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Portfolio perspectives

Each month, you'll have access to the latest insights from our Portfolio Solutions experts to help you address evolving issues that may affect your clients' portfolios.

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Vanguard Portfolio Solutions

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Limiting downside with buffer funds—is there a catch?

Market losses can greatly impact the future investment behavior of the investors who lived through them. Black Monday in 1987, the bursting of the tech bubble in 2000, the global financial crisis in 2008, and then more recently, the 2022 stock *and* bond market decline ignited loss aversion as a primary focus of many investors.

One of the outcomes of this increased loss aversion is a heightened interest in financial products designed to reduce or limit the impact of losses. Although they take many forms, structured products with this focus are often called *buffer funds*, or more recently, *buffer ETFs*.

What is a buffer fund/ETF?

Buffer funds come in a variety of structures and formats, and the terms of each are unique. Typically, they offer the ability to cushion losses in the stock market, as measured over a one-year period. Let's use an example of a 10% buffer fund whose cap is 16% to better illustrate how this works. The 10% buffer means that the investor avoids the first 10% of market declines. However, this comes at a cost; investors also give up gains above a certain level—in this case, gains are capped at 16%. In 2024, the S&P 500 was up 25.19%,* but an investor in our example would have only gained 16%. And, in a significant market crash, losses beyond the "buffer" are still realized by the investor. So, an investor in a 10% buffer fund would have lost more than 28% of their investment in 2008, when the S&P 500 Index declined 38.49%.

But was 2024 an isolated case? Consider that 49 out of the last 99 years saw the stock market (S&P 500) produce returns greater than 16%, meaning that 50% of the time, a holder of a buffer fund would have missed out on market gains.*

How do they work?

Buffer funds use the options market to help bring the desired outcome to reality. The options trading strategy employed is called a "collar" and has two parts. First, the underlying strategy buys puts that will increase in value if a group of stocks (typically an index like the S&P 500) decline from their current level. This helps safeguard against losses. Second, the purchase of these puts is funded by selling calls that would create a liability if the index rises to a certain level above its current value, as well as selling puts that expose investors to a liability for losses beyond the buffer percentage.

*** Vanguard analysis of S&P 500 Index data. Past performance is not a guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.**

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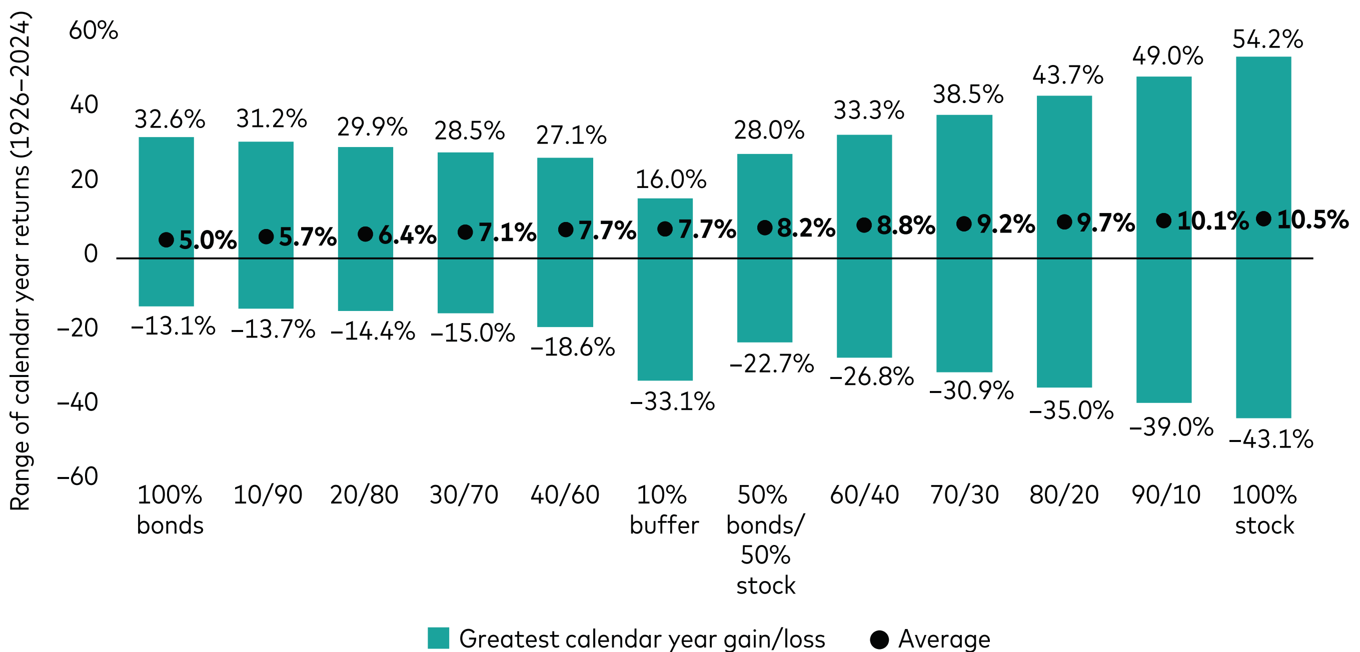
Are buffer funds a way to have your cake and eat it too?

