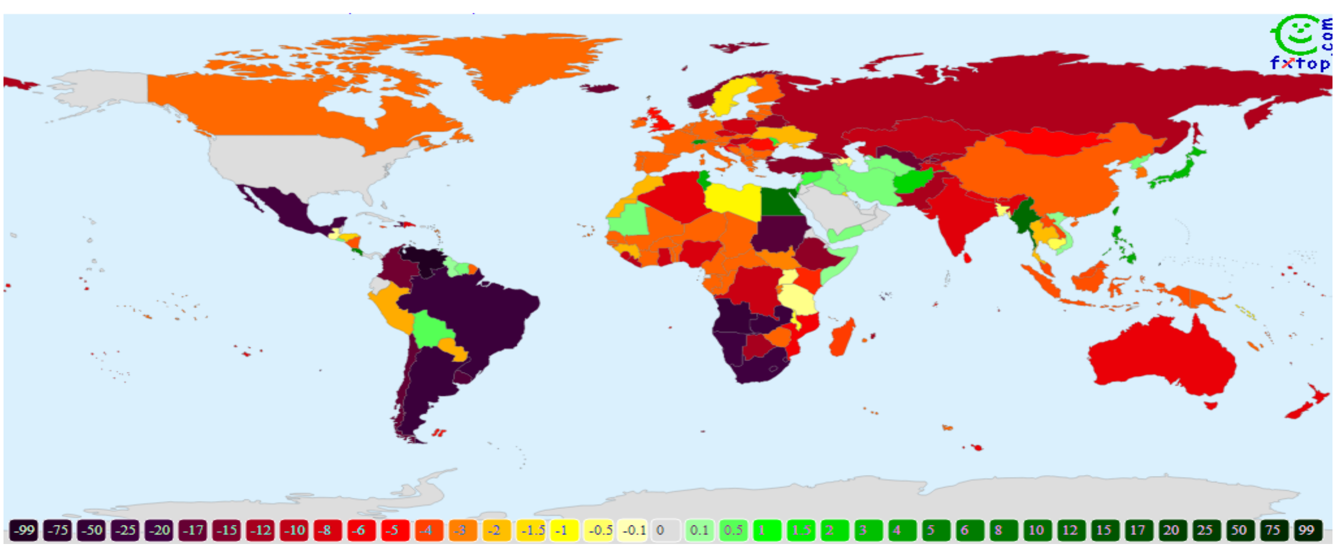
US dollar-denominated borrowings by emerging market (EM) corporations have increased rapidly in recent years (non bank in excess of $ 11.4 trillion according to Bank of International Settlements in 2018), raising concerns about possible currency mismatch risk, debt defaults, and capital flight from those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

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



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



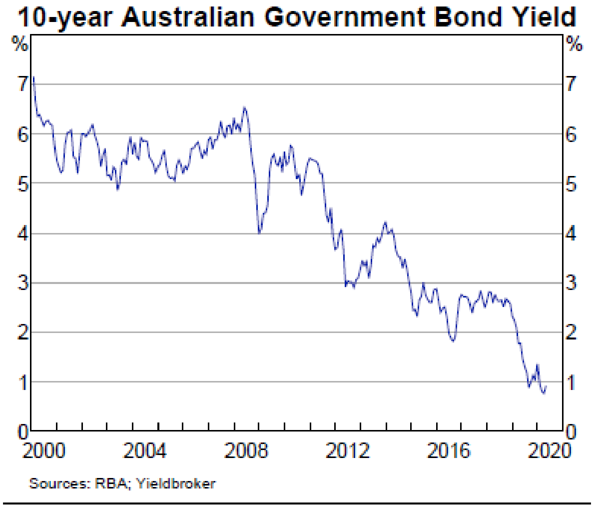
Bond yields

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 1.8% (September 18, 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.

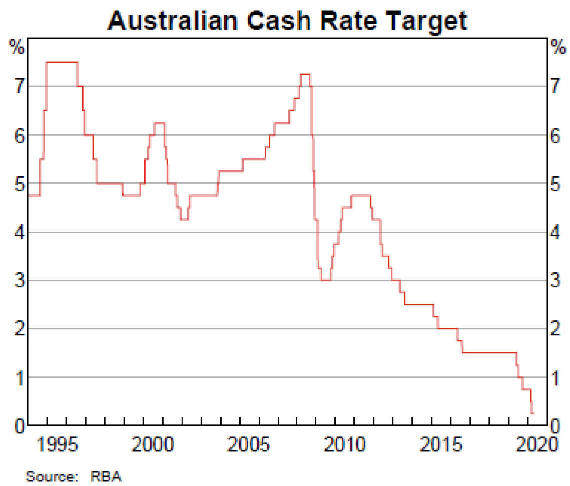
RBA meeting:

- October 6, 2020

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

Market pricing of interest rate cut to 0.00% at October 6 meeting based on inter-bank cash rate futures: no change: 33%; fall 67%

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



Interest Rates and QE- International

Key dates are:

European Union decisions (now -0.5%)

- October 29, 2020

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

US Federal Reserve decisions (now 0.25%):

- November 4-5, 2020

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

Bank of England decisions (now 0.1%)

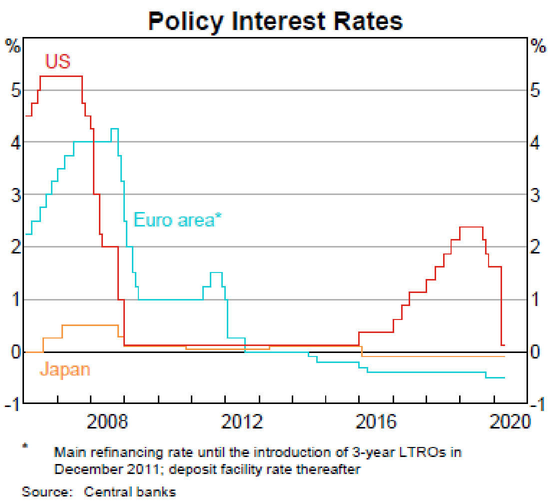
- November 5, 2020

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

Bank of Japan decisions (now -0.1%):

- October 28-29 2020

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



WHAT WE ARE READING

Zero Hedge: Why One Bank Thinks The World Is "On The Cusp Of A New Era Characterized By Disorder"

https://www.zerohedge.com/markets/why-one-bank-thinks-world-cusp-new-era-characterized-disorder

1. The first era of globalisation (1860-1914)
2. The Great Wars and the Depression (1914-1945)
3. Bretton Woods and the return to a gold-based monetary system (1945-1971)
4. The start of fiat money and the high-inflation era of the 1970s (1971-1980)
5. The second era of globalisation (1980-2020?)
6. The Age of Disorder (2020?-????)

Zero Hedge: 'Father Of Credit Risk Modelling' Has Ominous Warning Over "Insolvent" Companies Piling Up Debt

https://www.zerohedge.com/markets/father-credit-risk-modeling-has-ominous-warning-over-insolvent-companies-piling-debt

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

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

On my radar: The pandemic and debt with parameters

https://www.cmgwealth.com/ri/on-my-radar-the-pandemic-and-debt/

"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

Further details at: www.gyrostat.com.au