# Perspective

# There Ain't No Such Thing as a Free Lunch

**(Especially When Eating at the Buffer Buffet)**

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Being an equity investor is hard. Volatility can be high, drawdowns can be long, and nobody can definitively say when returns are going to be good or bad. It's no wonder so many financial "innovations" over the years have been successfully marketed and sold as making equity risk a little easier to bear.[1]

One example is structured products, which typically use a combination of options to customize the return distribution of a given asset—for example, a collar strategy which buys a put option to mitigate downside risk and pays for this protection by selling a call option (and giving up some of the upside). Strategies like these have been around for decades but lately are seeing a resurgence in the form of "buffer funds" (which are just a little more complicated than old-fashioned collars). A lot of people (apparently especially, uh ok, boomers) really seem to like these funds.

But do they work?

Nope.

Our latest piece on Buffer Funds appears in the current issue of the Journal of Portfolio Management. Once again, and with more analysis (and co-authors) than our two previous posts on the topic, we find these products don't hold up to scrutiny, either empirically or theoretically. This shouldn't be surprising, as buffer funds (and products like them) can fundamentally be thought of as having one thing going for them and three things against:

- Positive expected returns of the underlying asset (usually called the "reference asset");
- Negative returns from (generally) being long the volatility risk premium;
- Negative returns from the cost of trading the options; and
- Negative returns from the fees.

It's not a short paper, so here's the TL;DR version of the results:

- Buffer funds in aggregate have delivered worse risk-adjusted returns than their reference assets;
- This degradation generally worsens with time;
- Realized returns can vary wildly from payoff diagrams for all periods other than the exact dates on which the underlying options are purchased and sold;
- These funds have generally performed worse than a simple beta-matched stock/cash combination over the three largest drawdowns of the past decade (so a simple strategy superior to buffer funds would be to own somewhat less in equities versus cash); and
- These inferior outcomes hold not only pretax but also after-tax.

Buffer funds by and large have sold investors the promise of comfort, cloaked in complexity, at the cost of risk-adjusted returns. Our paper shows there are simpler, less expensive, and more effective ways to deal with the risk of equity markets. Once again, Robert Heinlein and his TANSTAAFL, provides investors more value than a (growing) slice of our industry.

[1] We don't shy away from doing this ourselves, believing as we do in adding low-correlated sources of return, and in particular noting the historical contributions of trend following strategies in equity drawdowns. The difference is, unlike Buffer Funds, we believe the evidence, theory and empirics show our ideas work. :)