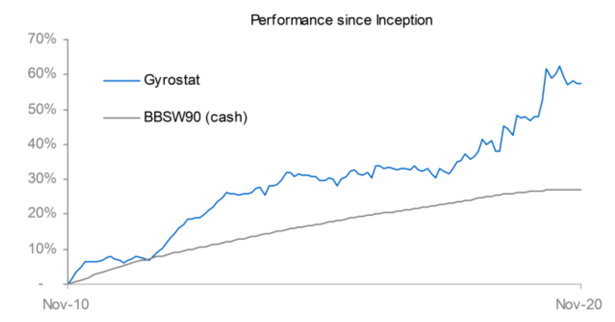
GYRATIONS

Volatility is our friend – risk managed investing

Portfolio construction: Reduce exposure to drawdown losses, increase income

Gyrostat Capital Management Pty Ltd   November 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 <u>always</u> happens – stock market boom-bust cycles

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

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

MANAGE UNCERTAINTY THROUGH PORTFOLIO CONSTRUCTION

The 'mystery' of the unprecedented Central Bank and Federal Government stimulus measures in response to Covid continues to unfold. Will markets continue to be supported and rise, or will the sharply deteriorinating earnings and economic fundamentals see the completion of this extended investment cycle from 'peak' to 'trough'?

More importantly, is your lifestyle fragile to the outcome? It doesn't need to be through portfolio construction.

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.

The premise behind established finance portfolio construction theory to include diversified non correlated assets relates primarily to 'investment risk management' –you can prepare for all outcomes without the need to predict.

Many portfolios are no longer diversified non correlated as a result of zero bound or negative interest rates. Previously bond interest rates would increase in 'later cycle' market conditions and be cut to stimulate the economy on market falls – with bonds acting as a non correlated asset that increased in value on market falls whilst providing regular income. In zero bound interest rates environments (the consensus view in Australia) most defensive assets provide little or no income, nor do they increase in value on market falls if interest rates are no longer to be cut below 'zero'.

There have been 10 years of Government retirement income reviews in Australia to encourage the development of non correlated financial products that can be added to fortify your portfolio. 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 meet all of these requirements and is a risk managed investing specialist – using equity markets and derivatives to create a highly defensive non correlated fund that reliably increases in value on large markets falls, whilst providing a regular quarterly income and returns through the complete investment cycle. Gyrostat has consistently delivered income to investors whilst for 40 consecutive quarters having no draw-downs exceeding its pre-defined -3% risk parameter.

When explaining portfolio construction to your children or grandchildren, we consider it analogous to The Three Little Pigs – is your portfolio built of straw, wood, or bricks!?

What are the capital loss exposures embedded in your portfolio as the 'peak' to 'trough' cycle unfolds as it always has and a large correction happens?

This is relatively easy to check – how did your portfolio perform 1 February to 31 March 2020?

1 Feb 2020 to 31 March 2020:	ASX – 26.8%, Gyrostat + 9.1%, Cash +0.02%

A more detailed explanation of our role in portfolio construction, including industry comparisons of other risk management approaches, is available at:

http://www.gyrostat.com.au/news/gyrostat-corporate-presentation-at-30-september-2020/

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 is a 'conservative' asset.

