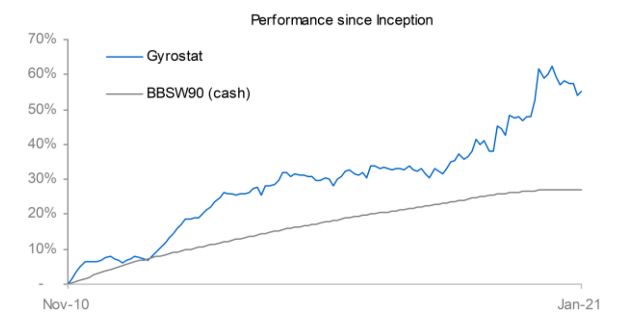
GYRATIONS

Volatility is our friend – risk managed investing

Portfolio construction: <u>Reduce</u> portfolio risk and <u>increase</u> equity income

Gyrostat Capital Management Pty Ltd February 2021

THIS MONTH



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

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

The unexpected <u>always</u> happens – 'late cycle' stock market boom-bust cycles

Our solutions reduce portfolio drawdown risk whilst increasing equity income -3 unit classes:

- **Absolute Return Income Equity Class – 'highly defensive' equity income; sequencing risk**
- **Leveraged Absolute Return Income Equity Class – 'equity income' minimum BBSW+6%**
- **Risk Managed Australian Equities Class – benchmark ASX200 – sequencing risk**

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 rising bond yields from expectations of increasing inflationary pressures see 'late cyle' major market falls and 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. Gyrostat Absolute Return Income Equity Fund class has consistently delivered income to investors whilst for 40 consecutive quarters having no draw-downs exceeding its pre-defined - 3% risk parameter. We have recently expanded the range of classes to offer our solution to the specific issues you are seeking to address through portfolio construction and the asset allocation classification – whether "equity income', "Australian equities", or "highly defensive – alternative".

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 a more detailed explanation of our three classes of units is available at:

https://www.gyrostat.com.au/news/gyrostat-corporate-presentation-february-2021/

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.

- "Level 1" - diversifying risk- varying the allocation of 'conservative and 'growth' assets.
- "Level 2" - protection sometimes 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 always 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

"You've spent so much time putting it all together – what's the point if it is going to fall apart on major market falls.

"You can do *nothing*, or you can do *something*" – Ben Feldman

GYROSTAT RISK MANAGED EQUITY FUND UNIT CLASSES

Gyrostat Capital's investment philosophy is founded on the belief that conventional portfolio design that seeks to generate income and/or capital growth is prone to undesirable volatility and large negative shocks. Gyrostat Capital aims to mitigate and control this volatility, while achieving stable returns with regular income streams over the medium-to-long term. In designing the Fund, Gyrostat Capital seeks to provide solutions for a low interest rate environment and major market corrections. Gyrostat Capital's objective is to deliver a regular and stable income stream with capital security. Returns are designed to increase with market volatility.

Proprietary systems identify volatility skews for lowest cost protection within defined risk parameter always in place.

Each Class has differing risk-return characteristics but all Classes are based on the risk managed approach developed by Gyrostat Capital and is backed by a Class specific pool of assets and liabilities held on a segregated basis.

