Limiting Risk -- and Reward -- With Buffered ETFs

In today's volatile market, investors looking to limit risk can turn to a relatively new type of exchange-traded fund -- one that protects against losses, but also offers upside potential.

The combination of downside protection and upside participation makes BETFs attractive for a variety of investors.

When the market heads south, it can be painful to watch your hard-earned savings drop in value. Long-term investors can take comfort in the fact that, historically, stocks as an asset class have eventually rebounded, though past performance is no assurance of future results. But for risk-averse investors, especially those with a short-term investing horizon, the journey can be unnerving. How much will your investment drop in value? How long will it take to recover -- if it recovers? Is there a way of limiting your downside exposure but still benefit from the potential upside?

Enter buffered exchange-traded funds (BETFs). Also known as defined outcome, target outcome, or structured outcome funds, these instruments track an index but set limits on losses and gains, in effect, defining a range of possible returns. The combination of downside protection and upside participation makes them attractive for a variety of investors. Although structured investments that employ similar strategies have been around for a long time, only recently have they been wrapped into an ETF, making them more liquid, transparent, and accessible to everyday investors.

A Variety of Outcomes

There are now well over 100 BETFs available, and they differ widely in their possible outcomes. Most track a major market index, such as the S&P 500, but offer a "buffer" against losses as well as a cap on gains. A typical BETF covers losses if the underlying index declines up to a certain percent. The price you pay for that buffer is a cap on possible returns. Here's a hypothetical example.

Hypothetical Buffered ETF That Tracks the S&P 500 5% downside buffer, 20% upside cap.			
Market Performance	**Your investment value**	**$ Gain/Loss**	**% Gain/Loss**
Starting value	$10,000	$0	0%
S&P 500 loses 5%	$10,000	$0	0%
S&P 500 loses 10%	$9,500	($500)	-5%
S&P 500 loses 20%	$8,500	($1,500)	-15%
S&P 500 gains 5%	$10,500	$500	+5%
S&P 500 gains 10%	$11,000	$1,000	+10%
S&P 500 gains 20%	$12,000	$2,000	+20%
S&P 500 gains 30%	$12,000	$2,000	+20%

This example shows a BETF with a 5% downside buffer and a 20% upside cap. But BETFs differ widely, some with larger buffers or higher caps. How much you give up in potential returns depends largely on the amount of protection the fund offers. The greater the buffer, the lower the cap on gains.

How They Work

BETFs don't actually own any stocks or bonds. Instead, they use options, which are linked to the performance of an index. A typical BETF has four components: A long, deep-in-the-money call option to give the ETF market exposure; a long put option to hedge the downside; a short, out-of-the-money call option; and a short put that is further out of the money than the long put. If all that sounds like a foreign language to you, you are not alone -- which is why these complex products are best bought through a qualified financial professional.

Most BETFs are designed to be held for 12 months, called the outcome period. Once that period is up, you can continue to hold the fund, but the terms -- typically the level of the upside cap -- reset to reflect current market levels. As with all ETFs, you can sell BETFs at any time. But if you do sell before the outcome date, returns will be based on market value at that time.

Are BETFs Right for You?

BETFs are best suited for risk-averse investors who are willing to sacrifice potential gains for the comfort of reducing the possibility of loss. They may also work for retirees and pre-retirees, who have shorter investing horizons and may not be able

© 2023 SS&C All rights reserved. Reproduction in whole or in part prohibited, except by permission. All rights reserved.

to wait out a bear market. Keep in mind that, like all funds, BETFs come with fees, which typically range from 0.7% to 0.9%. Talk to a financial professional to see if BEFTs are right for your portfolio.

© 2023 SS&C All rights reserved. Reproduction in whole or in part prohibited, except by permission. All rights reserved.