ASSET MANAGER'S LENS

Buffer ETFs and Fixed Income: Different Tools, Different Roles

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Understanding the Difference Between Risk-Managed Equity and Fixed Income

In recent years, Buffer ETFs have gained attention among investors seeking to participate in equity market returns while managing downside risk. These strategies, sometimes referred to as Defined Outcome ETFs, are designed to provide a predetermined level of downside protection in exchange for limiting a portion of potential upside.

As interest in the category has grown, some investors have begun evaluating whether Buffer ETFs could serve as an alternative to portions of a traditional fixed income allocation.

Buffer ETFs are investment vehicles that use options strategies to provide a defined level of downside protection against market losses while maintaining exposure to market gains up to a predetermined cap. These funds are typically tied to a broad market index and are designed for investors seeking a more structured risk-return profile than traditional equity investments.

While Buffer ETFs can play a valuable role in a portfolio, it's important to recognize that they are fundamentally different from fixed income investments. Comparing a Buffer ETF to a traditional fixed income strategy is not simply a comparison of expected returns. Rather, it is a comparison of different return sources, different risk exposures, and different roles within a diversified portfolio.

Interest Rates

Buffer ETFs use options on an underlying index, often an equity index such as the S&P 500, to seek a defined range of outcomes over a specific period, commonly one year.

The strategy generally seeks to:

- Provide exposure to an underlying equity index
- Absorb a predetermined portion of index losses over the outcome period
- Limit upside participation through a cap
- Reset the outcome period according to the fund's stated methodology

For example, a Buffer ETF may be designed to absorb the first 10% of index losses over a one-year outcome period while capping upside participation at a predetermined level.

A hypothetical payoff structure might look like this:

S&P 500 Return	Hypothetical Buffer ETF Return
+10%	+10%
-5%	0%
-10%	0%
-15%	-5%
-30%	-20%

This example is for illustrative purposes only. Actual outcomes will vary based on the structure of the ETF, the cap, the buffer level, fees, expenses, market conditions, and the timing of an investor's purchase.

The key concept is straightforward: investors give up some potential upside in exchange for a defined amount of downside protection.

The Most Important Distinction: Different Sources of Return

One reason Buffer ETFs have attracted attention is that some investors view them as a potential alternative to a traditional fixed income allocation. While both may be used as risk-management tools within a portfolio, the sources of return and risk exposures are fundamentally different.further information on opportunities we have added to our portfolios during the first quarter.

Fixed Income Returns Are Primarily Driven By:

- Coupon income
- Reinvestment of interest payments
- Credit spread movements
- Interest rate movements
- Roll-down and duration effects

Buffer ETF Returns Are Primarily Driven By:

- Equity market performance
- Options pricing
- The level of the upside cap
- The size of the downside buffer
- The outcome period and timing of purchase

Unlike traditional bonds, Buffer ETFs do not provide contractual coupon income. Their outcomes are linked to the performance of an underlying index and the options structure used to create the defined outcome.

This distinction matters. Fixed income allocations are often used to provide income, diversification, liquidity, and potential ballast during periods of equity market stress. Buffer ETFs may reduce a portion of equity downside risk, but they remain meaningfully influenced by equity market movements.

Understanding Risk Through Portfolio Construction

Discussions about Buffer ETFs often focus on expected returns. But portfolio construction is about more than return potential. It is also about understanding the role each allocation is intended to serve.

Investors should begin with a simple question: **What function is this allocation intended to perform?**

If the goal is:

- Income generation
- Capital preservation
- Diversification from equities
- Liquidity
- Interest rate exposure

then traditional fixed income may continue to play an important role.

If the goal is:

- Equity participation with reduced downside exposure
- A more defined range of potential outcomes
- A willingness to accept capped upside in exchange for downside protection

then a Buffer ETF may be an appropriate tool to evaluate.

These objectives may complement one another within a diversified portfolio, but they are not necessarily interchangeable.

What Happens During Market Stress?

Periods of market stress often provide a useful illustration of how different asset classes may behave when investors face heightened uncertainty. It is during these environments that differences in correlation, income generation, liquidity, and downside participation tend to become most apparent.

The examples below illustrate how equities and fixed income have historically responded during several significant market events, including periods that presented challenges for both asset classes.

Upside Participation with Reduced Downside Capture

		Cumulative Returns	
Market Environment	Period	S&P 500 Index	Bloomberg US Aggregate Bond Index
Dot-Com Bust	03.24.2000 - 10.09.2002	-47.38%	29.14%
Global Financials Crisis	10.09.2007 - 03.09.2009	-55.22%	7.18%
COVID Market Shock	02.19.2020 - 03.23.2020	-33.92%	-0.94%
2022 Rate Shock	01.01.2022 - 12.31.2022	-18.12%	-13.01%

Source: Bloomberg

Historically, high-quality fixed income securities have often exhibited lower correlation to equities during periods of market stress, particularly when interest rates declined or investors sought higher-quality assets. However, these relationships can vary over time and are not guaranteed. Fixed income investments also remain subject to interest rate, credit, and market risks.

Buffer ETFs, by contrast, derive their returns from equity indexes and options strategies tied to those indexes. As a result, their performance may remain meaningfully influenced by equity market movements, even when a buffer absorbs a portion of losses.

Consider a simplified example:

If the S&P 500 declines by 30% during an outcome period, a Buffer ETF with a 10% downside buffer may still experience a loss of approximately 20%, before considering fees, expenses, and other factors.

That outcome may be preferable to participating in the full market decline, but it is materially different from the role many investors expect a traditional fixed income allocation to serve.

The distinction is not simply one of return. It is also one of correlation, liquidity, income generation, and portfolio role.

Where Buffer ETFs May Fit

Buffer ETFs can be a useful portfolio tool for investors who:

- Desire equity market participation
- Are willing to accept capped upside
- Seek a degree of downside protection
- Understand the importance of the outcome period
- Have a risk tolerance consistent with equity-linked investments

Investors should also recognize that downside protection is generally limited to a predefined range of losses and a specific outcome period. As a result, investment outcomes may differ from expectations if shares are purchased or sold during the outcome period, making it important to understand how the strategy's defined outcome is established and maintained.

Final Thoughts

The growing popularity of Buffer ETFs reflects investors' ongoing efforts to balance risk and return across a range of market environments. These strategies can provide a defined framework for participating in equity markets while seeking to reduce a portion of downside exposure.

At the same time, Buffer ETFs and traditional fixed income derive returns from fundamentally different sources and may serve different roles within a portfolio.

Ultimately, the question isn't whether Buffer ETFs are better or worse than traditional fixed income. Rather, investors should understand that these strategies may behave differently across market environments and are often designed to address different portfolio objectives. Evaluating the role each investment is intended to play within a portfolio remains one of the most important considerations in the portfolio construction process.

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