Small Caps Look Poised to Outperform – Consider a Quarterly Buffer ETF

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Given the fact that the average bear market will erase 30% of a stock portfolio's value, we believe it's imperative for retirees and investors nearing retirement to have some level of protection if they want to participate in the stock market. Thankfully, with the introduction of Buffer ETFs in 2018, investors can now purchase liquid investments in an ETF wrapper that provide a level of protection against losses. The popularity of Buffer ETFs has skyrocketed with over $50 billion already invested in this fast-growing exchange-traded fund niche.[1]

As a refresher, Buffer ETFs allow investors to participate in stock market gains to a predetermined cap while also providing downside protection, known as a buffer. The level of protection varies depending on the buffer series. The upside cap will also vary depending on the amount of protection provided in the Buffer series. Cap levels are variable and are heavily influenced by market volatility and interest rates. A typical outcome period for a Buffer ETF is 12 months, but you are not locked in for the duration - they are liquid and can be bought or sold throughout the trading day, just like other ETFs.

Over the past week we reviewed nearly 200 Buffer ETFs that trade on U.S. markets and found one that looks particularly appealing in the current market environment.

RBUF: Quarterly Buffer from Innovator

U.S. Small Cap 10 Buffer ETF (RBUF), is a quarterly Buffer ETF offered by *Innovator.* It tracks the Russell 2000 (IWM) to an upside cap while offering 10% protection every three months. At the end of the 3-month outcome period, RBUF resets, in a tax-efficient manner, with fresh 10% protection and a new upside cap. Currently RBUF has intra-outcome parameters that look particularly attractive.

As mentioned earlier, Buffer ETFs typically have 12-month outcome periods. In order to receive the defined outcome published at the outset of the outcome period, an investor would need to hold the ETF for 12 months, beginning on the reset date. In an uncertain investment environment, a 12-month holding period can seem like an eternity. Thankfully, some Buffer ETF providers now offer ETFs with shorter outcome periods (3 or 6 months).

Innovator offers numerous quarterly Buffer ETFs that track various well-known underlying assets (e.g. IWM, QQQ, SPY) with varying levels of protection. Here are some of the advantages of a short outcome period: 1) In a rising market, it allows investors to lock in profits faster, with fresh protection and a new upside cap. 2) It provides more frequent

[1] Jackson, R. (2024, July 5). A prolific first half for ETF flows. *Morningstar.* https://www.morningstar.com/funds/prolific-first-half-etf-flows#bitcoin-and-buffer-etfs-pave-the-way-for-alternative-etfs

protection. Most Buffer ETFs offer 10% or 15% protection every 12 months, but with 10% protection every 3 months, a quarterly buffer effectively provides more protection if looked at over a total 12-month period. 3) In a volatile, choppy market, a quarterly Buffer ETF could outperform a Buffer ETF with a longer outcome period.

Below are the current Potential Outcome Parameters for RBUF (as of October 25, 2024): www.innovatoretfs.com

Ticker	Name	Ref. Asset	Remaining Buffer	Remaining Outcome Period	Remaining Cap
RBUF	U.S. Small Cap 10 Buffer ETF	IWM	9.0%	67 days	5.2%

"Fund return and current outcome period values assume reinvestment of capital gain distributions, if any. Investors purchasing the fund intra-period will achieve a different defined outcome than those who entered on day one. The remaining cap represents the maximum return the fund can achieve at its current price. The reference asset may need to rise higher or lower than the remaining cap before the remaining cap is realized. If the remaining buffer is greater than the fund's starting buffer, a portion of the buffer will be realized before the downside before buffer begins. After the downside before buffer has been realized, the final portion of the buffer will begin again." [2]

RBUF offers 9% protection over the remaining 67 days of the outcome period while providing a net cap (after fees) of 5.2% (28.3% annualized).

Does RBUF offer enough protection?

Given the current intra-outcome parameters, an investor purchasing RBUF today would have protection on initial losses of approximately 9% during the remaining outcome period of 67 days. However, if the underlying asset (IWM) were to decline by more than 9% at the end of the outcome period, the investor would lose 1-to-1 with IWM. Is 9% protection enough to prevent losses over a typical 2-month period? What does history tell us?

Below are data on the number of occurrences IWM has declined by more than 9% (buffer as of 10/25/2024) over a 2-month period since the inception of IWM in May 2000.

Number of Occurrences	Number of Outcome Periods	Probability
26	292	8.90%

Past performance is not indicative of future results. The data used to calculate the probabilities are based on calendar month returns. The data on monthly returns are from StatMuse and Yahoo Finance. The authors of this article are not responsible, in any way, for discrepancies in data. Errors in the data or calculations are possible and are not the responsibility of the authors. The Fund's investment objectives, risks, charges and expenses should be considered before investing.

The probability of IWM dropping more than 9% over a 2-month period is 8.90%. Put differently, there is a greater than 91% probability of <u>not</u> losing money in RBUF, given the current level of protection over an outcome period of approximately 60 days.

