ABR Dynamic Funds – 2Q 2024 Newsletter

A New Form of Evil?

How the Wrappers on "Boomer Candy" May Be Hiding the True Ingredients

In this quarter's newsletter, ABR will explore some particularly nasty new forms of repackaged cheap goods with a higher sticker price. Think of it as repackaging Band-Aids and Advil and calling it a First-Aid Kit, and then selling it at many times the price of the individual components. Of course, some people are happy to pay for this "simplicity," but if you have a fiduciary responsibility to your client NOT to overpay for things, why would you?

Background on "Boomer Candy"

The Wall Street Journal's recent article, "Boomer Candy,"[1] discusses a variety of the option-overlay, hedged-equity, buffer, and defined-risk exchange-traded products. Investors using these strategies likely want exposure to the "equity bucket" but with reduced risk and reward, especially with the market near all-time highs. But what have they really experienced?

Here is a chart of some well-known strategies, along with their expenses, correlations & betas to S&P 500, strategy type, and approximate assets under management. **Note that these strategies generally correlate 90% to the S&P 500, with a reduced beta of around 0.5 on average.**

"Name"	Expenses (approx.)	Correlation to S&P 500	Beta to S&P 500	General Strategy	AUM (approx.)
"Buffer"	0.80%	0.95	0.47	buy put spread, sell call	20b (across suite of buffer series)
"Hedged Equity"	0.60%	0.89	0.45	buy put	20b (product)
"Premium Income"	0.35%	0.92	0.60	sell call	30b (product)
"Oldest Collar Fund"	0.95%	0.91	0.42	collar	6b (product - launched in 1970s)

Fed Funds Rate	**5.25%**

If an investor uses these strategies, they essentially "own" the S&P 500, but, for every dollar invested, they only receive about 50% of the exposure they would get if they just bought SPY, the most widely-held ETF in the world (and costing only 0.09% annually).

[1] "These Hot New Funds Are 'Boomer Candy' for Retirees," The Wall Street Journal, 6/23/24

So, if an investor used these strategies, what have they effectively paid for this S&P 500 exposure, in terms of SPY equivalency? Using the Fed Funds Rate of 5.25% (for the excess cash that wouldn't need to be invested if using SPY) and the Expense Ratio of these strategies, we arrive at the following chart:

"Name"	Expenses (approx.)	Correlation to S&P 500	Beta to S&P 500	Effective Cost of buying Equivalent Amount of SPY (using Fed Funds rate)	General Strategy	AUM (approx.)
"Buffer"	0.80%	0.95	0.47	**3.58%**	buy put spread, sell call	20b (across suite of buffer series)
"Hedged Equity"	0.60%	0.89	0.45	**3.49%**	buy put	20b (product)
"Premium Income"	0.35%	0.92	0.60	**2.45%**	sell call	30b (product)
"Oldest Collar Fund"	0.95%	0.91	0.42	**4.00%**	collar	6b (product - launched in 1970s)

SPY Fee:	**0.09%**	**Fed Funds Rate**	**5.25%**

The average equivalent price, including both the stated expenses and the opportunity cost of missed interest at the risk-free rate, for the S&P 500 exposure that would normally cost 0.09% is a whopping 3.38%, or 36.5x the price of SPY! How would clients feel knowing they paid nearly 3.4% essentially for SPY-like exposure over time?

100% Downside Protection, but at What Cost?

The Boomer Candy article specifically featured the latest form of this old idea: "100% downside protection." Specifically, the article discusses a recent product launch, which touts S&P 500 exposure with 100% downside protection and a cap on gains of 9.81%, when held over exactly the one-year period of the option collar (long a put option and short a call option).

At first glance, it sounds great, but is the latest round of fearmongering and "can't lose" product launches perhaps too good to be true? What are these asset managers *effectively* providing and why is Main Street gobbling up tens of billions of dollars of these strategies?

What you're effectively getting is 95% exposure to the "T-bills bucket" (the risk-free rate) and a 10-dollar call spread on the S&P 500, all at a MUCH higher price than doing this simple trade yourself. *Say it ain't so!*

We will now take a closer look at the general strategy of S&P 500 exposure with 100% downside protection and a 10% cap on gains over a one-year period. Let's call these "zero downside" strategies "Boomer Candy" for the remainder of this note. Functionally, there is an easy way to understand it.

What Is the ACTUAL Strategy?