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

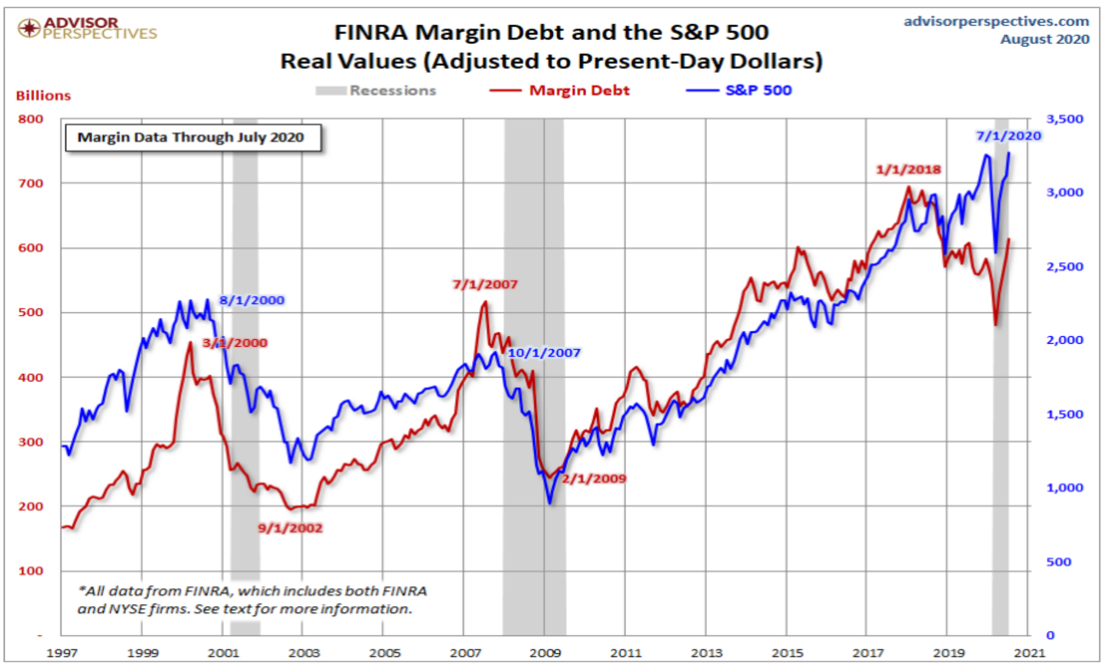
FEATURE ARTICLE: WHY MARKETS FALL FAST

The more uncertain the environment the more important it becomes to structure your portfolio to include diversified non correlated assets. Market cycles result from positive and negative feedback loops (booms and busts) as expectations become far removed from reality. Doubts grow, but through inertia the trend remains. The trend eventually reverses in the opposite direction, as reality can not keep up with expectations.

A more detailed explanation on markets consistent with how we see them is available at George Soros Lecture Series: Financial Markets https://www.youtube.com/watch?v=RHSEEJDKJho

The bust is short and steep, from the <u>forced liquidation of unsound positions</u>, particularly in far from equilibrium states. These forced liquidations are a function of the structure of the markets and psychological behaviour of investment participants.

1) Leveraged positions must be unwound – margin loans



https://www.advisorperspectives.com/dshort/updates/2020/08/20/margin-debt-and-the-market-up-another-5-in-july

2) Risk management tools eg Value at Risk based on price deviations/mathematical models reliance get badly burnt

Ray Dalio – A Template for Navigating Big Debt Crises in reviewing past crises concludes: -

> "Value at Risk (VAR), is a measure of recent volatility in markets and portfolios, was commonly used by investment firms and commercial banks to determine the likely magnitude and occurrence of losses.
>
> This way of thinking about risk caused many investors to increase their exposures beyond what would normally be seen as prudent. They looked at the recent volatility in their VAR calculations, and by and large expected it to continue moving forward. **This is human nature and it was dumb because past volatility and past correlations aren't reliable forecasts of future risks.**" https://www.principles.com/big-debt-crises/ p121

3) Change in investor psychology is compounded by algorithmic trading. One framework for considering stock markets is that shorter term outcomes are driven by investor psychology independent from economic realities, with

longer term trends driven by fundamentals. Technical analysis attempts to capture the market psychology through trend analysis. These trends are prone to rapid changes, accelerated by advances in technology and algorithmic trading.

