GYROSTAT
CAPITAL MANAGEMENT

Submission: Objective of Superannuation

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Executive Summary

- We support the recommended primary objective of superannuation to provide income in retirement to substitute or supplement the Age Pension. Enshrining this objective in legislation, and implementing the Financial System Inquiry ("FSI") recommendation 11, will encourage the development of better comprehensive income products for retirement ("CIPR").
- We make specific commentary on subsidiary objectives in relation to the FSI conclusion that there are a limited range of retirement income products.
- The subsidiary objectives our submission covers are:
  - Help people manage financial risks in retirement;
  - Be invested in the best interest of superannuation fund members maximising risk-adjusted returns;
  - Be simple and efficient and provide safeguards.
- FSI Recommendation 11 observed that CIPRs should have exposure to growth assets and that superannuation funds may work with life insurance companies, other funds or other entities to provide CIPRs. This could include the fintech industry consistent with Government policy.
- We explore the role of equity protected funds as a component of a CIPR. The historical issue that always protecting your portfolio is 'expensive' can be addressed through the management of Australian Securities Exchange ("ASX") options. This is the key to lowering the cost, and made possible through advances in technology and deregulation.
- The implementation of a risk managed solution requires the following additional features:
  - Financially strong counter-party;
  - Transparent mark to market valuations;
  - Capacity to scale the product offering.

  These are aligned with the stated objectives of the Australian Stock Exchange.

Do you agree with the objectives recommended by the FSI?

We support the recommended primary objective of superannuation to provide income in retirement to substitute or supplement the Age Pension. Enshrining this objective in legislation, and implementing the Financial System Inquiry ("FSI") recommendation 11, will assist the Government to meet its objective to facilitate the development of better comprehensive income products for retirement ("CIPR").

We make specific commentary on subsidiary objectives in relation to the Financial System Inquiry ("FSI") conclusion that there are a limited range of retirement income products.

The subsidiary objectives that relate to retirement income products are:

- Help people manage financial risks in retirement;
- Be invested in the best interest of superannuation fund members maximising risk-adjusted returns; and
- Be simple and efficient and provide safeguards.

Our specific commentary is on Chapter 2 of the FSI, in particular recommendation 11:

"Require superannuation trustees to pre-select a comprehensive income product for members' retirement… Impediments to product development should be removed."

The Financial System Inquiry listed three desired features for "comprehensive retirement income products.

- High income: Regular and stable income
- Longevity: invest in growth assets with risk management features
- Flexibility: low cost, 'cooling off' period

There are 3 strategic trends that make achieving retirement income policy objectives more difficult:

- Low interest rates
- Global debt levels
- Ageing population

Low interest rates reduce the rate of return, and hence level of income from traditional 'lower risk' assets such as term deposits, annuities, endowment bonds, bond funds, and hybrid securities. Investing too much in defensive assets like cash and term deposits may mean that the growth in a portfolio does not keep up with what is required, and savings may run out earlier than anticipated. However, investing too much in growth assets exposes a portfolio to market volatility and share price losses, so capital may also run out earlier than anticipated.

A solution in the design of CIPRs is to have a combination of products, including growth assets with risk management features. The FSI report envisaged that superannuation funds may work with life insurance companies, other funds or other entities to provide CIPRs. This could include the fintech industry consistent with Government policy.

The role of equity protected funds

Equity protected funds provide a risk managed exposure to growth assets.

There are many financial products being marketed on the basis of the risk mitigation. However, protection on your investment at all times is rarely in place.

The Lonsec report "Income in retirement – the pros & cons" considers the asset classes commonly used to generate retirement income:

- Term deposits
- Annuities
- Endowment Bonds
- Bond funds
- Equities – income focused
- Hybrids

Most "income" alternatives don't invest in growth assets. Protection of the investment at all times is rarely in place.

The Lonsec Report noted:

> "Funds that apply derivatives based strategies will also seek to manage the volatility of their funds via various options trades, with the aim of reducing downside risk, while at the same time dampening potential return upside."

Historically the perception has been that having protection always in place is 'expensive'. The ASX handbook "Guide to Equity Options for Investment Managers: Additional ways to achieve return and manage risk in equity portfolios" states:

> "Perpetually protecting a stock can be expensive. For example, 12 month at-the-money put options typically cost between 5% and 10% of the value of the shares. In most instances, this would be a large part of your expected return on the stock. Therefore, it is usually not cost-effective to have protection in place twelve months of the year – this strategy is generally more appropriate for shorter periods when

> you expect the share price may decline. On the other hand, long-term protection can be considered better value for money because time decay accelerates towards expiry. Just as in other real-world situations where protection is expensive but necessary, the same is true of equity portfolio management in certain instances."

Buying and holding stocks, combined with the management of the ASX options is the key to lowering its cost. This is enabled by developments in technology and deregulation.

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 managed. On market rises gains are locked in with more protection. On market falls protection which is no longer required is sold. 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.

The development of a risk management solution requires the following additional features:

- Financially strong counter-party
- Transparent mark to market valuations
- Capacity to scale the product offering

These are aligned with the stated objectives of the Australian Stock Exchange.

> "The new global regulatory environment creates business opportunities, particularly in post-trade and **risk management services** … ASX's investments underscore its commitment to deliver world class risk management solutions to investors."
>
> *Rick Holliday–Smith, Chairman, ASX Ltd.*
>
> *21 August 2014 Annual Report*

About Gyrostat Capital Stability Fund

We are a diversified income fund with capital stability – delivering income greater than cash returns (minimum 3% above the cash rate, currently 5.1% pa paid semi-annually) with downside protection always in place. 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. Throughout the investment cycle we protect capital when markets fall and have a track record of capturing 30%-50% of stock upside. Our strategy benefits from increasing stock market volatility.