	Gyrostat Absolute Return Income Equity Class	**Gyrostat Leveraged Absolute Return Income Equity Class**	**Gyrostat Risk Managed Australian Equities Class**
Returns objective	6% -8% in trending markets, greater than 8% in changing markets, BBSW 90 + 3% in stable markets	Greater than income	Outperform ASX200 accumulation index over rolling 12 months
Income objective	Minimum BBSW 90 + 3%	Minimum BBSW 90 + 6%	ASX200 accumulation index
Protection objective	No quarterly Net Asset Value draw-downs exceeding 3%	No quarterly Net Asset Value draw-downs exceeding 6%	Protection always in place
Benchmark	BBSW 90 + 3%	BBSW 90 + 3%	ASX200 accumulation index
Leverage	The Class may borrow up to 30% of the Class Unit's assets (measured at the time of debt incurrence) on a secured or unsecured basis.	The Class may borrow up to 100% of the Class Unit's assets (measured at the time of debt incurrence) on a secured or unsecured basis.	The Class may borrow up to 100% of the Class Unit's assets (measured at the time of debt incurrence) on a secured or unsecured basis.
Distribution policy	Minimum distribution: the 90 day bank bill swap rate (BBSW90) + 3% pa paid quarterly.	Minimum distribution: the BBSW90 + 6% pa. Paid quarterly.	To match the ASX200 accumulation index
Sub-Fund	Absolute Return Income Equity	Leveraged Absolute Return Income Equity	Risk Managed Australian Equities
Classification	Alternative Defensive	Equity Income	Australian Equities

Our general observations are:

• With protection always in place a 'one off' sell-off event would be beneficial for the Fund

• Increasing levels of volatility are beneficial for the Fund, as this creates the opportunity to more actively manage the 'options overlay' and lower the cost of protection

• There is also a static cost for those periods of lower volatility where the options do not trade. The cost of protection is higher during these periods

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

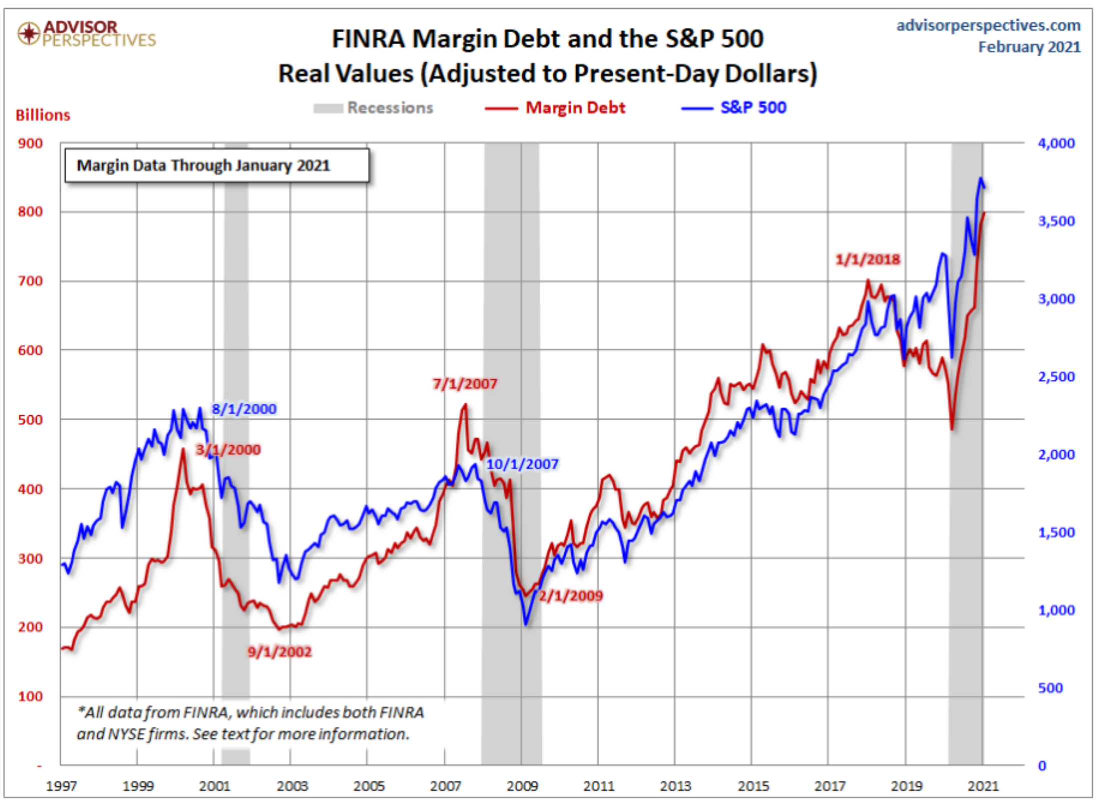
FEATURE ARTICLE: WHY MARKETS FALL FAST

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 forced liquidation of unsound positions, 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 has continued to increase to record levels in Jan 2021



https://www.advisorperspectives.com/dshort/updates/2021/02/18/margin-debt-and-the-market-up-2-6-in-january-continues-record-trend

