Buffer ETF Webinar 2/19 Transcript

00:00:05 Matthew Collins

Good afternoon, everyone, and thank you for joining.

00:00:08 Matthew Collins

I'm Matt Collins, head of ETFs here at PGIM.

00:00:11 Matthew Collins

For those of you not familiar with PGIM, we are the $1.5 trillion asset management arm of Prudential Financial.

00:00:18 Matthew Collins

Prudential is celebrating 150 years of solving some of the most complex investment problems that exist, and we have one of the longest histories in the market doing that.

00:00:30 Matthew Collins

As we sit here today,

00:00:32 Matthew Collins

There is no greater challenge than navigating where we are in the equity market.

00:00:37 Matthew Collins

Essentially, we are at the top of the roller coaster, all peering down, waiting for that next drop in the equity market, and trying to understand how do you continue to stay invested in the equity market, but protect yourself for what seems to be sort of an inevitable outcome as we look towards more volatility in the market.

00:01:00 Matthew Collins

And within the asset management arm industry and within PGIM and Prudential, as we talk to clients, we talk about goal-based investing through this singular view towards retirement.

00:01:16 Matthew Collins

While retirement is a critical portion of the spectrum of life, that is not how life works.

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Life happens in a set of intervals.

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And it's a set of intervals that we're constantly saving for, whether it's your first house, college tuition, wedding, house repairs, maybe a second house if you're lucky enough.

00:01:38 Matthew Collins

Clients are consistently trying to invest and protect for that next goal.

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And retirement sometimes is the least of their concerns because

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They may work longer, they may work less.

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They are protecting to very unique life events.

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And the worst thing that can happen is you've accumulated through incredible equity runs like we've had over the last five years, or maybe it's a 20-year horizon, you've accumulated what you need, and then the equity market, the bottom falls out.

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And that's when you hear most often from your end clients in terms of how do we get out of this run?

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How do we protect ourselves against these kind of situations?

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And that is where the power of defined outcome ETFs, otherwise known as buffer ETFs, come into play.

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At Prudential, we have a very long history of offering annuity contracts.

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And what we wanted to do is bring that exact same concept, but in a much more accessible vehicle at a very low cost.

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So you can take that concept and apply it to your investment portfolio and to various client solutions with a defined outcome

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equity solution that puts a window frame around your S&P 500 experience and allows your clients and your portfolios to see exactly the amount of risk you want to see out of your equity portfolio.

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Buffer ETFs, and I'll intermingle the term buffer and defined outcome, they to me mean really the same thing, is now a 65 billion, it's probably 70 billion plus industry today that didn't exist three years ago.

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essentially.

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But most of you, as I mentioned, are familiar with annuity contracts and structured notes.

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Those are very popular investment vehicles and investment solutions that have existed for 20, 30 years in the market to incredible demand.

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But we wanted to bring something that is far more tax efficient and low cost to the market.

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And with this full service offering that's out there in the market, you've seen buffer ETFs be one of the most explosive segments

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of the ETF market growing almost exponentially just over the last few years.

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Ceruli recently did a study.

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They are projecting that this defined outcome ETF space in the next five years reaches $300 billion.

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And if you look at the top flows across the active ETF category and across the ETF, you constantly see what we refer to as solution-based products gaining share.

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This is

00:04:14 Matthew Collins

the new way of investing for a lot of clients, taking old concepts into a new vehicle in the ETF form in a far more manageable experience for clients.

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And the reason for the success of defined outcome ETFs is traditional hedging has simply not worked, particularly over the last three years.

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And my son has an unhealthy obsession with action movies, and I've seen my fair share of chases

00:04:43 Matthew Collins

in movies as a villain or someone's trying to run from building to building and they're leaping to the next building.

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And unfortunately for a lot of clients, that leap from equities to fixed income has been too much.

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The volatility that's existed in the fixed income market has really negated the benefit of that hedge.

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The power of defined outcome ETFs is to keep you invested in the equity market, in the S&P 500, in the NASDAQ,

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but narrow the range of outcomes and provide much more bond-like volatility.

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The critical component here, if you go back on any time period, whether it's 5, 10, 20, 30 years, the power of equities is undeniable.

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You have to be in equities to achieve your retirement outcomes.

