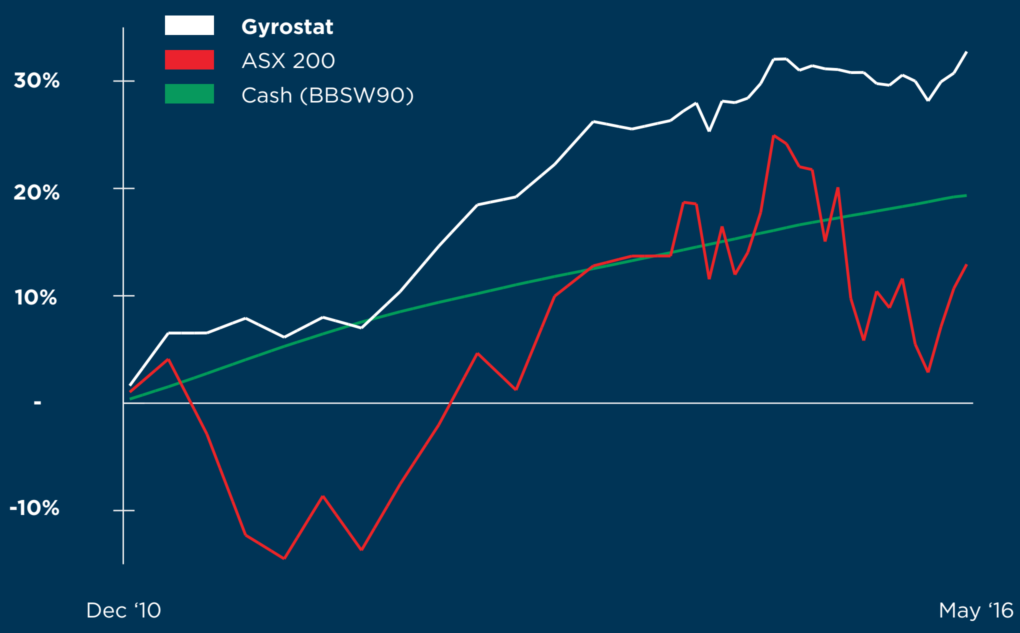
“Do it yourself” risk managed equity income with protection

Explanation and Costs

31 May 2016



GYROSTAT
RISK MANAGED EQUITY FUNDS

"Do it yourself" risk managed equity income - explanation and cost

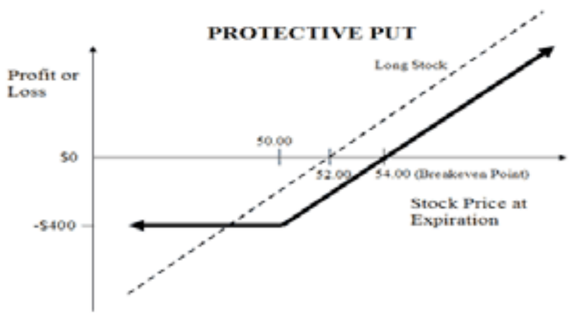
By Craig Racine, Managing Director and Chief Investment Officer, Gyrostat Capital Management

- Many investors seek income from dividends, but are concerned about capital losses. It is possible to protect your portfolio. This report will show you the current market costs.
- Investors can implement "do it yourself" equity protection for effective risk management. The ASX offers investor education at their web-site.
- We calculate the annualized cost for 'blue chip' higher yielding stocks based upon current market conditions, varying the duration of protection and capital at risk. Market conditions are constantly changing.

> "As you **approach retirement** it's prudent that you consider reducing your exposure to riskier assets like equities and increase exposure in safer assets like cash/bonds. However with current interest rates and the benefits franking credits provide via shares it is something that is seldom done.
>
> Overweight holdings in shares expose your retirement savings to market corrections, a lesson learned the hard way for many during the GFC.
>
> There is a valid alternative that allows you to continue to receive franking credits and benefit from share price appreciation but protects your portfolio from large market corrections.
>
> Purchasing protection from the options market can help"
>
> www.asx.com.au/products/equity-options/eto-for-smsf.htm

The theoretical knowledge on how to "insure" your portfolio has been around since 1973 when Fisher Black and Myron Scholes published a paper, the basis for which a Nobel Prize in Economics was awarded fourteen years later. Their work created one of the most important concepts in modern financial theory, the mathematical model for pricing derivative investment instruments, including options.

