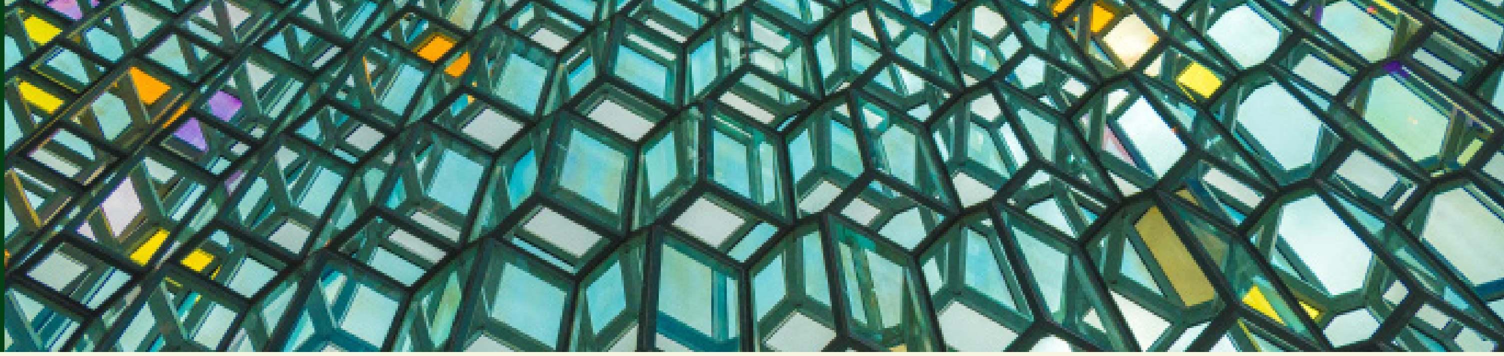

Investing ideas

What equity options-based ETFs bring to the table

Key takeaways

- Equity options-based ETFs are an emerging category of actively managed ETFs that provide a liquid alternative to long-only funds.
- The strategies combine buying securities with the purchase and sale of derivatives (put and call options) to create funds similar to traditional equity funds but with downside protection or yield generation, and may offer complementary benefits within the equity allocation of a portfolio.
- By offering downside protection and dampening volatility, equity options-based ETFs may help keep clients invested through periods of turbulence and prevent emotional decision-making.

The explosion of actively managed ETFs over the past several years has changed the portfolio construction landscape, opening new opportunities to use the tax efficient ETF vehicle structure to pursue a wider variety of investment goals. The latest development? The emergence of equity options-based ETFs.

Equity options-based strategies have been around for decades, and have frequently been deployed by hedge funds. With the growth of the equity options market in recent years, these sophisticated, derivatives-based investment strategies can now be found in an ETF wrapper. Read on to find out what role options-based ETFs can play in a portfolio, and whether they're right for your clients.

Equity options strategies typically combine a long equity portfolio with put and/or call options. Options contracts are agreements to buy (calls) or sell (puts) securities at a set price (the strike price). Using options, portfolio managers can effectively set an artificial floor or a ceiling around the prices of the assets in their portfolio, with the aim of reducing volatility, reducing downside risk, or increasing yield. As such, these strategies may offer specific benefits in comparison to a pure long-only equity allocation.

Types of equity options strategies

The most common equity options strategies are: Defensive long puts, yield-generating call-selling, and defensive collars.

Defensive long put strategies deploy put options to help protect against downside risk. The put allows portfolio managers to sell securities at a set price, kicking in when the market declines to limit a position's losses. In a rising market, the cost of purchasing the put options will reduce the overall returns compared to a long-only fund with the same holdings.

Yield-generating call-selling strategies sell call options, generally with a strike price greater than the current market price of the assets. The income generated from the sale of the options enhances the overall yield by providing an additional yield source separate from the yield generated by the core equity portfolio. In a sharply rising market, the call options may be exercised, imposing a ceiling on the value of the shares in the fund. In a flat or moderately bullish market, the sale of the calls generated positive cash flow and should improve total returns above the level offered by dividends alone.

Defensive collar strategies (sometimes called "buffer ETFs") combine both short call options and long put options. In other words, collar strategies use options to create both a floor and a ceiling on returns, with the goal of limiting losses though capping upside potential. This approach can effectively reduce the volatility of returns while mitigating the cost of the options on the fund's overall performance.

Different market environments, different effects on performance

The options overlay of these funds means that their performance will vary from that of the broader market. Different equity options strategies will thrive in different market environments.

Defensive put strategies may be particularly effective when the broad market faces a sharp drawdown. Comparing a put protection index against the broader S&P 500 during the COVID-19 drawdown, the put protection index returned 28.1% over the course of 2020, while the S&P 500 returned 17.4%.[1]

Collar strategies have worked well when markets have faced sustained higher volatility, as in the bear market of 2022. From December 2021 to December 2022, the S&P 500 collar index returned –15.1%, compared to –18.1% for the S&P 500.[2]

Yield-enhancing strategies have the potential to provide increased yield in a variety of market environments, and may offer outperformance in periods of flat or slowly rising markets.