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You have to be in equities to achieve any kind of goal that's five years and beyond.

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78% of market returns are positive.

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But what do your clients remember?

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They remember those drastic drawdowns.

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And if you look at the chart on the left, the navy boxes is where the equity market ends up on an annual basis.

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78% of the time positive.

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But those light blue diamonds are the drawdowns that happen within those years.

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And when does your client call you?

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They call you when that happens, right?

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And that scares them off, not just half the time, but it scares them off next year, five years from now.

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Well, I don't want to experience that.

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Defined outcomes protect against those drawdowns and help mitigate those drawdowns.

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But more importantly, when there is a drawdown, there is a path out.

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And that is critical for a lot of clients that are saving particularly goal-based

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investors in the market.

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Historically, going back to 1992, stocks, you have to be there.

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You have to be in stocks to achieve any meaningful appreciation in the market to keep up with inflation.

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But if you look on the right side, there is a pullback of 5% to 10% three times per year.

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And one of the greatest challenges for a financial advisor is to

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talk their clients into where they need to be versus where they want to be.

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They want to be in cash and just sit there, but they can't to achieve their goals.

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And the defined outcome industry is really built around mitigating these drawdowns that happen every year and usually quite often.

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Bond volatility, we're in a bit of a conundrum.

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Yields are at extremely attractive levels.

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We waited a decade to get to sort of that 4% or 5%

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risk-free, interest rate.

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The problem is any level of duration that's been taken on in the market has completely overwhelmed, from a volatility perspective, that income.

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And where you're seeing demand in the market, on the fixed income side, you're seeing it to low to no duration, high quality products like AAA CLOs and ultra short.

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But then the rest of the demand is going to these solution-based equities where they're trying to replace what they historically achieved out of the

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fixed income universe through a sort of a low vol, minimal upside in the equity market to achieve those kind of returns.

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And here's that gap.

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There is an enormous gap between the risk and return of the equity market.

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And we're using the S&P 500 to judge the overall equity return.

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Look how far down you have to go.

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from a return perspective to diversify your portfolio down to bonds.

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And the reason the defined outcome space has moved to 65 billion in just three years and the annuity space continues to take off, as well as people want that bond-like volatility, but they want equity-like returns, right?

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They want all the good stuff.

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Defined outcomes, buffer ETFs are meant to push you towards the volatility of bonds, but think of the equity market like your coupon.

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And when you're tied to the equity market, you have a much higher probability of achieving long-term success if the equity market is driving your returns, particularly on a five-year plus time horizon.

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So here's how they work.

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We have a 12% downside protection series, a 20% downside protection series, and a 100% downside series.

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We have an ETF in the market every month throughout the year.

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And every month, we will tell you what the cap is.

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That cap, let's just say it's 16%.

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On the first business day of the month, we'll say you have 16% upside participation for one year.

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That defined outcome is good for one year.

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If the equity market is up 18%, you achieve 16% out of this ETF.

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If the equity market is up 5%, you get 5%.

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But there's a buffer.

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If on a 20% buffer series, if the market is down 18% over that one-year period, you have zero losses.

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And as we talk about how do I get out of those light blue diamonds, how do I get out of those nasty drawdowns that scare your clients endlessly for years to come, this is how you do it.

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You put a window frame around your S&P experience.

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And there are very few investments in the asset management world where you walk in day one and know exactly what's going to happen based off how the S&P performs in a very narrow range that works for your client.

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And here's your ride along the way.

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Unlike other vehicles where you have a lockup period, it may be two years, it may be six years in a structured product,

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Defined outcomes, you are free to buy on day one of the outcome and hold it for five years.

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We constantly refresh the outcome every year.

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You have to do nothing.

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There's no taxable event.

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But on the flip side, you're free to sell mid-period.

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And if we offer a 16% upside product and six months into the annual outcome, you want to move to something else, you may be up 8% and say, that's good enough.

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It gives you the flexibility to hold over very long periods, but also realize the liquidity of the defined outcome or buffer ETF versus other vehicles that may have a taxable event or you're locked in to that vehicle.

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So this is really giving that annuity protection-like concept, but in a much more accessible vehicle.