A put option gives you the right to sell a stock at a pre-defined price for a pre-defined period of time. You don't have to sell the stock; you can sell the protection back into the market and receive the cash. It is like an insurance policy, but like all insurance it comes at a price.



Protective Put Payoff Diagram

The level of implied volatility is one of the key determinants of the price of an option. This is the price of risk. At the market level this is reflected by the A-VIX.

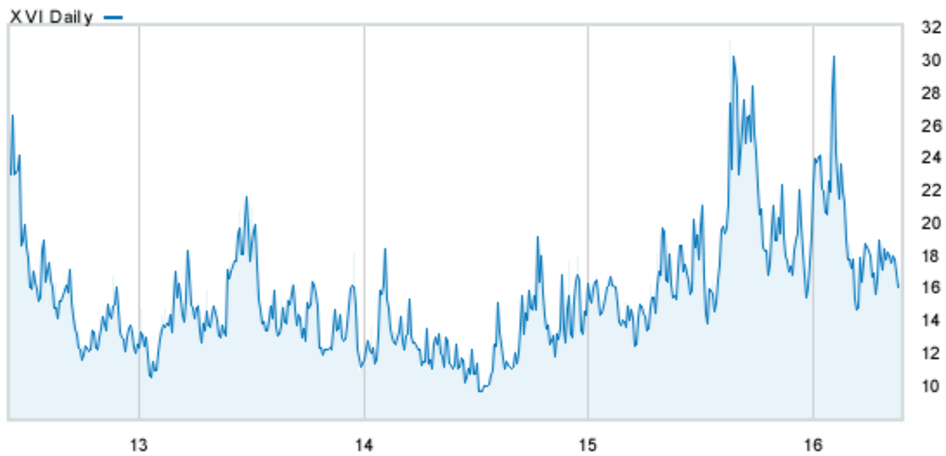
Understanding the A-VIX

The S&P/ASX 200 VIX (A-VIX) is a real-time volatility index that provides investors, financial media, researchers and economists with an insight into investor sentiment and expected levels of market volatility. The index tracks S&P/ASX 200 index option prices as a means of monitoring anticipated levels of near-term volatility in the Australian equity market.

A chart of the A-VIX for 1 year (to show shorter term variations) and 4 years (for historical context) is shown below.

The investor challenge is to 'convert' this to an annualized cost.

www.asx.com.au/products/sp-asx200-vix-index.htm



We have obtained live market prices with strike prices closest to 0%, 5% and 10% capital at risk. The analysis is based upon the cost after the receipt of dividends. We have calculated the level of implied volatility and then extrapolated the option price to enable a comparison across the stocks and the index. These have been converted to an annualized cost based on holding the option position to expiry.

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As of business **morning May 31** the current market conditions are:

	Capital at risk	Annualised Cost for 1 Month	Annualised Cost for 3 Months	Annualised Cost for 6 Months	Annualised Cost for 12 Months
XJO	**0%**	-25%	-13%	-9%	-
	5%	-4%	-7%	-6%	-
	10%	-1%	-3%	-4%	-
AMC	**0%**	-20%	-13%	-9%	-
	5%	-8%	-7%	-7%	-
	10%	-2%	-4%	-4%	-
ANZ	**0%**	-30%	-16%	-10%	-7%
	5%	-9%	-9%	-8%	-6%
	10%	-4%	-6%	-5%	-4%
BHP	**0%**	-51%	-29%	-17%	-
	5%	-32%	-20%	-14%	-
	10%	-16%	-14%	-12%	-
CBA	**0%**	-26%	-14%	-10%	-6%
	5%	-7%	-9%	-7%	-5%
	10%	-2%	-5%	-5%	-4%
LLC	**0%**	-28%	-21%	-12%	-
	5%	-12%	-13%	-8%	-
	10%	-4%	-7%	-5%	-
MQG	**0%**	-14%	-12%	-8%	-6%
	5%	-6%	-7%	-6%	-5%
	10%	-2%	-4%	-4%	-4%
NAB	**0%**	-28%	-16%	-11%	-6%
	5%	-11%	-9%	-8%	-5%
	10%	-4%	-6%	-5%	-5%
RIO	**0%**	-50%	-24%	-14%	-
	5%	-23%	-17%	-12%	-
	10%	-12%	-11%	-9%	-
TCL	**0%**	-18%	-14%	-8%	-6%
	5%	-5%	-7%	-6%	-4%
	10%	-3%	-3%	-3%	-3%
TLS	**0%**	-11%	-13%	-8%	-6%
	5%	-4%	-7%	-5%	-3%
	10%	-1%	-2%	-2%	-2%
WBC	**0%**	-29%	-15%	-10%	-7%
	5%	-10%	-9%	-8%	-6%
	10%	-4%	-5%	-5%	-4%
WES	**0%**	-30%	-13%	-10%	-
	5%	-8%	-7%	-7%	-
	10%	-3%	-4%	-4%	-
WFD	**0%**	-22%	-16%	-10%	-
	5%	-6%	-9%	-6%	-
	10%	-3%	-5%	-4%	-
WOW	**0%**	-49%	-22%	-11%	-
	5%	-19%	-14%	-8%	-
	10%	-4%	-6%	-6%	-

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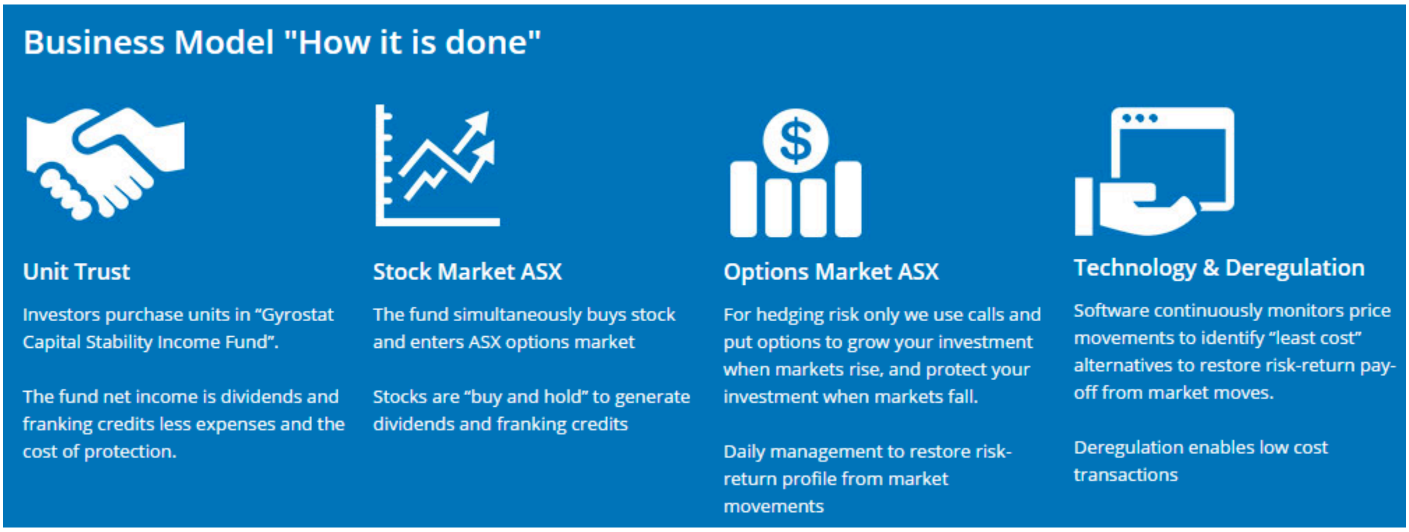
Protection always in place at an acceptable price

The historical issue that always protecting your portfolio is expensive is addressed through the management of ASX options, made possible through advances in technology and deregulation.

