Understanding Defined Outcome Exchange Traded Funds

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The insurance industry has long used the selling point that for certain types of Annuities and Life Insurance products, there is certainty that the investor would never lose money. That guarantee came with several costs, including upfront commissions, ongoing expenses, and limited liquidity. Over the last 7 or 8 years, the Financial Services industry has introduced a variety of Exchange Traded Fund (ETF) products with guarantees to protect against losses. The category is called “Defined Outcomes,” and it falls under a larger category known as “Hedged Equity.” Hedged equity funds use options strategies to enhance upside by buying call options, protect against downside risks by buying put options, or generate income by selling covered call options.

The Defined Outcome funds do not require investors to understand the intricacies of Options strategies or the Options Market; the ETFs use these strategies to provide a level of protection that can be similar to insurance or annuity products. We will describe the characteristics of the various Defined Outcome funds below, discussing when they could be a valuable addition to an investor’s portfolio and their associated costs. Buffer, Barrier Income, and Floor ETFs are the three major types of Defined Outcome funds, but there are variations, and new Defined Outcome funds enter the market almost every month.

The terminology used in describing the fund characteristics are:

Reference Security - This is the underlying market index that the fund tracks, e.g.:

- S&P 500 - U.S. Large Cap
- NASDAQ 100 - U.S. Technology
- Russell 2000 - U.S. Small and Mid-Cap
- MCSI EAFE - International Established Markets
- MCSI EM - Emerging Markets
- TLT - 20+ year Treasury Bond ETF

Outcome Period - the length of time over which the defined outcome is realized. This is mostly 1 year, but some funds use outcome periods of 3 months, 6 months, and 2 years.

Buffer - The amount of decline in the Reference Security in which the fund does not participate, i.e., the limit of the decline for which the investor is protected.

Upside Cap - The maximum Reference Security gain in which the fund participates, i.e., the limit of the upside in which the investor gets to participate.

The Defined Outcome ETFs available today are of four types:

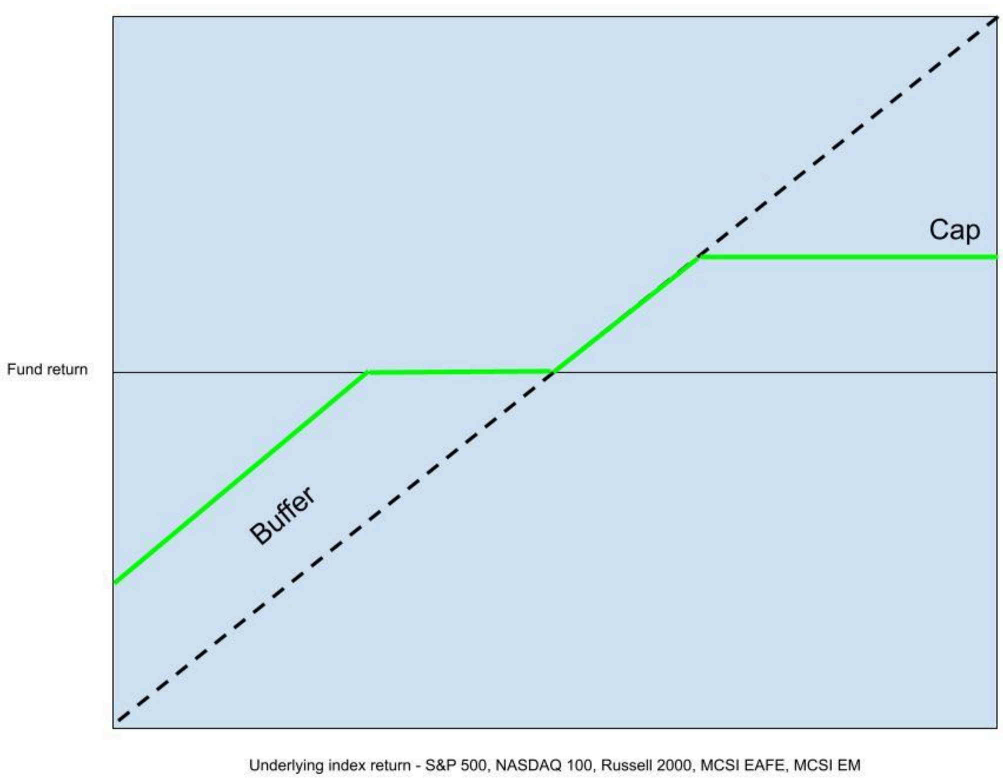
Buffer

A diversified portfolio can be created using the Buffer ETFs available on the market today, utilizing funds based on the available Reference Securities: US Large Cap, U.S. Mid-Small Cap, International, and Emerging Markets. Buffer ETFs offer several combinations of downside protection/Buffer and Upside Cap. The tradeoff for the fund manager providing downside protection is the limit in investor upside participation created by the Upside Cap. *The larger the Buffer, the more restrictive the Upside Cap.*

Examples of one-year outcome periods for Buffer ETFs based on the S&P 500 are in the table below. Note that the upside caps can change in future Outcome periods due to market volatility and interest rates.

