

Dynamic hedging can solve the retirement income product dilemma

Craig Racine, Managing Director and Chief Investment Officer of Gyrostat Capital Management

The problem: *A lack of retirement income products which protect and grow capital through the complete investment cycle*

There have been more than 10 years of Government retirement income reviews in Australia to encourage the development of retiree income products with downside protection.

The Financial System Enquiry, commissioned by the Australian Government concluded in their final report in 2014:

“The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.”

As recently as 23 June 2022 speaking at the Trans-Tasman Business Circle event APRA chair Wayne Byres said the superannuation sector is not equipped to deal with the current “significant demographic shift”.

*“An ever-growing number of members shift each year from the accumulation to the retirement phase, **only to encounter a lack of accessible financial advice or suitable products to help manage their nest eggs for potentially decades to come.**”*

In plain speech, this means retiree investors are exposed to significant losses of their capital with stock market falls, which is a regular and hazardous feature of the market. This can be measured by the maximum drawdown losses during the period of the investment, a commonly quoted statistic for all fund managers.

What is needed: *Retirement income product specifications – the criteria to be satisfied*

The various reviews have listed the criteria to be satisfied as follows: regular income, capital protection and growth, no lock in periods for investors, transparent pricing, address sequencing risk (major market falls reducing capital value), longevity risk (capital to grow through the complete investment cycle), strong counterparty and no credit default risks.

This ‘template’ of reviews has garnered significant industry comment and provides a template for retirement income product and innovation managers.

We believe that Gyrostat Risk Managed Equity Fund Class A satisfies all these requirements.

“Blue chip shares with protection for retiree income, 12 M +12.28%, 11 year track record of no quarterly downside losses > 3%, volatility is our friend with capital gains in rising and falling markets.”

The solution: Dynamic hedging – technology to the rescue

In 2011 global asset manager Russell Research concluded [dynamic hedging provides downside protection offers at a reasonable price](#). It's an approach that is also being used by leading global asset managers. Gyrostat benchmarks against these managers, as outlined in our review published in June 2021. Gyrostat commenced operations in December 2010.

[2021-06-11-Risk-Managed-Investing-Supporting-Pack-v1b.pdf](#)

A summary of the risk management approaches is as follows:

- Vary asset allocation between stocks and bonds (diversification)
- Buy underlying assets, write call options (Buy-write income funds)
- Long/short funds (market neutral, 130/30)
- Buy underlying assets, using a predictive approach to sell futures contracts at some times
- Buy underlying assets, buy put options at selected times using predictive approaches
- Buy put options and hold cash (volatility as an asset class)
- [Dynamic risk managed protection overlays \(dynamic hedging\)](#)

In plain speech, when Gyrostat utilises dynamic hedging of every \$ 1 invested, approximately 95c buys the stock, and around 5c the lowest cost protection. As the market price moves, the “gyrostat” is brought back into balance to restore this 95:5 recipe. This means if the stock falls, the value of protection goes up – the protection has done its job and a portion is sold for cash. On stock rises, the value of protection falls and more is acquired.

The aim is to achieve a stable and rising capital value, with income from the blue chip stock dividends and capital protection provided by entering option positions using a portion of the cashflow from dividends. In Australia, these are typically ASX20 stocks that also attach ‘franking credits’, offering additional benefits to retiree investors on zero or low marginal tax rates.

To implement this strategy requires sophisticated proprietary software systems. The key is to immediately identify the differences in the pricing of options (which academics have noted for decades have different levels of implied volatility) to identify the lowest cost protection in the market at that time. It was necessary for Gyrostat to build sophisticated systems which feed in live pricing from the stock exchange, immediately interpret the live data to identify the lowest cost protection and recommend the trades to make. Initially a 'hard risk' tolerance or limit on capital loss of no more than 2% per quarter was set, which was increased to 3% in March 2019.

Gyrostat has consistently delivered income to investors (quarterly with bumper payment in 4th quarter in strong return years) and has a track record of over eleven years with no quarterly drawdown greater than the pre-defined 3% limit. It has been designed to reliably increase in value on major market falls – a valuable offset to losses experienced in other parts of the retiree investors portfolio during stock market falls.

Gyrostat have partnered with Damien Hatfield and Tim Cheung and their team at Mantis in 2020 as distribution partner. “Our class A fund offers “blue chip shares with protection, for retiree income”, with class B a levered version (higher risk tolerance, higher expected return)”.

The responsible entity for the Gyrostat Risk Managed Equity Fund (ARSN 651 853 799) is Columbus Investment Services Limited (ACN 095 162 931) (AFSL221183) (**CISL**). The investment manager for the fund is Gyrostat Capital Management Advisers Pty Ltd (ACN 168 737 246), a duly authorised representative of Gyrostat Capital Management Pty Ltd (ACN 138 219 002) (**GCM**) and One Wholesale Fund Services Ltd (ACN 159 624 585).

The information provided in this document was not prepared by CISL but prepared by other parties. All of the commentary, statements of opinion and recommendations contain general advice only. This information does not take into account your investment objectives, particular needs or financial situation. You should seek independent financial advice.

The content of this document does not constitute an offer or solicitation to subscribe for units in the Funds or an offer to buy or sell any financial product. Accordingly, reliance should not be placed on this document as the basis for making an investment, financial or other decision.

Past performance is not a reliable indicator of future performance. Performance comparisons are provided purely for information purposes only and should not be relied upon. The information included in this document may include information that is predictive in character which may be affected by inaccurate assumptions or by known or unknown risks and uncertainties and may differ materially from results ultimately achieved.

Whilst all care has been taken in preparation of this document, neither CISL nor the Investment Manager give any representation or warranty as to the reliability, completeness or accuracy of the information contained in this document. Neither CISL nor the Investment Manager accepts liability for any inaccurate, incomplete or omitted information of any kind or any losses caused by using this information.

You should obtain and carefully consider the Product Disclosure Statement (**PDS**) and the Target Market Determination (TMD) for the Fund before making any decision about whether to acquire, or continue to hold, an interest in the Fund. Applications for units in the Fund can only be made pursuant to the application form relevant to the Fund. A copy of the PDS (dated 15 February 2022), TMD (dated 1 October 2021) and relevant application form can be obtained from www.gyrostat.com.au/application-forms or www.oneinvestment.com.au/gyrostat.