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Buffered ETFs

Institutional investors often attempt to reduce their investment risk by creating sophisticated derivate hedges using put and call options. Retail investors can access similar strategies by using buffered ETFs.

For example, there are ETFs you can purchase that provide investors with the returns of the S&P 500 price index for the next 12 months capped at 17%. They also provide downside protection in the form of a 10% buffer. In other words, if the index is down less than 10% you lose nothing and if the index is down more than 10% you only lose to the extent the losses exceed 10%. For example, if after a year the index is down 12% the investor would only lose 2%.

I recently back-tested how this would have compared to the actual S&P 500 price index. Between 2000 and 2020, $100,000 invested in the S&P 500 price index would have grown to $324,000. However, $100,000 invested in an ETF with a 10% buffer and a 17% cap would have grown to $345,000. In this case although the investor is limiting their upside each year in exchange for limiting their downside, the more conservative strategy would have outperformed over that particular 20-year time period.

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What is more interesting is that had an investor withdrawn $6,000 per year from the non-protected account they would have depleted their account in 17 years. However, had the investor pulled $6,000 per year from the buffered ETF account, they would have still had more than $50,000 in their account after 20 years.

The moral of the story is that for those who need their nest eggs to both grow and produce retirement income, keeping volatility low can be critical. When markets go down these buffered ETFs often offer some interesting opportunities on the secondary market.

We recently identified a buffered ETF that matures in late November and provides 20% downside protection and a 14% cap against the S&P 500 over the next three months. For those worried about midterm volatility, this could be an attractive way to invest.

Source: Yahoo Finance