

Mitigating Against Market Uncertainty

For many people the stock market is the key tool in their retirement planning. Since 2000, the S&P 500 has averaged about 7.5%. However, because over any given year or decade, the stocks could be positive or negative, the stock market is an imperfect tool for retirement planning.

If you are relying on earning 7-8% to keep up with inflation and create income, a retirement plan will be in a precarious position if stocks underperform, as inflation erodes wealth. By utilizing derivatives, investors can create predefined outcomes that will reduce the uncertainty of the stock market.

Major banks like JP Morgan Chase and Citibank offer 5-year notes that currently pay over 8% interest per year even if the stock market doesn't go up or even if it goes down by less than 40% when the note matures. An 8% return is higher than stocks have averaged since 2000. An 8% return may or not beat the market over the next 5 years, but it is much more predictable for planning purposes.

For those who are looking for growth, JP Morgan recently issued a note linked to the S&P 500 futures index (SPXFP) that will give investors participation in 100% of any increase in the index over the next 5 years but after 5 year the index is negative but by less than 30%, investors will not lose a dime. More importantly, if the index is positive at all after five years, investors will receive a minimum of 170% of their original investment. In other words, if over the next five years, the stock market index didn't appreciate that much but was still positive, investors would still make 70% over five years which exceeds historical averages.

There are ETF's that also utilize derivatives that track the S&P 500 with a 15% annual buffer. That means each year if the S&P 500 index is down, investors only lose if to the extent the index is down more than 15% in a year. In exchange investors' gains would be capped each year. Caps are currently about 14 to 15%.

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