

Index swap or individual swaps? How autocallable ETFs are built

Autocallable notes are the largest income category in the U.S. structured note market. ETFs now give investors access to these payoffs without buying individually negotiated notes. That raises a question headline yields don't answer: how does the ETF obtain its exposure? There are two ways, a single index swap or a series of individual swaps. The method affects valuation, trading costs, and taxes, but is not always visible on a fact sheet.

Two ways to build the same payoff

An index swap structure packages the entire ladder exposure into a single, rules-based index that the fund holds through one total return swap. The index holds the synthetic autocallable contracts, adds new ones on a set schedule, reinvests proceeds as contracts are called or mature, and applies each contract's coupon and barrier conditions on schedule. An independent provider calculates and publishes the index level daily.

An individual swap structure has the fund hold a series of separately negotiated swap positions, each replicating one autocallable payoff. There is no index in between. The manager assembles the collection directly, and each position carries its own reference asset, maturity, barriers, and call trigger.

The distinction is one of governance rather than payoff. The first approach is rules-based: the methodology is fixed and disclosed in advance, and the fund follows it. The second is discretionary: terms are set position by position at the manager's judgment.

At a glance

Dimension	Index swap	Individual swaps
Valuation	One published index, calculated daily by an independent provider	Counterparty bank marks, delivered privately
Track record	Published index history, in some cases to 2005	Limited or no history before fund inception
Trading costs	Single public print; tends to support tighter spreads	Dealer fees per creation; spreads widen under stress
Tax treatment	Return of capital / capital gains potential	More likely ordinary income
Collateral	~90–95% in custody, daily two-way margin, one standard	Negotiated per counterparty; varies by position
Scale	Inflows add notional to an existing swap	Requires sourcing each new position from dealers

What matters most

What it costs to trade under stress. An index structure absorbs the counterparty's hedging cost once at the index level. In an individual swap structure, a market maker creating or redeeming shares must transact with the banks behind each position, and each charges a fee to hedge it. In calm markets that cost stays contained. Under stress, dealers widen their quotes and market makers widen the fund's spread in turn, raising the cost of trading at the moment investors most want liquidity.

How distributions are taxed. In an index structure, coupons accrue inside the index rather than being distributed from individual instruments, and the swap is designed for capital gains treatment. This has allowed a substantial majority of distributions to be characterized as return of capital, which is not taxed when received but reduces cost basis and may defer tax until shares are sold. Income from separately negotiated positions is more likely to be ordinary income. Characterization is determined annually.

Where each structure fits

The case for individual swaps is flexibility. A manager can tie positions to different underliers, adjust terms individually, spread exposure across dealers, and decline to roll on unfavorable terms. That discretion is a real advantage, and also the source of the costs above: discretion and a single public valuation reference are difficult to have at once.

The case for an index swap is governance. A published methodology, an independent calculation agent, and a long index history give an advisor something to evaluate before committing capital. The trade-off is that the fund follows the methodology as written. Index structures carry their own risks, including calculation error and the leverage a volatility-targeting mechanism may apply when volatility is low.

The worst-of question

Historically, construction has tracked the reference asset: volatility-targeted strategies are built as index swaps, while worst-of strategies, which pay on the weakest performer in a basket, have been built as individual swaps. The reason is technical. A single-index payoff tracks one instrument through one formula, so the methodology can be published in advance and calculated daily. A worst-of payoff depends on the correlation among its underlyings, and no liquid, observable price for that correlation exists; it has to come from a dealer's model. Dealers price that risk conservatively, and the cost reaches the investor as wider spreads or weaker coupon terms.

That engineering problem is now solvable. A ladder worst-of basket can be delivered through an index, pairing the reference exposure with the governance an index structure already provides: independent daily calculation, a third-party pricing agent, standardized terms, and the ability to scale through the same index. The correlation assumption still originates with a dealer, but it is applied under published rules and reflected in one daily index level every participant can see. Investors no longer have to choose between the exposure they want and the transparency and scale of an indexed structure.

Questions worth asking

The diligence questions are the same either way. The answers are not.

- 1 Can I see historical performance and coupon data, how far back, and what share of scheduled coupons was paid?
- 2 Who prices and values the underlying positions each day?
- 3 How are distributions taxed, and what has the actual characterization been?
- 4 Is the strategy linked to a single index, a worst-of basket, or single stocks?
- 5 How is the ladder diversified across time, and how many positions does it hold?

Two products can carry the same label and take materially different risks to deliver it. The construction method is where that difference lives.

Investing involves risk, including possible loss of principal. There is no guarantee a fund will achieve its objective.

Swap, counterparty, and valuation risk. A fund may use total return swaps, which are derivatives and may increase volatility and losses. A counterparty may fail to perform, and collateral may be insufficient or delayed. Swaps may be valued using counterparty marks or models rather than observable prices.

Index risk. Performance depends on a fixed methodology that is followed as written, and on third-party calculation. Volatility targeting may apply leverage. Index results before fund inception are hypothetical, backtested, and not indicative of future results.

Autocallable and worst-of risk. Coupons are paid only if reference assets meet specified conditions and are not guaranteed. If an asset falls below a barrier, a fund may lose some or all of its exposure to that position. Early calls end future coupons, and upside is generally limited to coupons paid. Worst-of exposure is based on the weakest performer in a basket and depends on correlation assumptions that are not directly observable and are derived from dealer models.

Distribution and tax risk. Distributions are not guaranteed. Tax characterization is determined annually, and there is no assurance any portion will be return of capital or capital gain. Return of capital reduces cost basis and may increase taxes when shares are sold. Calamos does not provide tax advice. Consult your tax professional.

Calamos Financial Services LLC, Distributor
2020 Calamos Court | Naperville, IL 60563-2787
866.363.9219 | www.calamos.com | caminfo@calamos.com
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