4) A small group of stocks lead market gains – Apple market cap now exceeds the Russel 2000 Index.

https://www.zerohedge.com/markets/option-insanity-leads-furious-meltup-apple-above-russell-2000-emini-new-record-high

We note that legendary investor Jeremy Grantham says he is certain we are in a bubble, the fourth major bubble in his lifetime (Japan 1989, Dot.com 2000, USA Housing crisis 2008) in an article published November 14, 2020.

https://www.businessinsider.com.au/stock-market-outlook-investing-legend-jeremy-grantham-bubble-crazy-rally-2020-11?r=US&IR=T

Ray Dalio – A Template for Navigating Big Debt Crises outlines his criteria for the defining characteristics of a bubble.

https://www.principles.com/big-debt-crises/

> The US housing market was showing **every sign of a classic bubble**. To repeat my defining characteristics of a bubble:
>
> 1) **Prices are high relative to traditional measures.**
> 2) **Prices are discounting future rapid price appreciation from these high levels.**
> 3) **There is broad bullish sentiment.**
> 4) **Purchases are being financed by high leverage.**
> 5) **Buyers have made exceptionally extended forward purchases (e.g., built inventory, contracted forward purchases, etc.) to speculate or protect themselves against future price gains.**
> 6) **New buyers (i.e., those who weren't previously in the market) have entered the market.**
> 7) **Stimulative monetary policy helps inflate the bubble, and tight policy contributes to its popping.**

PORTFOLIO CONSTRUCTION CHECKLIST

1. What type of investor are you – in particular what is your 'risk' appetite?

Psychologists have noted that loss aversion increases if the consequences of possible loss can be ruinous to your lifestyle. This is particularly true of many retirees as reflected in the concept of sequencing risk. This is why the defensive asset allocation is higher depending upon your level of risk aversion. Gyrostat is a defensive asset allocation.

2. 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%.

3. How many assets in your portfolio reliably increase 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).

4. 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 – as a consequence 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.

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

OUTLOOK SCENARIOS TO ADDRESS

The risk of significant losses is elevated in our view. Scenarios to address in portfolio construction are:-

1. **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.

Market	High 19 Feb 2020	50% decline level	Market 17 November 2020	50% fall peak to trough scenario	March 23, 2020 lows	Re-test falls
SP500	3386	1693	3609*	-53%	2237	-38%
Nasdaq	9817	4808	11899 *	-60%	6860	-42%
ASX200	7163	3581	6498	-45%	4546	-30%
Hang Seng	29056 *20 Jan	14528	26415	-45%	21696	-17%

* SP500 and Nasdaq has exceeded 19 February 2020 previous high

2. **Larger 40-50 % falls**. Major corrections are a regular and hazardous feature of the investment cycle.

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 risen to record highs from the peak of 3386 (19 Feb 2020).

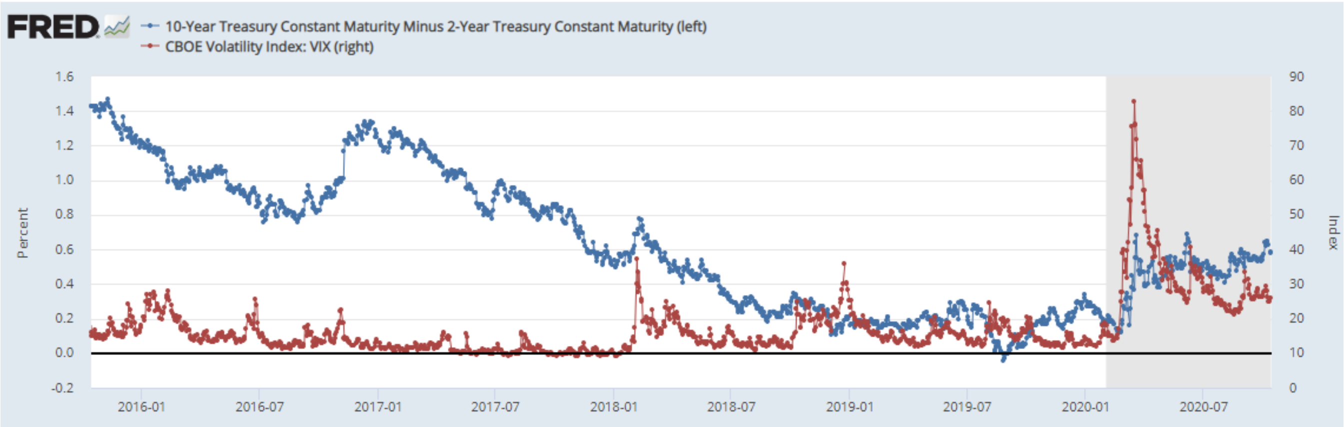
SP500 index: 90 year historic chart. Peak to trough falls > 20, duration of falls, time to recover