Buffer	Upside Cap
9%	15.53%
15%	12.03%
5% - 35%	11.81%
100%	7.52%

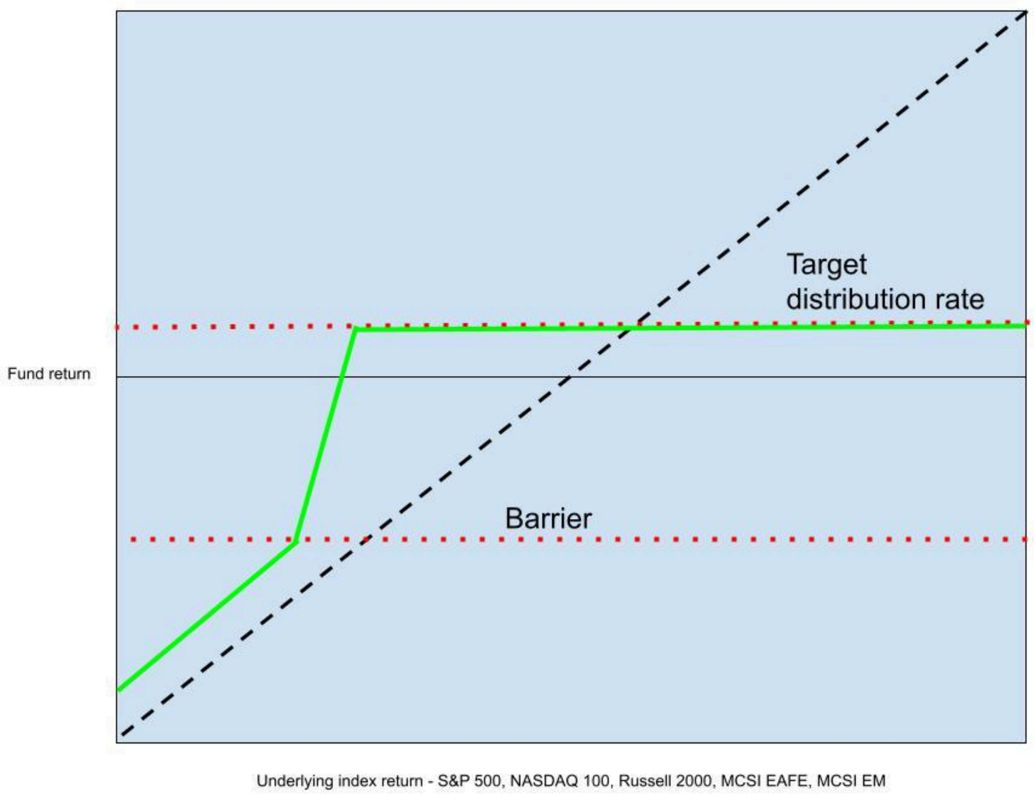
The return profile of a Buffer ETF looks like this:



Barrier Income

Barrier Income ETFs have a target distribution rate that is typically higher than that of traditional fixed-income funds. If the Reference Security stays above the specified barrier, that is the target return of the fund. If the Reference Security drops below the barrier - the fund's losses will be the same as the Reference Security cushioned only by the target distribution rate.