For every $100 an investor puts into Boomer Candy, that investor effectively buys 2 things:

1. **$95 in T-bills**
    a. After a full year, this amount grows to $100 at the current risk-free rate of approximately 5%.

2. **$5 in an S&P 500 option call spread** (the 100/110 call spread, to be specific)
    a. After a full year, this call spread is worth:
        i. $0 ($5 loss) if the S&P 500 is flat or down;
        ii. $10 ($5 gain) if the S&P 500 is up 10% or more:
        iii. or any amount between $0 and $10 if the S&P 500 is up 0-10%.

In summation, the $100 investment made into this new-fangled version of an old-fangled strategy can be worth anywhere from $100 to $110 after a year, depending on the performance of the S&P 500. However, there are also 5 important, yet perhaps hidden, features that may be drawbacks for long-term investors, and even for short-to-medium term investors.

Hidden Features and Why They May be Drawbacks

1. **Despite the slick marketing, investors *can* lose!** "But I thought you told me I have zero downside?"

    a. Only $95 of the initial $100 investment is getting the risk-free rate. You also effectively paid 5 bucks for a call spread that could possibly expire worthless, which would amount to a loss of $5. "Breaking even" in a year and getting your initial $100 back *is actually losing $5* when the **RISK-FREE** rate is 5%.

    b. Investors might also not have the experience they expect. You aren't necessarily investing day-1 of Boomer Candy's launch, so your path may be dependent on how the S&P 500 did BEFORE you invested in Boomer Candy. But, even if you do invest day-1, what are you going to do if the S&P 500 is up around 20% halfway through the year (see: 2024): are you going to hold on for dear life for the rest of the year? Are you going to sell it, roll it into another product, and pay short-term capital gains? All of the sudden, something that was supposed to make your life easy is putting you to some serious decisions.

2. **The fees sound high.**

    a. Let's assume an annual fee of 70 basis points, for example, for Boomer Candy. That is 70 bps for the $5 in a static call spread, which is simply bought and held for a year. It is also 70 bps for the $95 in T-bills. For context, but not as advice, SGOV also provides T-bill exposure, but for 7 basis points (one tenth of the price – that is not a typo!)

        i. This sounds like rather expensive S&P 500 beta.
            1. If the $95 in T-bills instead carried a fee of 7bps, then the remaining $5 in the call spread would have to come at an effective fee of 1,267bps (12%+) to reach the 70bps fee being charged by Boomer Candy on the full $100 investment.
            2. Put another way, with a high correlation to the S&P 500, but a beta of perhaps only approximately 0.25, practically speaking this strategy is charging unsuspecting investors at a rate of 2.80% for every 1.00 beta to the S&P 500. S&P 500 beta is approximately free in other forms.

3. **There is quite little diversification value.**

    a. Boomer Candy's returns are driven by fluctuations in the S&P 500, rather like the returns of the core of most portfolios. The strategy's correlation to the S&P 500 has been, and is expected to be, quite high over time.
        i. Therefore, despite the low, bond-like return caps in this strategy, it is not a bond or alternative exposure.
            1. Appendix 1 explores in more depth the reason these types of strategies have delivered high correlations and low betas – the worst of both worlds – to the S&P 500 over time. The brief explanation is that Boomer Candy is a simple "beta reducer," or static hedge.