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And if you look at the ride here, you were down about 50% less than the S&P 500 at peak drawdown.

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but you sort of end up pretty close to the same place as the S&P, but you're getting more upside than a traditional fixed income investment if the equity market cooperates.

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So why now?

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As I mentioned at the start of the call, it feels, I think, to many of us like we are at the top of a roller coaster.

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Now, as the drawdown, does it end up being 5% or 30%?

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We don't know.

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But we do know that we are at historically high valuations from a PE perspective, and something has to give at some point.

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There has to be some sort of give back.

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Now is the time to lock in the gains that you've experienced over the last five years in the equity market.

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Don't have FOMO, don't miss out on the next 5, 10% of the equity market should it continue to cooperate, but get rid of those big losses with defined outcome ETFs.

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And we went back 30 years, and we looked at the S&P 500 and said, what is the average return for the S&P 500 historically?

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And it's about 10.5%.

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I think most case studies will say clients really are trying to achieve 6% to 8% long-term in their 401 or their very long-term holdings.

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But given the recent run-up, that's actually moved up to 10.5%.

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These are the caps, the upside participation rate, that you can achieve in our defined outcome ETFs.

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And I'll just start with our 12% buffer series.

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That is approximately 14% upside with 12% downside protection over a one-year period.

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We also have the 20% series at 10.43.

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Now, if you think about the math on the S&P,

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over a 30-year period averages about 10.5%.

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If you can achieve 10.5%, but be protected for 20% loss on the S&P, not participate in the first 20% of S&P losses, now feels like a really attractive time to protect yourself against that steep drop.

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But if the equity market continues to push on, you have access to 10, almost 11%

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returns.

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We also have a NASDAQ 12% downside protection series.

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That gives you close to 17%.

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That's a really attractive cap level.

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You can sort of take the edge off the volatility in the NASDAQ and stay in it.

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And then we have a 100% protection series, which I'll talk about in a moment, which is a really nice step out of cash equity replacement where there's no downside

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but you can get around 6.5% upside in that max series.

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Here's why these products are taking off.

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You can invest in these products.

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Let's just say you invest $100,000 day one.

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If the market is up 12% over that year, your account value is $112,000.

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But behind the scenes, we do everything.

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We reset.

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the options within the portfolio and get a new cap.

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So as an investor, you can continue to step up with the equity market and you have nothing to do.

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There's no taxable event.

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There's no distribution in these products.

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Everything is your experience.

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It's your cost basis.

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When you choose to sell, that's your cost basis tax event.

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But unlike other products where you may get a lump sum, you may have distributions, this is a really nice replacement if you want defensive exposure, but not be subject to income taxes on a distributed bond product.

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There are a lot of products in the defined outcome space.

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I think there's about 500 plus products

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Don't be overwhelmed by the products.

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Over 80% of the products in the defined outcome space are tied simply to the S&P 500 or the NASDAQ.

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Extremely common indices, annual outcomes on these common indices, and you know exactly what you're owning.

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If you compare that to maybe a smart beta index strategy where it's a little confusing how it would act in a downturn or an active manager where you don't understand

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how that risk in that portfolio matches with the rest of your portfolio.

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These are dead straight on indices and defined outcome products on very basic indexes that are very easy to understand.

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The MAX series.

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So this is the 100% protection series.

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Last year, this was one of the most popular asset gathering segments of the defined outcome space.

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And the reasons are simple.

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Yields are expected to move down.

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Cash is a potentially could be less attractive with 100% downside, but around 6% to 6.5% upside.

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But most importantly, unlike a T-bill investment where you're paying taxes on all of the income that's distributed throughout the year, there is no income in the product.

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So if the S&P is up 3%, 4%, 5%, you get full capture up to 6%.

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with no downside protection, but most importantly, there's no taxable event and you don't have to pay income.

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As I said at the start of the call, use fixed income for income.

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If your clients need income, use it.

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If you're in a different phase of life and you're matching your liabilities, use fixed income.

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What these products are meant to do for the longer term horizon, keep you in the equity market,

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but give you that bond like Vol, but without sort of the taxable event that comes with a lot of the income associated with fixed income.

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This is why we find this story very, very easy to tell, both to the financial advisors that we talk to, but more importantly, as we talk to financial advisors, it's a conversation that they can have

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with their end clients, and those end clients understand this in about 30 seconds.

