Global X Derivative Strategy Classification System – Methodology

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Introduction

Global X constructed the derivative strategy classification system to provide a consistent framework for identifying and categorizing exchange traded funds (ETFs) whose core objectives involve the usage of derivatives. Third party financial data provider classification systems that offer their own proprietary categories tend to take a broader approach toward identifying & conveying derivative-based strategies. This classification system is meant to serve as a tool for investors so they may better understand the derivative-based strategies in which they are investing. The derivative strategy classification system relies on Global X's expertise, views, and opinions on investing in derivatives and the ETF industry.

Defining a Derivative-Based Strategy

Global X defines a derivative-based ETF as a strategy that utilizes derivatives such as options, swaps, futures, swaptions, or forward contracts as a core component of their investment objectives. These objectives include risk management, income generation, or capital appreciation enhancement. It should be noted that derivative usage is not limited to just equity-based products. It can also encompass fixed income, commodities, and currency-based derivatives, as well.

Most derivative-based strategies have the potential to provide investors with uncorrelated exposures to traditional asset classes and can be utilized both tactically and strategically within an investor's portfolio. These investments tend to provide access to unique and explicit outcomes, exposures, and risk/return profiles that cannot be achieved by investing in a typical 60/40 portfolio.

The process to identify a derivative-based strategy incorporates **three** main principles:

1) The product must utilize derivatives as a core component of its investment strategy. This does not necessarily mean that derivatives must make up the majority of the ETF's portfolio. However, derivatives must serve a key purpose in achieving the investment objective stated in the ETF's prospectus.
2) The derivative-based strategy can be utilized over a long-term period from the standpoint that it is able to be used tactically, for temporary exposure to express a market view, or within a strategic allocation. Strategies whose core objective is to be a daily trading tool will most likely not be considered for inclusion.
3) The strategy must use derivatives as a means to achieve 1 or more of the 3 main use cases of derivatives by either buying or selling short a specific type of derivative:
    a. Risk Management – These are strategies with an objective of achieving higher risk-adjusted returns by lowering overall portfolio volatility with the usage of derivatives.
    b. Income – Strategies that utilize derivatives as a core investment to potentially achieve high income for its investors.
    c. Performance Enhancement - Strategies that use derivatives to enhance the upside potential for capital appreciation, typically increasing the economic leverage used within a portfolio.

Taking the above principles into account, it should be noted that the derivative-based classification system does not consist of leveraged/inverse ETFs whose core objective is to track an index that rebalances daily. This goes against the 2nd principle stated above regarding the strategy being a long-term investment.

In addition, strategies that use derivatives only to obtain indirect exposure to another security will not be considered like certain commodities futures ETFs. Lastly, strategies that use derivatives as a "last resort", where their investments in derivatives tend to be minimal, may not be considered since this would be considered a secondary objective to the core strategy.

Classification

Based on the definitions and principles described above, the derivative-based classification system is organized into multiple layers for a more refined understanding as to the objective of each strategy. Note that some options strategies can be utilized for multiple purposes, whether that be for Income, Risk Management, or Performance Enhancement, resulting in some categories appearing more than one time. The system consists of four layers of classification: (1) *Derivative Objective* (2) *Derivative Strategy* (3) *Derivative Overlay* and; (4) *Derivative Tactic*.

Derivative Objective (First Layer) – Representing the broadest layer, this gives an understanding as to the core objective of the fund, utilizing the 3 derivative use cases defined in the Principles section.

(1) Risk Management
(2) Derivative Income
(3) Performance Enhancement

Derivative Strategy (Second Layer) – This layer will provide investors the means by which the investment objective is being pursued. For example, an ETF that utilizes derivatives with a Risk Management objective can be generated using either a Tail Risk Strategy to provide a level of downside protection or a Collar Strategy to provide a range-bound return outcome. Although slightly different, the commonality between these two overlays are the fact that their core purpose is to provide Risk Management.

Derivative Overlay (Third Layer) – This layer describes the specific derivatives being used and the manner in which they are being used (Long or Short, Bull or Bear). For example, a Tail Risk overlay can obtain a level of downside protection using many kinds of derivatives. Some overlays include either "going-long" with put options via a Protective Put or harnessing VIX Futures as an overlay on an existing stock portfolio.

Derivative Tactic (Fourth Layer) – The final layer helps to communicate to investors any unique considerations regarding the options overlay being used. For example, a strategy offering synthetic exposure may be access vehicles to a type of option or options strategy that is meant to offer investors the ability to implement their own hedges within a portfolio allocation. Another example is a Defined-Outcome ETF, which utilizes put spread collars to offer a specific level of downside protection with capped upside potential if held over the course of the stated "outcome-period", making each iteration different from one another.