[2] "U.S. Small Cap 10 Buffer ETF" Innovator ETFs, accessed October 4, 2024, https://www.innovatoretfs.com/etf/?ticker=rbuf

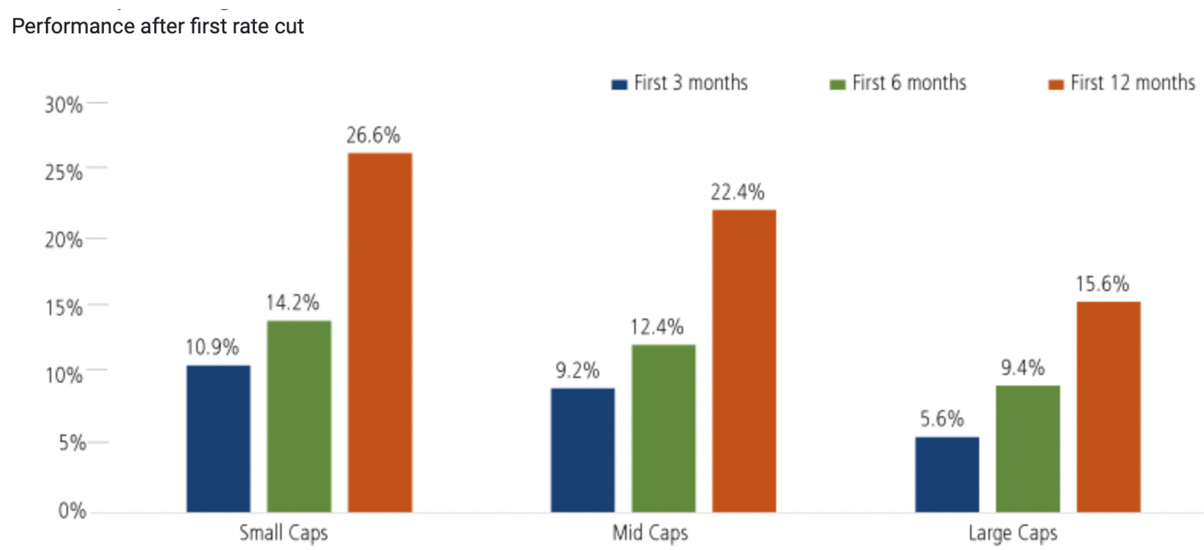
Why buy Small Caps now?

1) **Small Caps are undervalued by 15%**

According to *Morningstar*, as of September 30, small-cap stocks were trading at a 15% discount to fair value.[3] *Morningstar* estimates a company's fair value by predicting the company's future cash flows and discounting them to their present value. In addition, companies in the Russell 2000 are trading at 15.8 times their projected earnings over the next 12 months, below their 10-year multiple of 16.4, according to FTSE Russell. In comparison, the S&P 500 trades at a multiple of 21.5.[4]

2) **Small Caps have historically outperformed following the Fed's first rate cut**

Small caps tend to outperform when the Fed starts cutting interest rates. If history is a guide, with the Fed now cutting rates, and with further cuts expected, small caps could be poised to outperform. The table below shows how the three primary stock asset classes have performed following the first rate cut. Small caps handily outperformed both mid- and large-cap stocks over 3-, 6- and 12-month periods.



Past performance is no guarantee of future results. Source: Jefferies using Federal Reserve Board, Haver Analytics, Center for Research in Securities Prices (CRSP®), and the University of Chicago Booth School of Business. Note: used fed funds rate from 1954 until 1963, then used the discount rate from 1963 until 1994 and the fed funds rate thereafter.

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[3] Sekera, D. (2024, September 30). Q4 stock market outlook: where we see opportunities for investors. *Morningstar*. https://www.morningstar.com/markets/q4-stock-market-outlook-where-we-see-opportunities-investors

[4] Singh, H. (2024, October 3). If a soft landing is in the cards, why aren't small-cap stocks rallying? *The Wall Street Journal*. https://www.wsj.com/finance/stocks/if-a-soft-landing-is-in-the-cards-why-arent-small-cap-stocks-rallying. Market caps defined by CRSP based on placing market caps into deciles. Deciles 1 and 2 are large, and 6 through 8 are small. [4]

Summary

The combination of significant undervaluation, and a historical track record of outperformance following the first Federal Reserve rate cut, makes a compelling case for ownership of small cap stocks. If you are a risk-averse investor who would like a level of protection against initial losses, a quarterly Buffer ETF is an attractive way to participate in the potential upside of small caps. An intra-outcome purchase of RBUF now could indeed be timely.

At the time of publication, Stuart Chaussée, Henry Chaussée, and/or clients of Stuart Chaussée & Associates, Inc., held positions in RBUF and IWM. Holdings can change at any time. Under no circumstances does the information in this article represent investment advice or a recommendation to buy or sell securities.