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It's super easy to understand.

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And as we talked about earlier, look at the gap on the risk-return over the last year between bonds and sort of this turquoise color here and the S&P 500.

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How do you fill that gap?

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That's an incredibly challenging gap to fill,

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Because for most people, U.S.

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large cap is your lower risk investment in your equity portfolio.

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But then what?

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You have to leap to that next building.

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And unfortunately, it's a huge leap.

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What these defined outcome products are meant to do is stair step your way down to fixed income.

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And you can throw a dart at what these products do and know exactly what's going to happen.

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If you want to stay closer to the S&P 500, you use sort of the long-term average of a 12% buffer

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If you want a 20% buffer, you're getting much closer to bonds.

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This ability to toggle down risk is critical for investors in the market as they look for solutions to diversify away from outright beta in the S&P 500.

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And as I mentioned, there's no taxable event in buffer ETFs.

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We handle everything behind the scenes.

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The cost basis is yours.

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When you sell,

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That's for you.

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If you hold for 366 days, you move into long-term category.

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But there's no income on these products, which in today's environment can be a very attractive opportunity to be defensive without the taxable event.

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About 50% of the flows in the defined outcome universe are going to what we refer to as a ladder ETF.

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In a ladder ETF,

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If you think about how these products work, your subject, if you want to buy the February product as an example, on February 1st, you need to invest on February 1st.

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Now, you're free to invest throughout the year, but it's easiest to invest when you get the full cap on day one.

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Sometimes clients don't want to have to worry about what's the cap in February?

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What's the cap in March?

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They're using ladder ETFs, which buy all 12 months in equal weight.

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This becomes an excellent defensive equity position for a portfolio.

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And if you think about how to break this up from a behavioral perspective, think about the defined outcome monthly ETFs that have annual outcomes as the client conversation, right?

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The client conversation is I have cash flows.

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I'm going to lock you in for a year in this product and get X upside, X downside protection.

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That's your behavioral option.

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Your portfolio construction option, so you don't have to worry about what the cap is on a particular month or check in with our website to see how much cap is left or how much buffer.

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Use a ladder ETF for a extremely simple investment solution that gives you everything you want out of defined outcome buffer ETF investing, but takes away the timing risk.

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The number one question

00:21:34 Matthew Collins

that I get on the latter ETFs is how does it behave, right?

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Is the January product wildly different than the June product, as an example?

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And the fact of the matter is, they operate very much the same.

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You can pick any time period, and the vast majority of the defined outcome monthly ETFs that have annual outcomes look very much the same.

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But there's always going to be one that's well above the others and one that's well under the others.

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The ladder ETF is ultimately meant to smooth out that experience and give you an average of these outcomes so you don't have to worry about timing risk for the monthly vintages, particularly as it relates to cashflow.

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So this is a very nice scalable solution for portfolio construction across your practice.

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Here's a real-life example.

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Looking back at the

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March and April drawdown in the S&P 500.

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The ladder ETF was down about 50% less than the S&P 500, but you end up pretty much in the same place.

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And if you think about how important that is to talk to your clients about an equity vehicle that keeps them invested, but avoids these nasty drawdowns, but can give them a nice moderate equity return,

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What does that give you?

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It gives you a very attractive Sharpe ratio in your portfolio.

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Now, where does it fit?

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I've suggested that stay invested in the S&P.

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It's critical over long-term to have full beta.

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Use fixed income.

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It is a absolutely critical component of a portfolio.

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But this is meant to help you ladder down

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from equities to fixed income.

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So as you draw down your equity exposure, before you get to fixed income, begin to incorporate defined outcome buffer ETFs in these products to draw it down.

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Now, in terms of where PGIM fits in this, PGIM and Prudential were one of the first users in partnership with the CBOE to create what's referred to as flex options back in 1993.

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We are originator of these flex options.

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That is what sits behind these defined outcome ETFs.

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We have a very long history navigating this market.

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Prudential has an extraordinarily long history of solving very complex investment challenges.

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So we wanted to bring that concept, but most importantly, we wanted to bring it at a expense ratio that is much, much lower cost than what's out there in the market.