4. **There may be significant opportunity cost over time.**

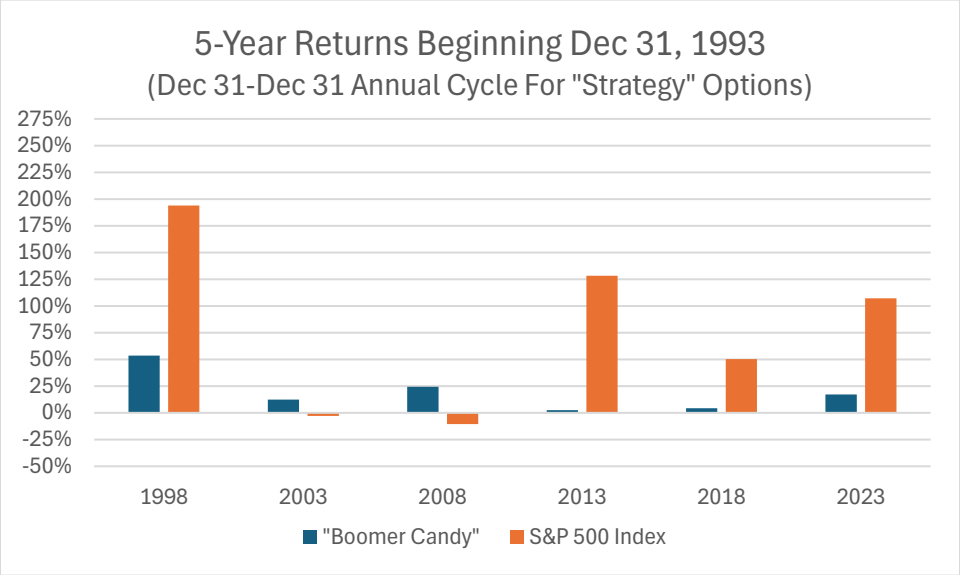
    a. Did you know you were effectively investing $95 out of your initial $100 into the risk-free rate when you purchased Boomer Candy? Is that what you meant to do?
        i. You're probably using this strategy to get exposure to the equity bucket but at a reduced risk and reward, especially with the market near all-time highs. But what you're really getting is 95% exposure to the risk-free rate and a 10-dollar call spread on the S&P 500.
            1. So are you getting what you want?
            2. If so, are there perhaps better and cheaper ways to achieve this?

    b. Consuming Boomer Candy would have resulted in an annualized return of approximately 4.1% (1.3% excess return), vs. 10.5% (7.7% excess return) for the S&P 500 since 1990 (with an average risk-free rate of 2.8% over that same time).[2]
        i. After 25 years at 10.5%, $100 grows $1,212. At 4.1%, that same $100 grows only to $274. If you're using this strategy for the equity bucket, you may grossly underperform equities, which have returned 10.5% annually since 1990 and about 9% over the past 100 years.

5. **The timing doesn't even matter as much as people initially think.**

    a. For investors with even just a five-year horizon, it is hard to find a start and end timing that make Boomer Candy look appetizing.
        i. For example, the following bar chart shows the five-year returns of using this strategy vs. using the S&P 500 over 30 years (total returns, not annualized), based on one particular starting point and option-expiration cycle.
            1. This 30-year period obviously includes major downturns in the S&P 500.
            2. Appendix 2 explores the quarterly timing in more depth. It is difficult to find a graph that makes this strategy look like a good choice.

[2] Using all rolling 252-business day periods over the history of SPXT data (since 9/11/1989), we capped the S&P 500 result at twice the prevailing risk-free rate, with a floor of zero. This methodology is meant to capture the at-the-money call spread with a purchase price that can be funded by the risk-free rate, as described above. The average annual result of this methodology was 4.2%, compared to 11.7% for the S&P 500. Average annual returns are not compounded. The compounded annual return of the S&P 500 over this same period was 10.5%. The estimated compounded annual return of this methodology was 4.1%.



Ongoing Management Issues & Conclusion

Finally, some readers may be thinking that they would only use Boomer Candy for one year. That's doubtful, if we are honest with ourselves. Myopic Loss Aversion describes the twofold human tendency to draw conclusions too frequently and to be more sensitive to losses than to gains.[3] Combine Myopic Loss Aversion, or a short-term fear of losses, with the fact that there will always be immediate-seeming reasons for concern (it is called a risk premium, after all) and it is difficult to believe many people who start down this route will be able to reverse course in a year.

For example, imagine the market has tanked, and panic is at extreme levels. Boomer Candy's "protection" will seem great on a go forward basis. Alternatively, imagine the market is higher a year from now. How many investors in Boomer Candy during that year wouldn't still believe a downturn is imminent, perhaps even more so after another year of gains? Don't forget how hard it is to time the top and bottom in equity markets; consumers of Boomer Candy are rather likely to face these situations, especially the latter one, over time.

It won't help that the financial media, in search of clicks, will bombard us with the latest reasons to be concerned, and the creators of Boomer Candy will host webinars highlighting those reasons.

What about only using Boomer Candy when the S&P 500 is around all-time highs? That's still no good over time. The S&P 500 has spent close to half the time within 5% of its all-time highs, and the average upcoming one-year return starting from those times has historically been the same as that over all starting points.

Imagine the stomach ache your portfolio may get from eating all of this Boomer Candy….

Just buy your Band-Aids and Advil for $20. Don't buy them in a First-Aid Kit for $200.

To learn more, please reach out to us at info@abrfunds.com.