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) with recent commentary and analysis in January 2021.

https://www.businessinsider.com.au/jeremy-grantham-biden-stimulus-inflate-stock-market-bubble-tesla-bitcoin-2021-1

Ray Dalio – A Template for Navigating Big Debt Crises outlines his criteria for the defining characteristics of a bubble, and outlines his views as a February 2021 in a post published at LinkedIn.

https://www.linkedin.com/pulse/we-stock-market-bubble-ray-dalio/

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?

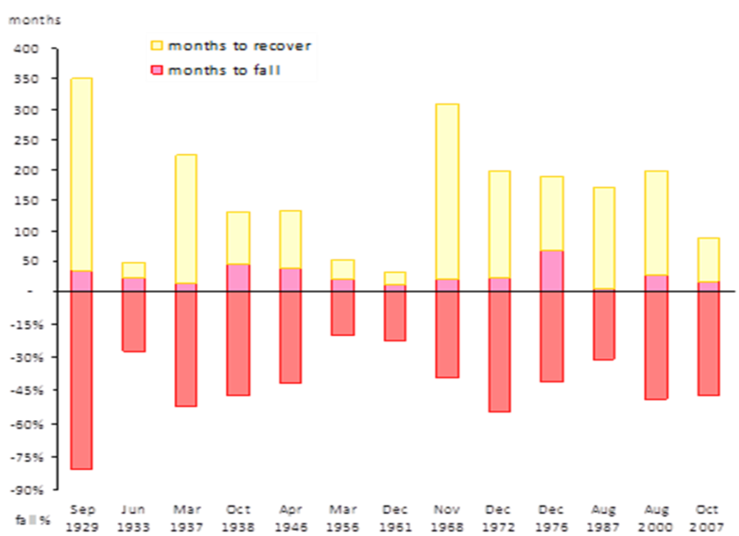
Psychologists have noted that loss aversion increases if the consequences of possible loss can be ruinous to your lifestyle. This is particularly true of many retirees as reflected in the concept of sequencing risk. This is why the defensive asset allocation is higher depending upon your level of risk aversion. Gyrostat is a defensive asset allocation with 3 unit classes depending upon the issues you wish to address through portfolio construction.

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%.

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



3. Why have you expanded the classes of units available to investors?

We have recently expanded the range of classes to offer our solution to the specific issues you are seeking to address through portfolio construction and the asset allocation classification – whether "equity income', "Australian equities", or "highly defensive – alternative".