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Most defined outcome ETFs

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are anywhere from 79 to 100 basis points.

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Those are incredibly expensive ETFs, given that S&P 500 exposure is often free.

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And a lot of large ETFs out there, we wanted to come to market and offer a game-changing level of expense savings.

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And I know expenses are obvious on the impact to the portfolio,

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It is that much more important in the defined outcome space because you are living in a very narrow range.

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We've talked about 14% upside, 12% downside protection.

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Well, when you live in that window frame, your clients have picked what they want to see out of the S&P 500.

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It's that much more obvious the impact of cost that exists in these products.

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So lowering the costs, our products are at 50 basis points, much cheaper.

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than the vast majority of other defined outcome ETFs that are out there in the market.

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So there's one question in the chat.

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Thank you again for submitting this.

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What does your client see?

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They see it every day.

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So these products trade like any other ETF in the market.

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They'll see a market price every day.

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And I like to describe these to some extent.

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They're not a bond, but the concept applies here as amortized bonds.

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So these ETFs, defined outcome ETFs are on a schedule.

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Starts on day one, ends on day 365.

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As you get closer to the end of the outcome, let's say you're in month 11, there's 30 days left in the outcome, there's not going to be a lot of movement in that product.

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But let's just say the, let's cut it off simple.

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In a January ETF, it's June.

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The equity market is up 15% in June, and the cap on the product was also, let's say, 15%.

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By June, your buffer ETF is most likely going to be up anywhere from 7% to 10%.

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And if the equity market continues to cooperate, it's going to start ticking up like an amortized bond towards the end of the outcome if the equity market continues to stay positive.

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But what a lot of clients love is they can say, you know what?

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That 10% is good enough.

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I know I was looking for 15 out of this, but I want to move to a different buffer.

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I want to refresh my buffer, move into a different part of the equity market.

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There's no lockup.

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You're free to go.

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If you like what you've earned, you move on, buy something else.

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On the flip side, you can hold it for 10 years, and you can constantly step up with the market.

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And the other question that popped in, is it price only or total return?

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No income, price only.

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on these products.

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This is a non-distributing product, so we do track the price return of the S&P 500.

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So with that, I will close out.

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Here's our full suite.

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I will say that there's a lot of options in the defined outcome space, but there are very few firms offering full service ETF offerings that have a refreshed cap every month in ETF

00:27:42 Matthew Collins

in the market at different buffer levels with refreshed caps that you can match your cash flow needs or your investment portfolio needs up with.

00:27:51 Matthew Collins

And we're very proud to offer a full service offering within the defined outcome space.

00:27:58 Matthew Collins

I think to close out, I will say this on the 12% series.

00:28:02 Matthew Collins

We went back to 1957 and looked at every loss that happened on an annual basis, rolling every month.

00:28:10 Matthew Collins

and said, what's the average drawdown?

00:28:14 Matthew Collins

The average drawdown going back to 1957 is 11.8%.

00:28:19 Matthew Collins

We offer, and we're the only firm to offer a 12% buffer.

00:28:22 Matthew Collins

And what we are doing, if you buy downside protection to the average event, you're maximizing the amount of upside for the protection that you've bought, right?

00:28:33 Matthew Collins

Because every dollar you protect is a dollar you give up on the upside.

00:28:37 Matthew Collins

The 20% series is really meant for today's environment, where you're at the top of the roller coaster.

00:28:43 Matthew Collins

And then the max buffer is your cash alternative.

00:28:45 Matthew Collins

And the NASDAQ series is meant to take a bite out of the volatility, but give you really nice upside.

00:28:52 Matthew Collins

And then we have a ladder option, BUFP, PBFR, and PBQQ, where you can add this to your portfolio in a very simple framework.

00:29:02 Matthew Collins

So I want to thank everyone.

00:29:03 Matthew Collins

This was meant to be a quick hit.

00:29:05 Matthew Collins

webinar.

00:29:06 Matthew Collins

Thank you for the questions.

00:29:08 Matthew Collins

I'm always here for support, and this will be available for replay as well.

00:29:12 Matthew Collins

So thank you, everyone, for joining.

00:29:13 Matthew Collins

Much appreciated.

[Disclosures on screen]