Response to the Retirement Income Review Consultation Paper from Gyrostat Capital Management

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About Gyrostat Capital Management

Gyrostat has operated for 36 consecutive quarters within a 'hard' pre-defined risk parameter (no more than 3% capital at risk with our maximum draw-down 2.2% in any circumstances) always in place, delivering regular income by passing through ASX-20 dividends, and meeting returns guidance based upon market conditions (demonstrating increasing returns with market volatility). The Fund buys and holds ASX-20 shares with lowest cost protection always in place with upside. It is a conservative asset allocation.

In the case of Gyrostat, we have protection always in place (this is now possible by using technology to identify volatility discrepancies for lowest cost protection) and dynamically manage these options with market moves.

This challenges the existing paradigm that protection always in place is too expensive.

Our solution is for retiree investors to simply add a **defensive asset** allocation which provides regular equity income (minimum BBSW90 + 3%) by passing through ASX-20 dividends with 'hard' protection always in place, including tail hedge for gains on large market falls.

By adding to retiree portfolios this generates higher returns/income than cash/bonds/term deposits AND addresses longevity and sequencing risk (with 9 year track record of returns increasing with volatility and downside tail always in place.)

We **complement existing growth asset allocations** with a track record of our returns increasing with volatility (tail hedge always in place for gains on large market falls. Ie: addresses sequencing risk).

There is an increasing demand for retirement income products with protection and an acknowledged lack of product.

New products need to address market risk, sequencing risk and liquidity (Financial System Inquiry 2014, Retirement Income Disclosure Consultation Paper 2018, Deloitte Actuaries & Consultants 2019).

The importance of new risk management techniques

While minimising the risks associated with lifetime investment earnings for Australians is a proposition with wide support, the Australian financial services sector is founded on a one-dimensional approach to risk management.

This traditional and prevailing approach of 'diversified' investment portfolios exposes both large tranches of the $2.9 trillion in superannuation funds under management and the publicly funded aged pension system to extensive over-subscription when major market corrections occur. These trends are exacerbated by the Australia's 'relatively high exposure to growth assets by international standards'[1].

To meet the objectives of the Retirement Incomes system, there is a need to design-in risk management (RM), and expand the range of RM options that are being provided to retirees.

This needs to draw from the emerging innovation and fintech sectors in Australia and globally to expand the types of RM methodologies that are currently being applied in retirement products. Current methodologies are one-dimensional, and all stem from the one core approach of 'not having all your eggs in one basket'.

This Submission also reflects the comments made in various reviews of Australia's Financial System, including the Murray Report. It recognises that there are alternative approaches to RM from which Australian retirees are not currently benefiting, which is in turn putting pressure on the operation of each of the three pillars of system, and the way in which these pillars interrelate.

Fiscal implications

The deployment of more sophisticated approaches to RM across the retirement income product portfolio would make a material impact on reducing the call on public finances to support pension payments.

In this way, the integration of more effective RM techniques in retirement products positively impacts all three pillars of the retirement income system:

- Aged pension – reduced calls on funding levels, and ensures a focus on pension funding being applied to the most appropriate recipients
- Superannuation Guarantee (SG) – greater protection of funds being committed through the SG process
- Voluntary savings through additional superannuation contributions – greater security to funds offered through improved RM processes will encourage additional contributions.

The improved performance of superannuation funds based on superior risk management approaches will also improve the value for money accruing to government from the range of tax concessions it offers around super contributions.

Overall integration with the Retirement Income system

The Retirement Income system as depicted in Figure 3 of the Consultation paper provides the framework against which to understand the broad range of areas that can be positively impacted through the use of improved RM techniques in retirement income products.

This Submission responds to selected Consultation Questions as they appear in the Consultation Paper.

Consultation question – p.8: In what areas of the retirement income system is there a need to improve understanding of its operation (within the community)?

[1] Australian Government (2019), Retirement Income Review Consultation Paper, p.11

Retirees and investors should be aware of the role that RM plays in securing their investments over the long term, have greater information available to them in relation to the availability of a broader range of RM-supported products, including easily-accessible information regarding how individual products rate in terms of RM against an industry-wide benchmark scale..

<u>Consultation questions – p.9</u>: What are the respective roles of the Government; the private sector, and individuals in enabling older Australians to achieve adequate retirement incomes?

The panel has also been asked to identify the role of each of the pillars in the retirement income system…What are the trade-offs between the pillars and how should the appropriate balance between the role of each pillar in the system be determined?

Government needs to continue to encourage the fintech sector in Australia, particularly with a focus on how new innovations being introduced by start-up and scale-up businesses that can increase the range and diversity of retirement income product offerings.

Programs such as the Accelerating Commercialisation and CRC-P grant initiatives should have an increased focus on the financial services sector to help ensure that there is world class product research, development and deployment being conducted in Australia.

<u>Consultation question – p.12</u>: Are the principles proposed by the panel (adequacy, equity, sustainability, and cohesion) appropriate benchmarks for assessing the outcomes the retirement income system is delivering…Are there other principles that should be included?

The presence and adequacy of comprehensive risk management techniques that protect the nest egg of Australians should be central to the indicators of the health of the retirement income system in Australia. While RM positively impacts the ability of the system to deliver on the benchmarks of adequacy, equity, sustainability and cohesion, isolating RM as a benchmark in its own right will assist in driving more comprehensive industry responses.

