Why active management matters for defined return investing

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Key Takeaways

- Implementation determines success. Defined return investing aims to increase the probability of achieving a target return, but how well a strategy is built and managed in practice is what turns that aim into investor outcomes.
- Interest rates, dividends and implied volatility are constantly moving, and each defined return investment has many adjustable characteristics. Active management gives the manager the flexibility to optimise those choices as conditions evolve.
- Multiple swap providers improve execution. Pricing follows risk appetite, so the best-priced provider changes frequently. Seeking pricing from several providers on multiple structures at once helps the manager minimise counterparty exposure and secure better terms.

The philosophy of defined return investing is to prioritise the probability of achieving a target return over maximising potential upside. But as with any good investment idea, success ultimately comes down to implementation.

Traditionally, investors have accessed defined return investments through individual structured products. The outcomes of these investments are predictable, but a single structured product in a portfolio, although easy to implement, exposes investors to individual product risks as well as timing risks on both entry and exit. More sophisticated defined return investors have often developed portfolios of individual structured products, providing a level of diversification, but such portfolios are operationally intensive to run, have liquidity limitations, and are still associated with issuer credit and concentration risks.

When looking at a single structured product vs a structured product portfolio, there are trade-offs. Implementation here can be thought of as a weighing scale, which balances operational intensity against investor outcomes. The same principle applies to defined outcome mutual funds and ETFs, where operational complexity and investor outcomes for passive index-based approaches and actively managed approaches, sit at different points on that scale.

Index-based passive ETF solutions are relatively simple to implement. However, they are rigid, and the underlying index to which the defined return investments are linked tends to be financially engineered. This engineered index can behave very differently to the equity market, sacrificing real-world predictability for

investors. Passive ETF implementations are simpler for the investment manager, generally being formed of a single swap with a single swap provider, but this is likely at the expense of investor outcomes.

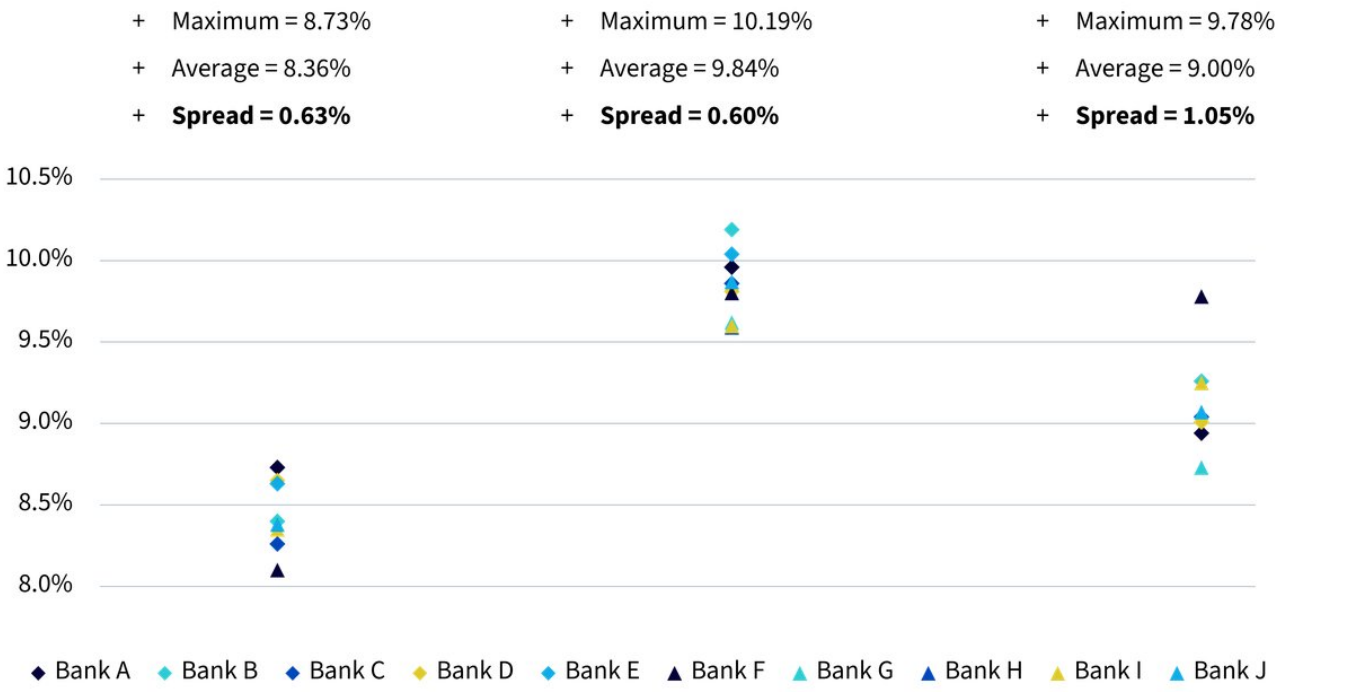
An actively managed ETF or mutual fund approach does not track an index, and so unlike most passive defined outcome ETFs, it can use real-world equity indices to retain the predictability that defined return investors expect. When using real-world indices such as S&P 500, Euro Stoxx 50 and FTSE 100 to build a defined return portfolio, active management becomes especially important. This is because pricing parameters for these indices such as interest rates, dividends and implied volatility are constantly changing. Additionally, an individual defined return investment has many characteristics that can be adjusted, leading to numerous potential investment decisions, and active management allows the investment manager the flexibility to optimise these choices.