As of 06/30/2024, the classification system has 3 Derivative Objectives, 13 Derivative Strategies, 24 Derivative Overlays, and 3 Derivative Tactics. Over time, the number of Objectives, Strategies, Overlays, and Tactics are expected to change as new derivative-based strategies come to market. These updates will be made by the Global X Derivative Strategy Classification Committee ("the committee") and take into account official fund prospectus filings as well as fund company materials.

Derivative Classification System, as of 06/30/2024

Derivative Objective (Layer 1)	Derivative Strategy (Layer 2)	Derivative Overlay (Layer 3)	Derivative Tactic (Layer 4)
Derivative Income	BuyWrite	Covered Call	
		Covered Call & Growth	
	PutWrite	Barrier Options	
	Futures-Based Income	Index Dividend Futures	
		VIX Futures Premium	
	Risk Managed Income	Net-Credit Collar	
	Spread Strategy	Bear Call Spread	
		Bull Put Spread	
Performance Enhancement	Economic Leverage	Long Call Options	
		Futures	
		Total Return Swap	
	Spread Strategy	Bull Call Spread	>100% Notional Coverage
		Bull Put Spread	
Risk Management	Collar Strategy	Put Spread Collar	Defined-Outcome
		Protective Collar	Defined-Outcome
	Credit Hedge	OTC Credit Derivatives	
	Inflation Hedge	Inflation Swaps	
		Yield Curve Options	
	Interest Rate Hedge	Interest Rate Swaps	
		Swaptions	Synthetic Exposure
	Spread Strategy	Bull Call Spread	
	Tail Risk	Fixed Income + Synthetic Equity	
		Long Put Options	
		Protective Put	
		Protective Put Spread	
		VIX Hedge	
	PutWrite		

The ETF industry is continually innovating to provide unique derivative exposures to investors. The Global X Derivative Strategy Classification Committee evaluates these innovations by first investigating if a fund aligns with the core three principles of what it believes a derivative strategy to be. Then, once a fund is deemed a "Derivative Strategy", the committee identifies what the core objective is, how this objective is being achieved, and what types of derivative positions are being utilized within the strategy by reviewing prospectuses, index methodologies (if applicable), stated objectives by the fund company, as well as underlying holdings. Once per quarter, the committee will review all new U.S.-Listed ETF launches to determine if the fund should be added and how it should be classified. In addition, the committee will also review any strategy changes that have occurred amongst existing ETFs within the Classification System that might merit reporting in the next quaterly Derivative Strategy ETF Report.

While an ETF may engage in multiple objectives or strategies utilizing derivatives, the committee will determine the classification based on the true nature of the ETF.

While an ETF may be classified within a certain objective, strategy, overlay, or tactic, Global X does not give any assurances that the ETF provides good and accurate exposure to the specific exposure it is targeting. For example, an ETF may convey or market itself in a specific manner but still utilize a specific derivative trading strategy that has its own nomenclature.

Maintenance

The derivative classification system is reviewed monthly by the Global X Derivative Strategy Classification Committee to consider new changes and/or additions to the layers (categories) stated above. In addition, the committee will also seek to add newly launched, U.S.-listed ETFs that fit the 3 main principles of a derivative-based strategy.

In the event that an ETF changes its investment objective to another one that goes against the 3 principles of a derivative-based strategy, the strategy will be removed from the classification system and its historical assets under management data will be maintained within the quarterly report. On the other hand, if an ETF changes its investment objective to something that fits within the parameters of the 3 principles, it will be considered for inclusion in the classification system where its AUM will start to be reflected in the report.

Global X accepts requests for reviews or appeals for any ETFs. Please contact Global X at research@globalxetfs.com, and the appeal will be considered in a timely manner. There are no guarantees that an appeal will result in a change in the ETF's classification.

Global X Derivative-Based Strategy Classification Committee

The Derivative-based ETF Report, including the classification system, falls under the supervision of the Global X Derivative-Based Strategy Classification Committee. The Committee consists of members from Global X's research and product teams who have extensive knowledge of the strategies themselves and the ETF industry. The goal of the committee is to properly identify and classify ETFs that fit the 3 principles. The Committee meets at least monthly to review the classification system, as well as on an ad-hoc basis to review new ETF launches or ETFs that change their strategy.

For more information on Global X, please contact research@globalxetfs.com