Management of the ASX options is the key to lowering its cost. In particular:

- There are differing levels of 'implied volatility' in the option market from differing maturities, or within the same maturity across a different range of strike prices. This has been observed by academics and market participants for many decades. Technology and software enables these to be identified in 'real time'.
- To further lower the cost of protection, you can receive premiums in return for limiting some of the upside. This is achieved by selling call options. Again, there are many series to choose from.
- With market movements, the "options" component can be actively managed. The trading reduces the cost. By actively managing, on market rises - locking in the gains with more protection; on market falls - sell some protection which is no longer required. Sophisticated software allows instant monitoring of a large number of price movements simultaneously.
- Transaction costs have fallen with deregulation. Deregulation allows funds managers and individuals to execute transactions at a low cost without the requirement to use a full service broker.

This is the approach taken by Gyrostat. We are always fully invested in blue chip high yielding ASX top 20 shares and insure downside with lowest cost alternatives (ASX bought put options). Gyrostat's unique offering is the ability to have a "hockey stick" risk-return profile at all times to participate in share price upside with minimal capital at risk. We pass on dividends and franking credits to our investors.



We participate in the upside if markets rise, and protect the downside when markets fall.

Further details available at:
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Retirement planning Craig Racine

End of seven-year rule brings a new ball game

For the first time in the history of the ASX, the All Ordinaries Index is lower than it was seven years ago. The seven-year rule used to be a persuasive sales pitch for financial planners. Now it is gone.

Times have changed. Global debt has increased by $57 trillion since 2007 and interest rates are at record low levels. Rental yields are heading in the same direction. Sharemarket volatility around the world adds to the uncertainties facing retirees.

Australia escaped the worst of the global financial crisis, but the record 25-year run of prosperity and growth seems set to end soon. The economic tremors in China and Europe add more uncertainty. This all spells trouble for retirement planning as the peak of the baby boom bulge moves past 65. In Paris last month, OECD secretary-general Angel Gurria warned about the risks created by current conditions.

He said: "Increasingly pension funds and life insurers are feeling the pressure to chase yield themselves, and to pursue higher risk investment strategies that could ultimately undermine their solvency. This not only poses financial sector risks, but potentially jeopardises the secure retirement of our citizens."

Reserve Bank of Australia governor Glenn Stevens recently questioned how an adequate flow of income could be generated for the retired "in a world where nominal returns on low-risk assets are so low".

David Murray, the chairman of the Financial System Inquiry, added more doubt when he said recently that "the retirement phase of superannuation is undeveloped and provides limited choice for managing risk in retirement". Put simply, the traditional approaches of buying high yielding stocks or buying stocks and selling call options are fragile and exposed.

Most attention on the financial planning industry recently has been, quite rightly, on the graft and corruption exposed by Fairfax Media in some of our biggest institutions. But the wider, long-term question is how the industry will produce income for its clients and manage the new risks. One answer is to deploy two other great movements of the past 25 years – technology and deregulation.

Deregulation allows fund managers and individuals to make unlimited numbers of transactions at low cost without the requirement to use a full service broker or other third party. And sophisticated software allows instant monitoring of large numbers of price movements simultaneously.

The deployment of these two weapons allows a form of insurance with downside protection always in place through the use of put and call options to lock in the sale price of the shares, no matter how low the share price may go.

The theoretical knowledge for this approach has been around since 1973 when Fisher Black and Myron Scholes published a paper that was the basis for a Nobel prize in economics awarded 14 years later. Their work created one of the most important concepts in modern financial theory, the mathematical model for pricing derivative investment instruments, including options. Recent software developments have opened the way for new ways to apply the model with deeper levels of sophistication and speed.