To this end, the product risk rating system outlined in The Retirement Income Disclosure Consultation Paper[2] should be prioritised and deployed.

Improved risk management measures will also assist in managing the 'natural tension between the principles of sustainability and adequacy', and improve the retirement income system's 'ability to adjust for trends and withstand one-off shocks'.[3]

Greater security around retirement savings through the use of integrated RM methodologies will also work to improve public confidence in the overall system, encourage its greater utilisation, and again have a beneficial flow-on around reducing the burden of the pension system on the public purse.

Resilience of the retirement income system in the current environment

The consultation paper rightly identifies the need for the retirement incomes system to be sustainable in the face of one-off economic shocks, and also to offer value to consumers in a low interest rate environment.

Utilising more innovative approaches to RM assist both policy outcomes.

Having downside risk protection measures 'always in place' will ensure that retiree balances are protected against the significant outcomes that would otherwise arise from market corrections or more significant events. As an example of this, over the last 9 years the Gyrostat model has

[2] Australian Government (2018), Retirement Income Disclosure Consultation paper, p.7
[3] Australian Government (2019), Retirement Income Review Consultation Paper, p.20

seen losses across periods of market correction limited to our 'hard' pre-defined risk parameter with maximum draw-down of -2.2% in any circumstances.

Equally in the context of the long-term low interest rate environment, the integration of improved RM measures into retirement income products will offer relatively higher returns to consumers whilst maintaining security around their savings. This broadens their choice beyond focusing on the standard low risk products such as term deposits which offer meagre returns in the context of current interest rate trends.

<u>Consultation questions – p 23:</u> What factors should be considered in assessing how the current settings of the retirement income system…affect its fiscal sustainability?

Again the absence of risk management as a key indicator around the operation of the system has a range of negative consequences, and sub-optimal impacts on the delivery of public policy objectives. A greater focus on RM will drive multiple outcomes including:

- *Ensuring the Super Funds that Government is effectively supporting through the operation of tax concessions on super contributions are incentivised to take greater steps to seek out new risk management offerings that can be incorporated into their products*
- *Minimising the call on the public purse in relation to the aged pension by encouraging greater contribution levels for better performing products*
- *Encouraging greater innovation and creativity amongst Australia's fintech system to develop more sophisticated and comprehensive approaches to risk management.*

<u>Consultation question – p 23:</u> How can the overall level of public confidence (in the system) be assessed? *The overall improvement to retirement income products offered as a result of an increased focus on the role of risk management can only enhance the public perception of the way in which the system is operating.*

Consultation question – page 24: Do individuals have sufficient access to retirement income products that manage the level and longevity of their income?

By its nature, improved risk management processes within the operation of retirement income products will diversify the range of offerings to retirees, promote greater competition amongst the supply side of the financial services industry, and provide more options for retirees to manage their nest eggs over throughout the duration of their retirement.

Appendix A: Risk Management Approaches

Overview

There are a variety of investment risk management approaches with the objective to meet the equity income needs of retirees and defend against losses in declining markets.

Typically, the investment generates dividends from a diversified portfolio of Australian shares with an investment risk management overlay that aims to reduce the volatility of returns, in particular defending against losses in declining markets.

A brief summary of the approaches is as follows:

- Vary asset allocation between stocks and bonds (diversification)
- 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)
- Buy underlying assets, buy put options (always in place 'hard' risk parameter)

Advances in investment risk management enable cost effective protection to always be in place for a 'hard' defined risk parameter (say no more than 3% capital at risk). Returns are designed to increase as volatility levels increase, as this provides more opportunities to lower protection costs.

To minimise costs and maximise profits:

- The Gyrostat proprietary software systems identify options series with the greatest profit potential for a defined cost, exploiting differing levels of implied volatility in the options market.
- "Active management" by buying or selling options with market movements.

The Gyrostat investment risk management approach utilises a unique set of investment software and process related intellectual property. Our strategy exploits the 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 enables our proprietary software systems to construct a volatility term structure and identify the 'least cost' call and put option alternatives available in the market at that time. There are many series to choose from. This is reflected in differing levels of 'implied volatility' across time periods and within a range of strike prices within the same time period. Gyrostat uses a variety of bought option and other strategies typically ranging from duration of 3–15 months, depending upon the prevailing option market conditions.

With market movements, the "options" component needs to be re-set or actively managed to ensure that the risk-return parameters meet the investment charter. This involves the buying or selling of options.

The key investment risk management features are:

- Protection is always in place to a specified absolute risk parameter (eg. no more than 2% at risk)
- Lower protection costs than existing approaches through option series selection and actively managing the options with market moves (enabled by technological advances and deregulation)
- For a given risk parameter, returns are maximised and re-set with market movements
- A financially strong counter-party - the ASX - for hedging activities
- Transparent mark to market valuations from ASX valuations

This has been tested and refined over the past 8 years through a specific wholesale fund – the Gyrostat Absolute Return Income Equity Fund at a risk tolerance of no more than 2% at risk per quarter.

Our approach can be applied to any listed stock or ETF which has a liquid traded options market. There are a wide number of possible applications. It is proposed to launch additional downside protection funds on other world indices, such as the Hang Seng, S&P500 and FTSE100.