Gyroscope Capital Management Group

Dividend Income Strategy

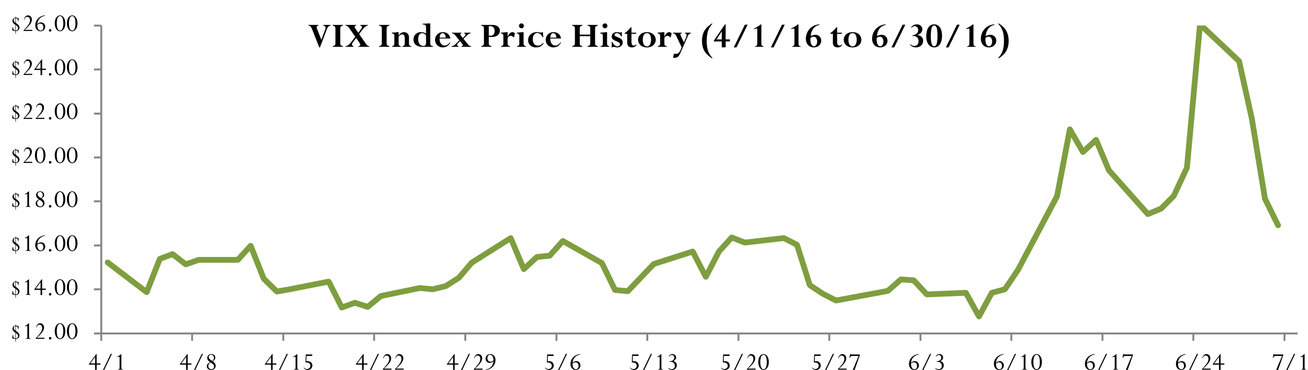
July, 2016

Quarterly Review and Commentary

How Does Uncertainty Affect Equity Markets?

To date, 2016 has proven itself as a year of considerable uncertainty. Outlooks for global growth have been revised downward amid China's economic slowdown and the impact of low oil prices on emerging markets. Expectations of U.S. rate increases have run the gambit and meaningful rate increases in 2016 now appear doubtful while interest rates across the globe have declined to multi-century lows. Uncertainty and speculation regarding Britain's referendum to depart from the E.U. ("BREXIT") created global angst and turmoil among market participants and regulatory and political uncertainty in the U.S. is the highest experienced in a generation.

Despite all this uncertainty, U.S. equity market participants did not appear to be overly concerned throughout the first two months of 2Q 2016. Implied market volatility, which reflects the uncertainty of equity markets, remained relatively flat before spiking in early June and subsiding again once BREXIT concerns diminished. Implied market volatility is akin to gravity in the sense that it cannot be directly witnessed or observed yet it is a powerful force that impacts our lives. The CBOE Market Volatility Index ("VIX") is a widely-recognized statistical measure of the implied volatility of the S&P 500 index that explains the relationship between option pricing and expectations of future market performance.



Source: FactSet Data

Why is the VIX Relevant to your Portfolio?

The VIX measures the magnitude of potential changes in equity markets but does not provide an indication of the direction of the change. **Generally speaking, the higher the level of the VIX, the higher is the price of equity options.** Volatility is the only variable in option pricing models that is not directly observable and has a strong positive effect on the price of both call and put option prices because it increases the magnitude of possible increases and decreases of equity prices. Volatility on the upside benefits calls but does not harm puts while volatility on the downside benefits puts but does not harm calls. This is true because when options are out-of-the-money, it does not matter how out-of-the-money they become. However, when options are in the money, increases (decreases) in stock prices benefit calls (puts).

Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results.

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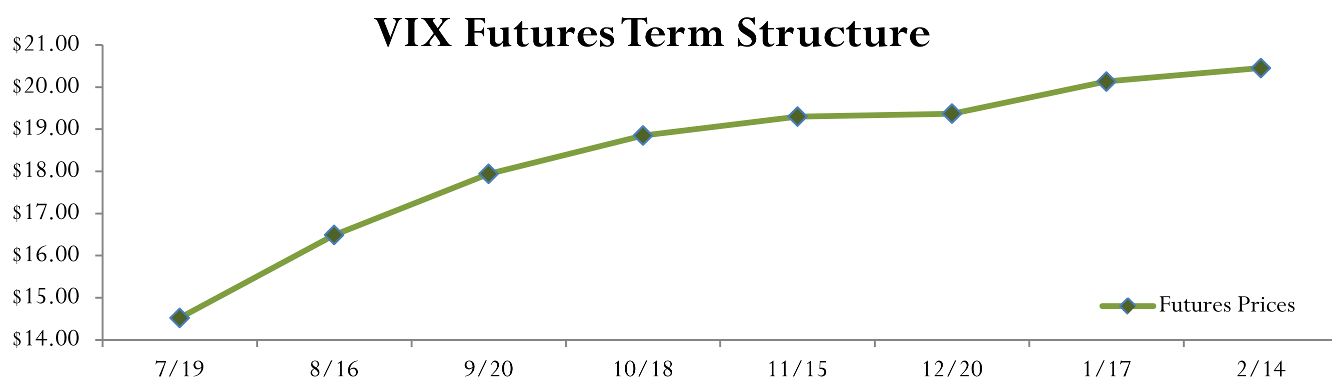
Dividend Income Strategy

The Dividend Income Portfolio ("D.I. Portfolio") benefits from increased volatility. Increased volatility raises the premium collected for selling covered calls, which in turn provides the D.I. Portfolio with additional current income and limited downside protection. As a result of volatility in the second quarter, the D.I. Portfolio was able to achieve a trailing-twelve-month distributable yield of 6.92%, which is above the stated 6% target. Holding all else constant, a sustained increase in the VIX should result in an increase in option premium yield for the D.I. Portfolio.

Fortunately, VIX futures, the derivative instruments that convey expectations of future market volatility, suggest that market participants anticipate that the increased volatility will return and persist for several months thereafter.

What are the Future Expectations of Volatility?



Source: http://vixcentral.com/

The factors driving uncertainty and volatility in the U.S. equity market do not appear as if they will shift any time soon. Also, the futures market suggests that volatility will increase over the next several months. We welcome the recent increase in implied market volatility and hope that it does exactly that.

As always, we welcome your questions/comments and are available at your convenience to discuss the Portfolio.

Thank you for investing with us!

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