At first glance, being able to participate to some degree in up markets and limit the impact of down markets sounds incredibly appealing to risk-averse investors. But what should you keep in mind if considering these products for a client?

While buffer fund performance in the rising rate environment of 2022 looks attractive in hindsight, the limited upside participation of buffer funds could cause longer-term returns to skew asymmetrically to the downside. This is visible in our analysis in the chart below (**see Figure 1**), where we compare a range of traditional stock/bond allocations to a hypothetical 10% buffer fund. The buffer fund, although designed to limit downside participation, actually has a negative skew, providing the average return of a 40% stock/60% bond portfolio with the downside of a 75% stock/25% bond portfolio. This owes primarily to its inability to take full advantage of major market recoveries. While buffer funds allow you to address the behavioral concerns of clients, the cap on upside returns could negatively affect their long-term investment results.

Figure 1: Upside cap on buffer funds creates downward bias to returns

Range of calendar year returns of bond/stock mixes relative to a 10% buffer fund



Hypothetical example. Past performance is not a guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Sources: Vanguard Investment Advisory Research Center calculations through December 31, 2024, using data from FactSet.

Notes: Stocks are represented by the Standard & Poor's 90 Index from 1926 through March 3, 1957; the S&P 500 Index from March 4, 1957, through 1974; the Wilshire 5000 Index from 1975 through April 22, 2005; the MSCI US Broad Market Index from April 23, 2005, through June 2, 2013; and the CRSP US Total Market Index thereafter. Bonds are represented by the S&P High Grade Corporate Index from 1926 through 1968, the Citigroup High Grade Index from 1969 through 1972, the Lehman Brothers U.S. Long Credit AA Index from 1973 through 1975, the Bloomberg U.S. Aggregate Bond Index from 1976 through 2009, and the Bloomberg U.S. Aggregate Float Adjusted Index thereafter. Annualized returns for the hypothetical buffer fund were calculated using the annual stock return data above and capping the annual return at 16%, applying a 10% buffer to any annual losses so that returns between 0% and –10% would be 0% and annual returns worse than –10% would be reduced by 10%.

Other drawbacks of buffer funds include a limited ability to rebalance, or a more limited ability to benefit from extreme market corrections mid-year, as well as a potential to recognize more of your return as income than as capital appreciation—making them less tax-efficient than you and your clients may expect.

This last point makes asset location an important consideration. Ideally, tax-inefficient assets are placed in tax-deferred or tax-exempt accounts and not positioned to compete for space in taxable accounts. For ultra-high-net-worth investors in particular, who hold a significant portion of their wealth in taxable accounts (and are in the highest tax bracket), this substantially limits the amount of portfolio space available to buffer fund assets.

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Next steps to consider: Contact Vanguard Portfolio Solutions

If you're still considering buffer funds as a potential way to manage your client's risk aversion, reach out to our investment consultants for a more detailed analysis on how they compare to traditional conservative asset allocation approaches in your current models.

Our team of experts can provide an objective perspective on your portfolio construction decisions, validating your choices or uncovering opportunities. Take advantage of our personalized analysis based on your specific concerns or challenges.

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