VOLATILITY BY THE NUMBERS

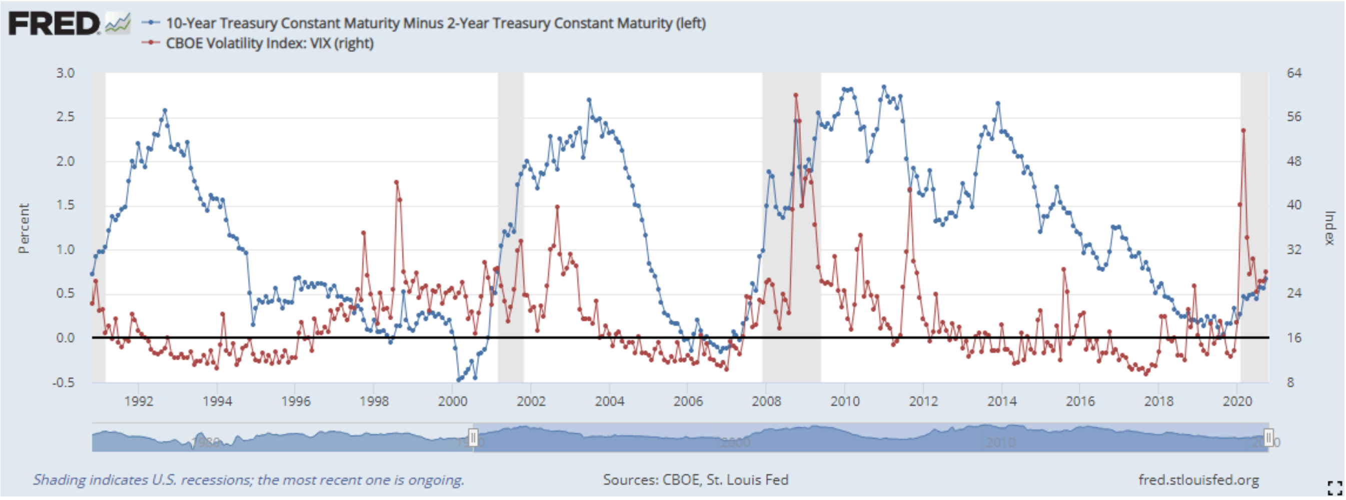
The USA Federal Reserve Economic Data publishes the VIX volatility index. Derived from the index prices of SP500 options it provides a measure of market risk and investor sentiment.

Since January 2018 there has been an increase in market volatility – consistent with the regular approximately 4-6 cycles between stable and more volatile conditions.

Federal Reserve Economic Data – VIX 5 years (shown in red)



Federal Reserve Economic Data – VIX 30 years (shown in red)



Source: https://fred.stlouisfed.org/graph/?g=k1bn

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.").

WHAT WE ARE READING

"Holy grail" portfolio construction: Ray Dalio
https://www.youtube.com/watch?v=Nu4lHaSh7D4&t=85s

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?-????)

Legendary investor Jeremy Grantham says he's certain the stock market is in a bubble after its 'truly crazy' rally this year.
https://www.businessinsider.com.au/stock-market-outlook-investing-legend-jeremy-grantham-bubble-crazy-rally-2020-11?r=US&IR=T

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

Further details at: www.gyrostat.com.au

ONLINE applications available (in most cases no forms required for identification), Investment platforms Mason Stevens, Netwealth, Powerwrap