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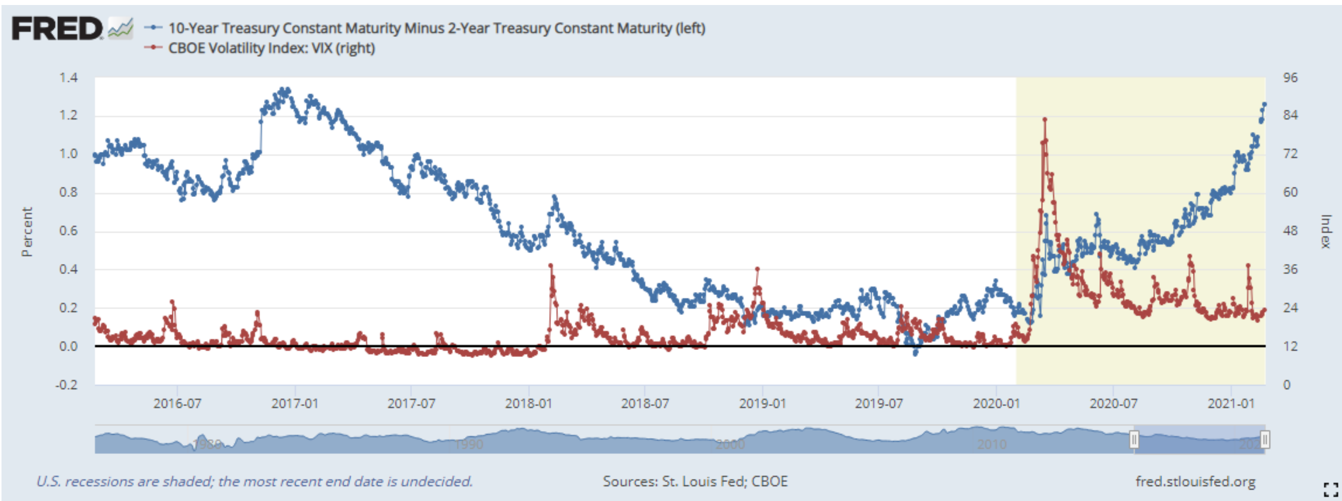
VOLATILITY BY THE NUMBERS

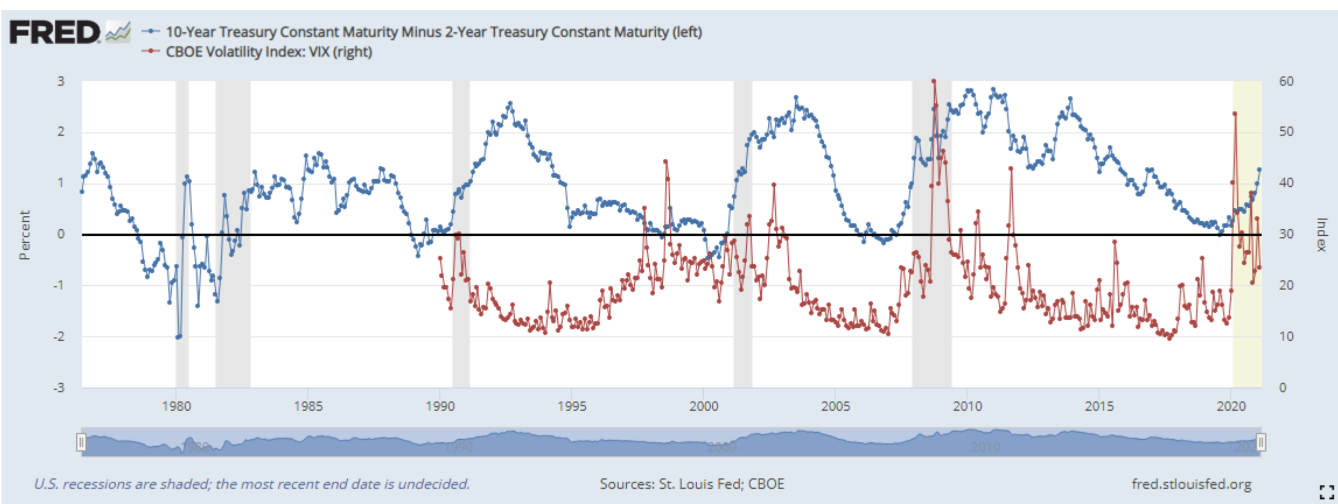
The USA Federal Reserve Economic Data publishes the VIX volatility index. Derived from the index prices of SP500 options it provides a measure of market risk and investor sentiment.

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 WE ARE READING

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

On My Radar: A Beacon of Light to Warn and Guide (February 12, 2021)
https://www.cmgwealth.com/ri/on-my-radar-a-beacon-of-light-to-warn-and-guide/

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?-????)

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