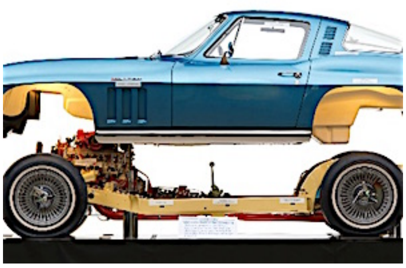
Meet the First 'Structured Outcome' ETF

By Kerry Pechter *Thu, Aug 30, 2018*

Innovator Capital Management and Milliman have built the first structured outcome product on an exchange-traded fund (ETF) chassis, challenging the annuity monopoly in this category.



Ever since "buffered" (or "structured" or variable) indexed products appeared in 2010, life insurers have had this growing market virtually to themselves. Starting with AXA's Structured Capital Strategies, each product has been built on an annuity chassis. In the 2Q2018, category sales reached $2.4 billion, up 12.6% year-over-year.

Now an asset management firm has entered the field. Earlier this month, Innovator Capital Management launched what it claims are the first products of this type to be built on an ETF (exchange-traded fund) chassis. Milliman Financial Risk Management LLC is the subadvisor.

The three Innovator ETFs invest in multiple options on the S&P500. Investors purchasing shares of the ETFs earn gains up to a cap and have limited or buffered exposure to losses, over an outcome period of approximately one year. In the past, the only non-annuities to offer similar performance were structured notes.

This month Innovator rolled out a suite of related ETFs, each with a different range of possible gains or losses:

- Innovator S&P 500 Buffer ETF (Cboe: BJUL). This ETF is designed to track the return of the S&P 500 up to a cap of 10.85% while buffering investors against the first 9% of losses over a one-year "outcome period," before fees and expenses.
- Innovator S&P 500 Power Buffer ETF (Cboe: PJUL): This ETF is designed to track the return of the S&P 500 up a cap of 8.11% while buffering investors against the first 15% of losses over the outcome period, before fees and expenses.
- Innovator S&P 500 Ultra Buffer ETF (Cboe: UJUL): This ETF is designed to track the return of the S&P 500 up to a cap of 8.77% while buffering investors against 30% of losses (from -5% to -35%) before fees and expenses.

The initial outcome period for PJUL and UJUL runs from August 8, 2018 to June 30, 2019. BJUL was listed on August 29, 2018 and also runs through June 30, 2019. At the conclusion of the outcome period the ETFs will not expire or terminate. Instead, they will roll into a new set of options positions, and the cap and buffer will "reset." Investors who jump into the funds mid-term will receive adjusted caps and buffers, which can be viewed real-time via a pricing tool on Innovator’s website.

Bruce Bond

“These types of payouts were originally available as structured notes, and many people are familiar with those products and how they work,” said Bruce Bond, co-founder and CEO of Innovator Capital Management, based in Wheaton, IL. “Our goal is to deliver that type of payout in the most efficient, low-cost way possible, and have it qualify for all the fiduciary accounts.”

Innovator is the ETF sponsor and will be selling the product, Bond told *RIJ*. “Our first effort will be to work with advisors who are fiduciaries who wouldn’t ordinarily use a structured product or an annuity. They currently have no access to this type of product in ETF form,” he said.

Investors in these products buy shares, just as they would any other ETF. Their investments are applied to the purchase of customized options on the S&P 500 Index. Investors in the ETFs own the options directly and bear the investment risk. The products involve no bond underwriter or insurance company, which makes them cheaper and more transparent than structured notes or annuities.

“When we talk to financial advisors, they often ask, ‘how else can I access structured outcomes? What do we do for the portion of our clients who might not want annuities or structured notes? This gives them a similar strategy in a liquid, transparent manner, and at a lower cost,” added Matt Kaufman, Principal and Senior Director, Product Development at Milliman.

“When you look at the structured outcome marketplace,” he added, “the sales process often involves a major decision about tying up a large portion of someone's wealth for a considerable period of time, often with relatively low transparency and liquidity during the holding period," he said.

"We find placing structured outcome strategies in the ETF wrapper provides a more transparent, liquid and accessible option for many people needing to access the growth of the equity markets, in a more defined or risk-managed way."

Here's how Innovator describes the ETFs:
"Each Fund will hold a portfolio of custom exchange-traded Flexible exchange options (FLEX options) that have varying strike prices (the price at which the option purchaser may buy or sell the security, at the expiration date), and the same expiration date (approximately one year). The layering of these FLEX Options with varying strike prices provides the mechanism for producing a Fund's desired outcome (i.e. Cap or buffer). Each Fund intends to roll options components annually, on the last business day of the month associated with each Fund."

Cboe describes FLEX options as the only listed options that allow users to select option contract terms. The underlying index, option type, exercise date, strike price, and settlement date are all customizable. These options also give investors the opportunity to trade on a larger scale with expanded or eliminated position limits.

Though the defined outcome parameters are set at yearly intervals, the products have all the liquidity associated with owning an ETF. Investors can trade them intra-day, and each ETF's share price fluctuates based on the performance of the underlying options positions, which in effect should move at some ratio (or delta) relative to the S&P 500. That ratio will be closer to 1:1 as the outcome period draws closer to its conclusion.

"As a result, the upside cap and buffer levels will be different for each investor who buys shares of an Innovator Defined Outcome ETF during the outcome period, but these outcome values can all be known prior to investing," Kaufman said.

Each of the ETFs has an expense ratio of 79 basis points a year. If the gains on the product were capped at 10% of the S&P500 Index, for instance, the investor would face an effective cap of 9.21%. Assuming that an advisor charges an annual management fee on the market value of the investor's entire portfolio, that too would reduce an investor's overall portfolio returns.

Innovator conceived these products at a time when it appeared that the DOL fiduciary rule would soon take effect, and that it would become more difficult for advisors to sell commissioned products to owners of rollover IRAs, which now have a collective value of about $9 trillion. ETFs do not have sales loads or commissions.

In choosing a subadvisor for its new product, Innovator logically picked Milliman, which had worked with Cboe and Standard & Poor’s to create four series of Cboe S&P500 Target Outcome Indexes, which are the benchmarks for the Innovator series. Cboe owns the indexes and licenses them exclusively to Innovator. Terms of the exclusivity were not made public, but other product structures outside of the ETF may be able to build products based on target outcome indexes.

“As the structured annuity, indexed annuity and ETF spaces develop, the appetite for structured outcomes that are built directly into the index methodology may increase,” Kaufman said.