[3] Thaler, R., Tversky, A., Kahneman, D., & Schwartz, A. (1997). The effect of myopia and loss aversion on risk taking: an experimental test. The Quarterly Journal of Economics, 112(2), 647-661.

Disclosures: This note is intended for informational purposes only. Nothing herein is or is intended to constitute investment advice, an endorsement, or a recommendation to buy, sell, or hold any instrument, product, derivative, or strategy, including SPY, SGOV and any form of "Boomer Candy," whether or not featured in the WSJ article.

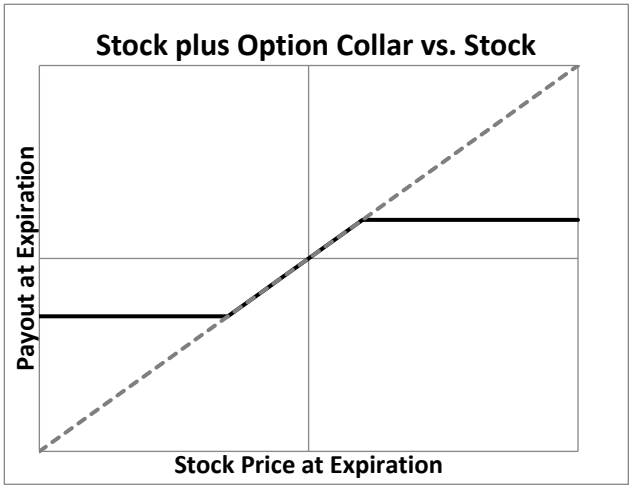
Past performance does not guarantee future results, and all investing involves risk, including the loss of principal. It is not possible to invest directly in an index.

SPXT is an unmanaged index of publicly traded, large capitalization U.S. companies, with dividends reinvested. FDTR is the upper bound of the short-term interest rate targeted by the Federal Reserve's Federal Open Market Committee (FOMC) as part of its monetary policy.

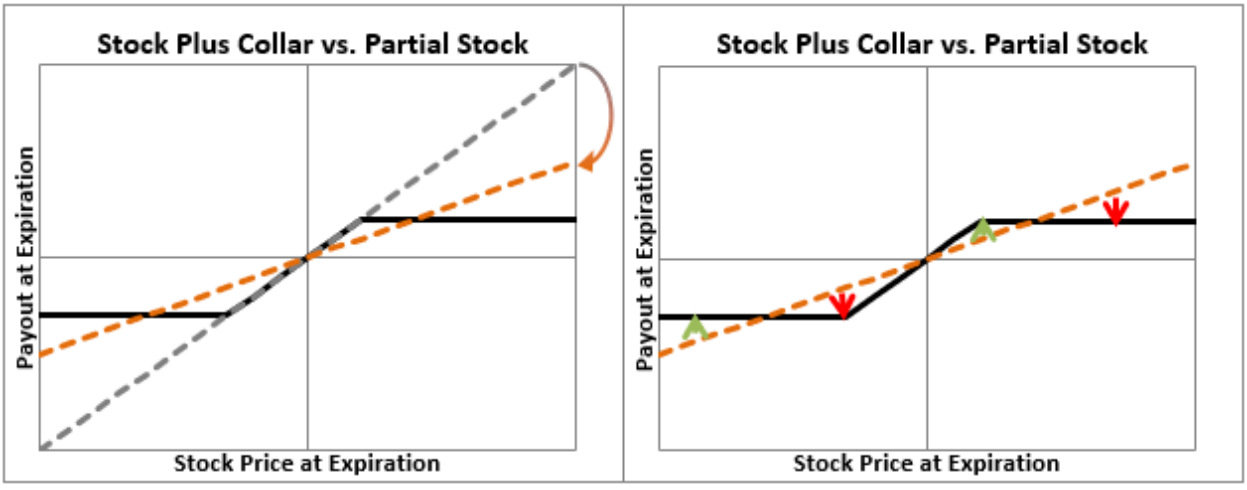
Appendix 1

Why have these option overlay strategies, with all their sophisticated-looking payout-at-expiration diagrams, been so simply and consistently like reduced exposure to the S&P 500 (or NASDAQ, or whatever their underlying index or stock may be) over time?

Defined, buffered, protected, and hedged results have typically been targeted through the use of option overlays. In particular, they have often been sought through the use of a collar, which is buying a put option to limit downside risk and simultaneously selling a call option to finance the purchase of the put option (and consequently limit upside reward potential). The resulting payoff-at-expiration diagrams, generalized by the solid black line in the following graph, may initially appear intriguing. But do these strategies make sense for long-term investors, or are they mostly just marketing gimmicks?