Role in portfolios

The downside protection potential of equity options strategies can make them appealing to investors who are averse to the volatility and risk of traditional long-only strategies, but who wish to include equity exposure in a portfolio. A moderate reduction in the drawdown of a portfolio during a bear market can have significant impact on recovery: A portfolio that declines by 50%

[1] Source: Fidelity Investments and Bloomberg Finance LP, CBOE S&P 500 5% Put Protection Index (PPUT), CBOE S&P 500 95/110 Collar Index (CLL), and the S&P 500.

[2] Source: Fidelity Investments and Bloomberg Finance LP. CBOE S&P 500 95/110 Collar Index (CLL) and the S&P 500 Index. Returns are in USD calculated using daily returns.

during a down market must double its value from its low to recoup its losses. A portfolio that dips 40% must rebound by two-thirds to regain its former levels. Blunting the dip may help prevent clients from making emotionally-driven trading decisions when markets are volatile. Staying invested while potentially shortening the time needed for recovery can help keep assets compounding over the long term.

Similarly, yield-generating strategies may offer improved yields when compared to total return or some traditional fixed income funds. This can be particularly useful to inventors concerned with generating yield during low-rate environments. Since the additional yield is generated by the sale of the call options, investors don't incur increased duration or credit risk to obtain it.

Exhibit 1: An overview of the potential benefits, costs, and expected behavior across market environments.

	1 **Defensive put**	2 **Defensive collar**	3 **Yield-generating call selling**
Targeted outcome	Downside risk mitigation	Downside risk mitigation	Income enhancement and cash flow
Key benefits	• Tail risk hedging • Upside participation less cost of puts • Volatility reduction	• Drawdown hedging • Upside participation, but capped • Volatility reduction	• Income enhancement • Upside participation, but capped • Moderate volatility reduction
Cost	Explicit: cost of puts	Implicit: upside truncation	Implicit: upside truncation

Source: Fidelity Investments. For illustrative purposes only.

Evaluating equity options ETFs

Equity options strategies are more complex than traditional long-only funds and come with a different set of risks. When evaluating equity options funds, you may wish to consider:

- **Does the fund use a rules-based, systematic option allocation framework?** Having such a framework in place may help improve portfolio consistency and reduce market timing risk.
- **Is the options allocation well-diversified?** Allocating options across multiple expiration dates and strike prices may enhance portfolio overlay efficacy or efficiency liquidity.
- **How often are the options rebalanced?** Systematic rebalancing helps ensure that the portfolio's risk attributes remain consistent regardless of when shares are purchased.

Conclusion

Equity options-based ETFs are a new tool in a portfolio constructor's toolkit—one that may enable them to solve new problems. Providing equity exposure with a different risk profile than traditional long-only funds, they may enable advisors to incorporate equities into client portfolios in a way that better aligns with investors' risk appetite and long-term goals. Because equity options strategies vary widely and carry distinct risk/return characteristics than traditional long-only equity strategies; it's important to have a thorough understanding of the fund's design and objectives before investing. For more insights from Fidelity's experts on equity options strategies, see our white paper on Liquid Alternatives.

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Risks

Equity options entail the risks that purchased options expire worthless and sold options incur significant losses depending on market moves. It is possible to lose money if the underlying security moves dramatically in price in an unfavorable direction. Options trading entails complexities, resulting in the possibility that investors will make mistakes. Certain options may be less liquid, trading in lower volumes. The direct costs of trading options can be higher than other types of investments. There are also indirect costs based on the bid price and ask price; or the prices received for writing and buying them. Another risk is the risk of time decay, which is the declining time period until expiration.

Diversification does not ensure a profit or guarantee against a loss.

Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Writing call options involves the risk that the fund may be required to sell the underlying security or instrument (or settle in cash an amount of equal value) at a disadvantageous price or below the market price of such underlying security or instrument, at the time the option is exercised. As the writer of a call option, the fund forgoes, during the option's life, the opportunity to profit from increases in the market value of the underlying security or instrument covering the option above the sum of the premium and the exercise price but retains the risk of loss should the price of the underlying security or instrument decline. Additionally, the fund's call option writing strategy may not fully protect it against declines in the value of the market. While the fund will normally pay its income as distributions, the fund's distributions may exceed the fund's income and gains for the fund's taxable year. Distributions in excess of the fund's current and accumulated earnings and profits will be treated as a return of capital and may have a negative impact on the fund. The fund's ability to distribute income to shareholders will depend on the yield available on the common stocks held by the fund and the premiums received by the fund with respect to its written call options. Changes in the dividend policies of companies held by the fund could make it difficult for the fund to provide a predictable level of income. In addition, the premiums received by the fund with respect to its written call options will vary over time and based on market conditions. Securities selected using quantitative analysis can perform differently from the market as a whole as a result of the factors used in the analysis, the weight placed on each factor, and changes in the factors' historical trends. High portfolio turnover (more than 100%) may result in increased transaction costs and potentially higher capital gains or losses. The effects of higher than normal portfolio turnover may adversely affect the fund's performance. An ETF may trade at a premium or discount to its Net Asset Value (NAV). These alternative investment strategies may not be suitable for all investors and are not intended to be a complete investment program for any investor. There is no assurance that the ETFs will be profitable.

Past performance and dividend rates are historical and do not guarantee future results.

All indices are unmanaged. You cannot invest directly in an index.

ETFs are subject to market fluctuation, the risks of their underlying investments, management fees, and other expenses.

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