Buffer Strategies Outside of Structured Notes

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Buffer Strategy Mutual Fund/ETF Intro

December 9, 2017—I recently came across an article in Institutional Investor, “ETF Disruptors Set Sights on Insurance” regarding a novel line of ETFs (Innovator Defined Income Series) that offers the same benefit as a structured note or a structured (aka hybrid) annuity. This sparked me to do some research and compose a summary of the expansion of this particular style of structured notes onto other platforms. The structure we are focusing on is a buffer strategy that does not provide a pure capital guarantee (100% in all markets) but instead limits downside risk in some fashion at the cost of an upside cap.

The positioning against structured notes is fair, as those are financial instruments, but annuities have other ancillary benefits, including the death benefit and the ability to annuitize, though these may be unimportant to many annuity investors seeking out buffer strategies. Perhaps the greatest distinction of these products is the liquidity. These are suited as shorter-term investment options, since there is no surrender (only transaction fees associated with ETFs), they renew on a yearly basis, and there is actual daily valuation. There are tax advantages compared with an annuity, as they are taxed based on capital gains.

Historical Expansion of Buffer Strategies Beyond Structured Notes

The inception of the first structured note variable annuity came after the financial crisis. This product, AXA Structured Contract Strategies, was always very clearly positioned as an alternative to structured notes in an environment where structured products, albeit very different ones, played a significant role in the crisis. In particular, this underscored the reality of counterparty risk and the fact that many structured notes were being offered to clients without full transparency and under the guise of a guarantee when there was not truly a structure to support that guarantee in similar fashion to the insurance industry, whose bread and butter is guarantees.

The market appeal of AXA's new contract was to offer a similar option but
• With a true guarantee;
• With transparency;
• Supported by an enhanced regulatory structure compared with structured products;
• Absent the poor reputation of structured products.

From AXA’s perspective, this offering had numerous benefits, including
• Appeal to new population of non-annuity-selling advisors;
• Low-capital guarantee;
• Alternative to traditional VA when volatility coverage is more important than tail risk coverage.

The annuity industry was quite skeptical about this product because the guarantee didn’t fit into any existing categories or client needs. However, for advisors who had previously been selling life guarantees in circumstances where a limited volatility-oriented capital guarantee would suffice, this became a sound alternative. As AXA shifted its focus on this product over more capital-intense products with hefty tail risk management concerns, a significant chunk of annual sales gravitated towards SCS and, eventually, others entered the market. With additional product development, other insurers introduced the option of a true capital guarantee, which falls into a different category entirely, as it serves a different planning purpose.
The regulatory concerns about structured notes have been ongoing, including attention from the SEC and Finra as well as actions against firms for misleading investors. Thus, the value of the reliability of the annuity chassis in comparison with the opacity of structured notes continues to resonate.

**Buffer Strategies Reach Mutual Funds**

The expansion of buffer strategies to the mutual fund platform is unclear. There certainly had been, predating the financial crisis, some similar notes offered, and principal protection is an idea that rounded the horn and came back around again in the wake of 2008 debacle. However, there is certainly precedent for a buffer mutual fund that is tied even more to the CBOE than the new ETFs, in that the investment advisor itself is CBOE Vest, a wholly owned subsidiary of CBOE.

CBOE Vest launched CBOE Vest S&P 500 Buffer Protect Strategy Fund (BUMGX) on December 7, 2016. The fund follows an index which itself is composed of underlying monthly indices; each month's tranche establishes an options strategy to protect against 10% of losses while capping performance. Each month has a separate cap which is listed publicly on the website associated with each monthly index. The underlying instruments are primarily FLEX Options (a CBOE product) as well as cash. There are other options using the same underlying instruments but none deploying a buffer strategy. There is a 2x upside/1x downside fund (and ETF series in registration) that is similar to one of the new ETFs from Innovator.

An [SEC mutual fund search of “CBOE Vest” reveals](https://www.sec.gov) a large number of fund registrations, including an [ETF series registered 10/24/2017](https://www.etf.com) that uses the same 10% buffer strategy. The fees are still blank on the ETFs and they are available only for the monthly series, not a version that includes each month.

**Innovator ETFs Overview**

While the ETFs announced in the Institutional Investor article are not necessarily completely unique, they do offer novel iterations of the buffers, including ones not available on annuities. The funds are still in registration and the fees there are still blank, but the article states that fees will be less than 1.00% (there is no 12b-1 distribution fee). Fees are a key benefit, as these are touted as being less expensive than their counterparts. A cursory glance at the CBOE Vest mutual fund fees shows a variety of share classes ranging from Institutional at 1.26% total (no 12b-1 fee) and a 0.75% management fee to a fully loaded C share (2.26%, with a 1.00% 12b-1 fee).

In all of the fund-based versions, the caps are not stated within the prospectus but instead refer the investor to a separate website. The ultimate cost/benefit to the investor are unclear because of that, so it is difficult to back the claim that they are less expensive. The BNP Paribas article suggests that the mutual fund structure is actually more profitable. There is no guarantee of performance. As registered products, they are subject to a higher degree of regulatory oversight and accountability than structured notes do.

These funds are closely tied with the CBOE, as they use [CBOE indices](https://www.cboe.com) (ones that are not actually listed on the CBOE site), invest in CBOE FLEX Options instruments, and are intended to be sold on a CBOE exchange (Bats BZX Exchange) only. The CBOE Vest ETFs in registration do not state a specific exchange.
Innovator Defined Income Series Fund Summaries

Registrations for four Innovator Defined Income Series funds can be found here. Each is issued for a particular month, but the point-to-point period is one year. Three of the four funds offer a buffer, but they all have a basically similar strategy using a cap and the same underlying instruments.


Originally registered 5/15/2017, extended and then updated twice; original name was quite catchy, “Innovator Shielded S&P 500 ETF; 1 Up to a Cap, 1 Down, Shielded from -5% to -35%, CBOE Annual PTP Strategy, (MONTH) Series.” The buffer zone is -5% to -35%; within that zone, seeks total loss of 5%. For smaller losses, does not buffer at all. For greater losses, buffers by 30%.


Originally registered 5/15/2017, extended and then updated twice; original name was quite catchy, “Innovator Enhanced S&P 500 ETF; 3 Up to a Cap, 1 Down, CBOE Annual PTP Strategy (MONTH) Series.” The buffer zone is -0% to -15%; within that zone, seeks total loss of 0%. For greater losses, buffers by 15%.

**Innovator S&P 500 Enhance and Shield ETF (Month)** – 485ABPOS – 11-07-2017

Originally registered 5/15/2017, extended and then updated, finalized in BPOS form and then extended until January 2, 2018; original name was quite catchy, “Innovator Enhance and Buffer S&P 500 ETF; 2 Up to a Cap, 1 Down, 10% Buffer, CBOE Annual PTP Strategy, (MONTH) Series.” The buffer zone is -0% to -10%; within that zone, seeks total loss of 0%. For greater losses, buffers by 10%.

**Innovator S&P 500 Ultra ETF (Month)** – 485BPOS – 11/07-2017

Originally registered 9/08/2017, finalized in BPOS form and then extended until January 2, 2018. There is no buffer, but there is a cap. The objective is to exceed the return of the S&P 500 Price Index.
Bibliography


SEC action: [UBS to Pay $19.5 Million Settlement Involving Notes Linked to Currency Index](https://www.sec.gov/spotlight/ubs-currency-index-notes-settlement.htm) (October 13, 2015, retrieved 12/9/2017)

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