Most fund managers will be searching for ways to adapt to the new market paradigms to deliver better returns in a sluggish investment environment. This introduces another risk for investors who may be at the mercy of unintended consequences of new investment products.

Some exotic products will be exposed as fatally flawed. A recent example is bank hybrids, which were supposed to be a cross between the safety of cash and the risk of shares, with a yield somewhere in between. Unfortunately, some investors have found that hybrids are capable not only of producing the best of both worlds, but also the worst.

Investors and trustees of self-managed superannuation funds need to get used to the marketing by financial planners of more novel products aimed at producing higher returns than the old formulas. Investors should look for strategies with a proven track record. Those asked to participate in novel approaches should check for safeguards, including a straightforward business model with minimal capital at risk at all times and a financially strong counterparty such as the ASX for hedging activities, be cautious about leverage within a fund, ensure instruments are traded on an exchange which provides transparency and ask questions about whether the offering is robust in all market conditions.

Craig Racine is managing director of Gyrostat Capital Management.

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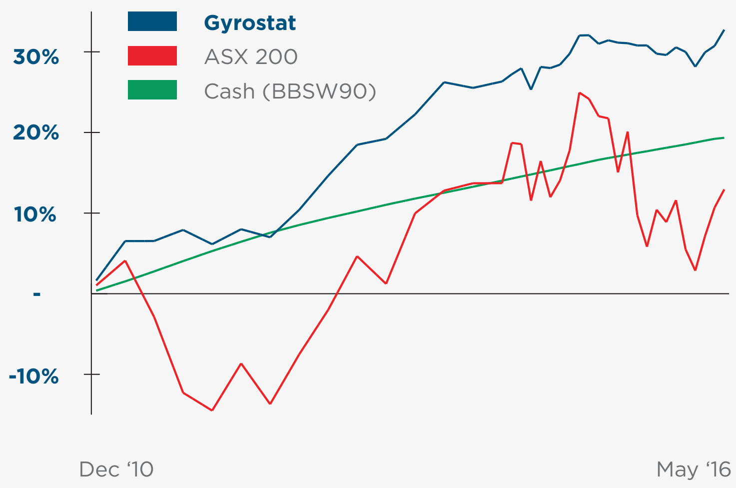
If your objective is to generate a higher level of income than cash and term deposits, whilst always protecting and growing your capital investment...

...OUR FUND CAN HELP.

Risk managed equity income fund

- Minimum distribution cash rate plus 3% (currently 5.3%)
- Growing your investment on market rises or large 'one off' falls
- Protecting your investment when markets fall
- Compounded returns of 33% since inception
- 21 consecutive quarters of no losses exceeding 2%



WE BUY AND HOLD BLUE CHIP STOCKS AND PASS ON THE FRANKED DIVIDEND.

We simultaneously enter the Australian Securities Exchange ("ASX") options market to hedge risk.

We are always fully invested with minimal capital at risk.

Our Track Record of Returns:

Period	Gyrostat	ASX 200	BBSW 3M
31 Mar 2012	6.1%	-6.7%	4.9%
31 Mar 2013	7.6%	2.0%	4.3%
31 Mar 2014	7.1%	4.0%	3.8%
31 Mar 2015	6.7%	5.2%	3.6%
31 Mar 2016	5.1%	1.3%	3.3%

* compunded annualised returns since inception

Business Model - "How we invest"

Unit Trust

Investors purchase units in "Gyrostat Capital Stability Income Fund".

The fund net income is dividends and franking credits less expenses and the cost of protection.

Stock Market ASX

The fund simultaneously buys stock and enters ASX options market

Stocks are "buy and hold" to generate dividends and franking credits

Options Market ASX

For hedging risk only we use calls and put options to grow your investment when markets rise, and protect your investment when markets fall.

Daily management to restore risk-return profile from market movements

Technology & Deregulation

Software continuously monitors price movements to identify "least cost" alternatives to restore risk-return pay-off from market moves.

Deregulation enables low cost transactions

Further details available at:
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