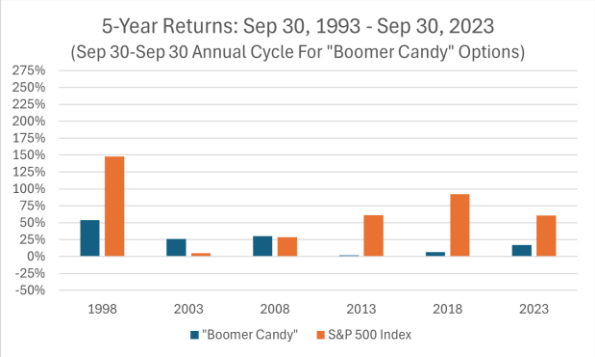


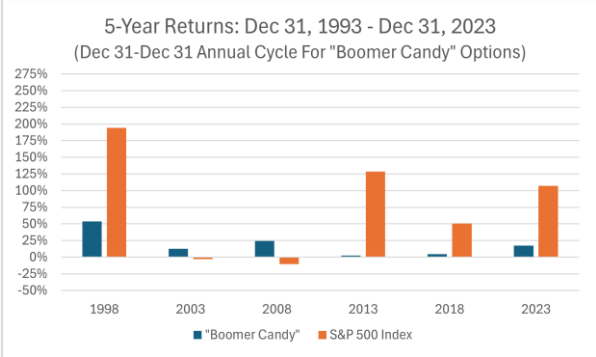
For long-term investors, the answer lies in a very simple shift in the point of comparison. Instead of comparing the solid black payoff-at-expiration line to the dotted grey equity investment line, let's instead compare it to a partial investment in equities, represented by the dotted orange lines in the next graphs. Over the course of exactly one full option expiration cycle, or outcome period, the stock plus collar investor might do a bit better (green arrows) or a bit worse (red arrows) than the partial equity investor. However, for long-term investors, repeatedly playing this game can be expected to result in some periods with a bit of outperformance and other periods with a bit of underperformance, with those periods generally having an offsetting effect over time.

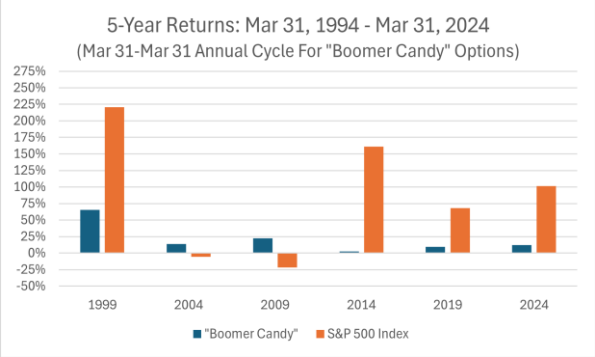


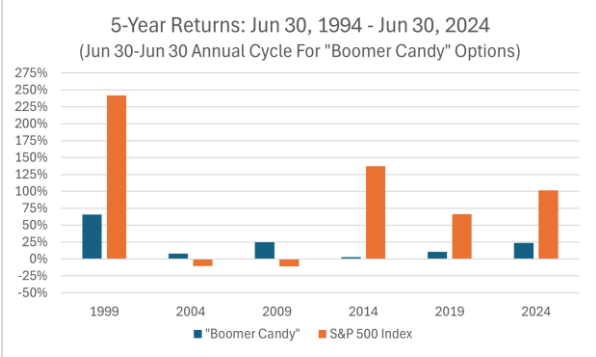
Appendix 2

Most investors have at least 5-year horizons. Furthermore, timing the tops and bottoms of equity markets is extremely difficult. Combined, those facts suggest that most investors should consider at the very least 5-year-long periods of time. The following bar charts show the 5-year returns – of quarterly starting points and option expiration cycles – from investing in Boomer Candy (blue) vs. the S&P 500 Index (orange) since 1990. We don't think any of the charts make Boomer Candy look appetizing. And recall that these charts include the bursting of the tech bubble, the GFC, the Euro debt crisis, Covid-19, and the first half of 2022.









ABR Dynamic Funds LLC
17 State Street, Suite 725
New York, NY 10004
212-918-4664
info@abrfunds.com