As market conditions evolve over time, the investment most likely to help the portfolio achieve its objective changes meaningfully. And when it comes to a portfolio of defined return investments, every new investment needs to be viewed in the context of the whole portfolio, where each incremental decision maximises the probability of the ETF or mutual fund achieving its target objectives. Therefore, an actively managed approach for defined return investing is vital, and even though this is operationally more complex, it allows an investment manager to optimise portfolio decisions with the aim of improving long-term investment outcomes, while retaining the predictability that investors expect.

Flexibility is also key for execution, and that comes from having multiple swap providers. The ability to trade defined return investments institutionally through swaps, not notes, allows the investment manager to minimise counterparty exposure, largely removing credit considerations from the investment decision. When swap providers are placed on a level playing field, it is risk appetite that drives differences in pricing, and this appetite, like market conditions, is always shifting. A swap provider may be offering the best pricing on one index underlying but poor pricing on another or be strong on aggressive barrier shapes but weak on defensive barrier shapes. Often, the swap provider that is pricing best one month may be pricing worst the next. Overall, this pricing disparity changes frequently, and so an investment manager should consider multiple structures for the portfolio at the same time and ask for pricing from multiple swap providers. Figure 1 shows how much pricing can differ between swap providers. It compares real quotes for defensive autocallables from ten providers across three auctions.

Figure 1: Trading with multiple counterparties allows for better pricing over time

Real auction pricing for defensive autocallables over multiple months



Source: WisdomTree from 7 November 2019 to 2 June 2026. **Historical performance is not an indication of future performance and any investments may go down in value.**

Once executable pricing is received, trades should then be assessed again in the context of the wider portfolio. Only then can the investment manager determine and execute the investment that maximises the probability of achieving the ETF or mutual fund's target objectives. This process requires continuous optimisation and alongside multiple swaps with multiple providers, is operationally demanding for the manager; but for the investor, it is likely to lead to improved long-term outcomes.

Defined return investing aims to increase the probability of delivering a target investment return, but how well such a strategy is implemented is fundamental for providing effective investor outcomes in practice. Active management allows an investment manager the agility to optimise portfolio decisions, pricing, and execution, as market conditions evolve, helping maximise the likelihood that long-term target investment outcomes are ultimately achieved.

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