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Buffer ETFs vs. Index-Linked Annuities

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Like most ETFs, the buffer ETFs are registered with the SEC on Form N-1A as "open-end" investment companies, and they issue and redeem their shares at net asset value (NAV) only as part of large blocks, known as "creation units." Although the creation units can be purchased and redeemed only by a limited number of "authorized participants," other investors can purchase and sell shares of the buffer ETFs on the Cboe BZX exchange.

Buffer annuities, by contrast, are registered with the SEC on Form S-1 or S-3 and are not traded on any exchange.

General Purpose

Buffer ETFs and buffer annuities both offer investors the prospect of earning returns over specified periods of time (return periods), based on the performance of a specified securities index. For example, each buffer ETF that is currently being offered has a one-year return period that seeks to provide a return which closely approximates the return of the S&P 500 Index (without reinvestment of dividends), subject to (a) a specified maximum rate of return (i.e., a "cap") and (b) a "buffer" that seeks to provide a specified amount of protection against negative returns over the return period.

Similar to these buffer ETFs, the buffer annuities issued by insurance companies offer index-based returns over various return periods, subject to various specified caps, buffers and other terms.

Under both the buffer ETFs and buffer annuities, the index and duration of each return period, as well as the amount of the applicable cap, buffer, and other terms, are established at the beginning of that period. At the end of a return period, the invested value (after crediting the return for that period) generally rolls over automatically into a new return period.

Supporting Investments

Like other ETFs, a buffer ETF's investment return over any return period is determined by the change in its NAV and any distributions paid on its shares during that period. The buffer ETFs invest most of their assets in various customizable put and call options on the S&P 500 Index that are traded on the Chicago Board Options Exchange (Flexible Options).

Specifically, a subadviser to the buffer ETFs seeks to structure and manage each ETF's portfolio of Flexible Options so that the ETF's total return over the return period will closely approximate the return of the index, subject to the specified cap and the buffer for that return period. Investors have no guarantee, however, that the buffer ETF will achieve the return that it seeks for any return period. Therefore, even if investors maintain their investment in a buffer ETF for an entire return period, their investment return and buffer protection may be less than that return period sought to provide.

In contrast, under a buffer annuity, the issuing insurance company promises that investors who maintain their investment for an entire return period will be credited with the index's performance over that period, subject to the cap, buffer, and other terms that are applicable to that return period. If the insurer's return on the assets it invests to support this promise is less than it has promised to investors, the insurance company must bear the loss. Similarly, the insurer can keep any amounts that it earns in excess of the return promised to investors.

Other Differences

The buffer ETFs do not incorporate numerous features that are commonly available under buffer annuities, such as guaranteed lifetime income benefits, enhanced income benefits, and enhanced death benefits.

On the other hand, investors usually bear, directly or indirectly, more types of fees and charges under buffer annuities, as compared to buffer ETFs. This typically reflects the additional features and guarantees that characterize buffer annuities.

The products also have different tax consequences for investors. For instance, buffer annuities offer more opportunity for tax deferred build-up of investment gains. However, distributions under the buffer ETFs are potentially taxable at long-term capital gains or qualified dividend rates that are lower than the rates at which gains distributed from a buffer annuity would be taxed. Also, tax penalties that can apply to early withdrawals from a buffer annuity would not apply to withdrawals from a buffer ETF.

On the other hand, the following possibilities that could affect an investor's return or liquidity under a buffer ETF generally would not be relevant to investors in a buffer annuity:

- Any suboptimal decisions by the subadviser in managing a buffer ETF's portfolio of Flexible Options.
- Any illiquidity, unavailability, or difficulty in valuing any of the Flexible Options that the buffer ETF holds or that its subadviser would like to use.
- The risk of large flows of funds into or out of the buffer ETF during the course of a return period, which could complicate portfolio management in a way that adversely affects even investors who persist throughout the entire return period.
- Inadequate support from authorized participants, market makers, and other arbitragers, as such support is necessary to assure that the prices at which ETF shares trade on a securities exchange closely track the ETF's NAV.

Potential New Type of Variable Annuity Option

It may be possible for insurers to offer variable annuity contracts whose investment options include one or more underlying fund series that follow investment objectives and strategies that are comparable to those described above for the buffer ETFs. Such a product could be attractive to investors because it could offer them:

- The investment characteristics of a buffer ETF (except that neither the variable annuity nor any such underlying fund option would be an "ETF" or otherwise traded on an exchange), and
- Other features of a traditional buffer annuity, except for the type of investment guarantee that buffer annuities provide.

Such a combined product also could be attractive to some insurers for various reasons. Among other things, the product would be registered with the SEC on Form N-4, which some insurers may prefer to the registration forms required for traditional buffer annuities.