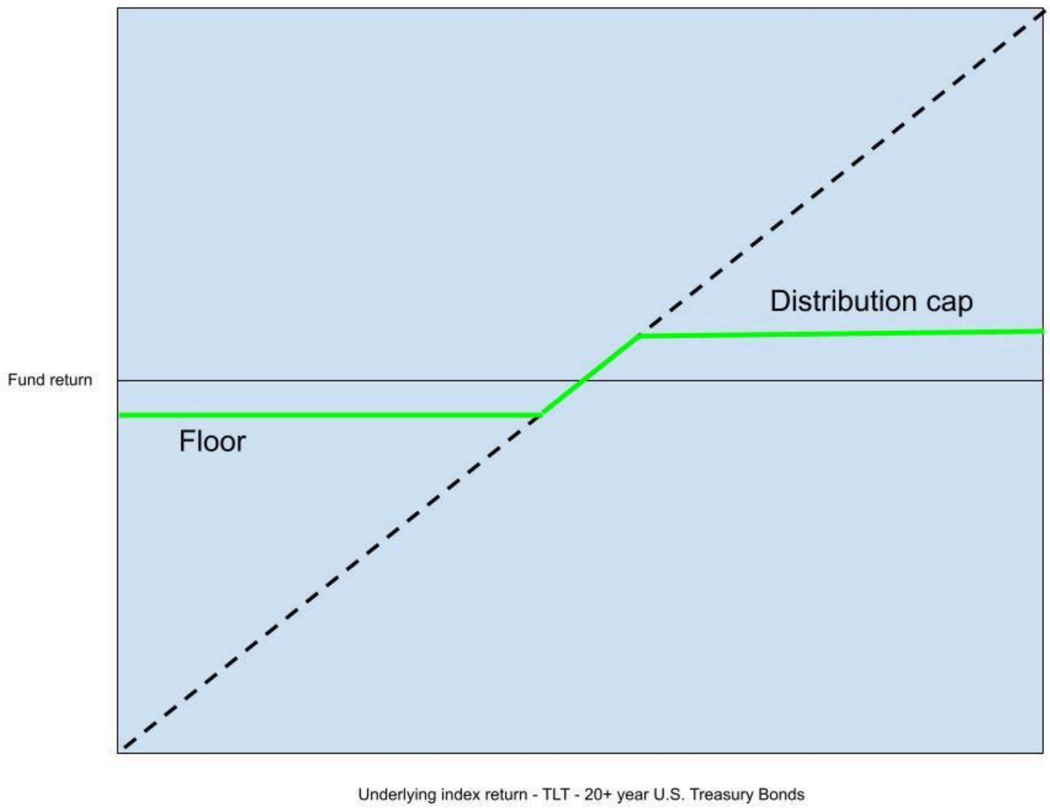
The return profile of the Barrier Income ETF looks like this:



Floor Income

Floor Income ETFs seek to replicate the performance of TLT, the 20+ year Treasury Bond ETF, up to a defined cap, with a maximum loss limited by the floor.

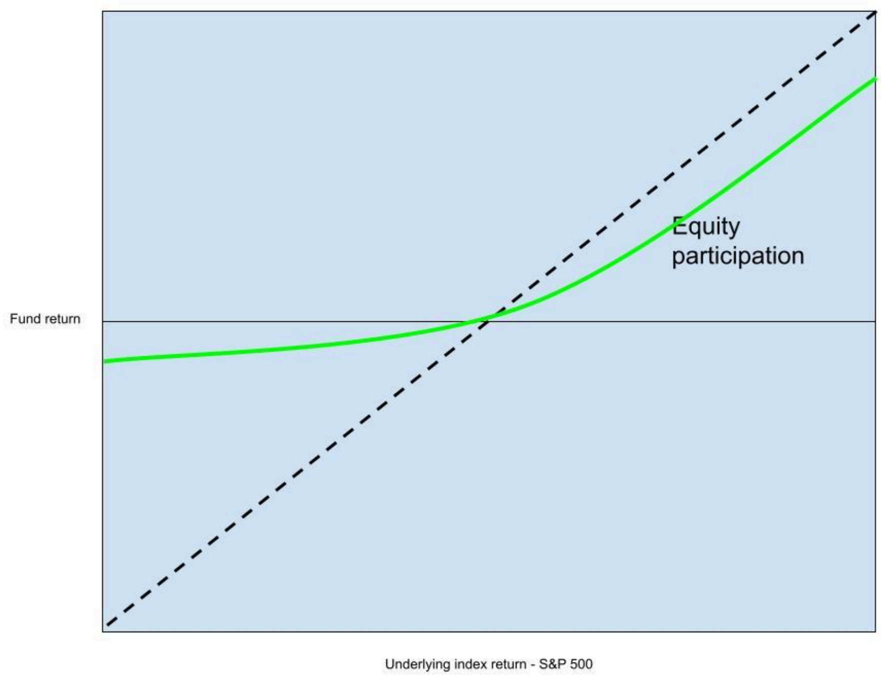
The return profile of a Floor Income ETF looks like this:



Floor Equity

Floor Equity ETFs seek to offer participation in the upside of a Reference Security while limiting the downside to the floor.

The return profile of a Floor Equity ETF looks like this:



Cost of Defined Outcome ETFs

In times of uncertainty and market volatility, Defined Income funds can offer protection from market downturns in the ways described above. The cost of that protection takes two forms:

1. The ETFs charge annual fees of between .6% and .8% for management and operating expenses.
2. As noted above, the upside is capped, so if the Reference Asset has significant gains, the Defined Outcome funds will not receive the full benefit of those gains.

The full range of Defined Outcome ETFs and their performance is a complex topic. If you're interested in learning more, Smarter Bear offers no-cost, no-obligation first meetings where we can answer questions and provide further insight into these potentially useful alternatives.