Diversifying Alpha with Strategy ETFs

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Summary of 2016 ETF Flows and Trends[1]

- Total US-listed ETF Assets stood at $2.6 trillion at the end of 2016, a 19.6% increase from the end of 2015. Total estimated net flows for the year were a record $287 billion, outpacing flows in 2015 by $42 billion.
- Total Assets increased by more than 25% in four ETF categories, including Commodities ETFs (+31.7%), Municipal Bond ETFs (+29.7%), US Equity ETFs (+26.5%), and Taxable Bond ETFs (+25.9%).
- US Equity ETFs and Taxable Bond ETFs dominated estimated net asset flows in 2016, bringing in $140 billion and $86 billion, respectively. No ETF category had estimated net outflows in 2016.

Table 1

US Category Group	Total US-Listed ETF Assets (12/31/16)	Total Assets: Year-over-year % increase	2016 Estimated Net Asset Flows	Q4 2016 Estimated Net Asset Flows	Previous Quarter Estimated Net Asset Flows (Q3 2016)
Allocation	$9,868,464,933	15.1%	$1,013,934,750	$965,690,934	$630,648,946
Alternative	$43,112,630,485	-1.8%	$3,286,855,221	($2,823,777,912)	$2,075,339,223
Commodities	$60,823,149,955	31.7%	$10,411,296,549	($7,351,712,270)	$1,497,278,635
International Equity	$457,130,312,234	3.4%	$10,935,712,662	$15,112,621,448	$4,864,292,395
Municipal Bond	$23,767,700,031	29.7%	$6,330,669,794	$1,338,763,108	$1,782,606,832
Sector Equity	$346,447,954,373	15.8%	$29,715,030,157	$22,101,271,205	$9,290,945,224
Taxable Bond	$422,796,713,212	25.9%	$85,538,592,247	$12,874,401,594	$27,299,337,049
US Equity	$1,191,116,728,617	26.5%	$140,119,390,271	$84,628,383,031	$45,621,978,224
Total	**$2,555,063,653,840**	**19.6%**	**$287,351,481,651**	**$126,845,641,138**	**$93,062,426,528**

Source: Morningstar, as of 12/31/16. Includes all US-listed exchange-traded funds, exchange-traded notes and other exchange-traded products.

A Snapshot of Q4 2016 ETF Flows and Trends

- Estimated net inflows for US listed ETFs totaled $127 billion in Q4 2016, the largest quarter on record.
- The strongest category for estimated net asset flows was US Equity ETFs, with $84.6 billion in estimated net inflows, also setting a new high water mark. Sector Equity ETFs also posted a strong showing with $22.1 billion in estimated net inflows.
- Estimated net inflows into Taxable Bond ETFs totaled $12.8 billion in Q4, marking the weakest quarter in 2016.
- Commodities ETFs and Alternatives ETFs faced estimated net outflows in Q4, totaling $7.4 billion, and $2.8 billion, respectively.

All net inflow and outflow numbers are estimates based on information provided by Morningstar.

Passively Managed Large-cap US Equity ETFs have Outperformed

Over the past decade, many investors have given up on actively managed mutual funds, particularly in asset classes generally considered most "efficient", such as large-cap US stocks. This behavior has coincided with a long stretch of underperformance by actively managed large-cap US equity mutual funds, less than a third of which (31%) outperformed broad S&P benchmark indices during the 10-year period ending on 12/31/16.[2] Interestingly, during the same period, nearly two-thirds (65%) of passively managed large-cap US equity ETFs outperformed broad S&P benchmark indices.[3]

The fact that passively managed ETFs have tended to outperform—not only their actively managed counterparts, but also broad S&P benchmarks—may come as a surprise to some. It is, however, important to recognize that passively managed index funds track many different indices, guided by distinct strategies that determine portfolio holdings. Many of these strategies are designed to seek outperformance versus broad benchmarks, and apparently, several have been successful in doing so over the past decade.

Complementary Large-cap Strategies

Among the top 10 performing large-cap US equity ETFs over the past 10 years are two First Trust ETFs, which employ distinct—and we believe complementary—strategies: the First Trust Value Line® Dividend Index Fund (FVD) and the First Trust US Equity Opportunities ETF (FPX). On the one hand, FVD is a large-cap value ETF that tracks an index which selects stocks that have been screened for financial strength, low volatility, and an above average dividend yield. On the other hand, FPX is a large-cap growth ETF that tracks an index which selects stocks that have recently gone public, by means of either an initial public offering (IPO) or spin-off. While both ETFs have outperformed the S&P 500 Index over the past decade, they have done so by employing dissimilar strategies, which have tended to underperform in different market environments, making the two ETFs an especially interesting pair.

Past performance is not a guarantee of future results and there is no assurance that the events or improvements mentioned herein will continue.

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Table 2: 10-year Risk and Return Statistics (as of 12/31/16)

	Average Annual Returns	Standard Deviation	Beta	Upside Capture Ratio	Downside Capture Ratio	Alpha
FVD	8.19%	13.29%	0.82	86.50%	75.14%	2.20%
FPX	10.31%	18.55%	1.12	119.96%	109.02%	2.81%
S&P 500 Index	6.95%	15.28%	1.00	100.00%	100.00%	0.00%

Source: Morningstar. Past performance is not a guarantee of future results.

Diversifying Risk

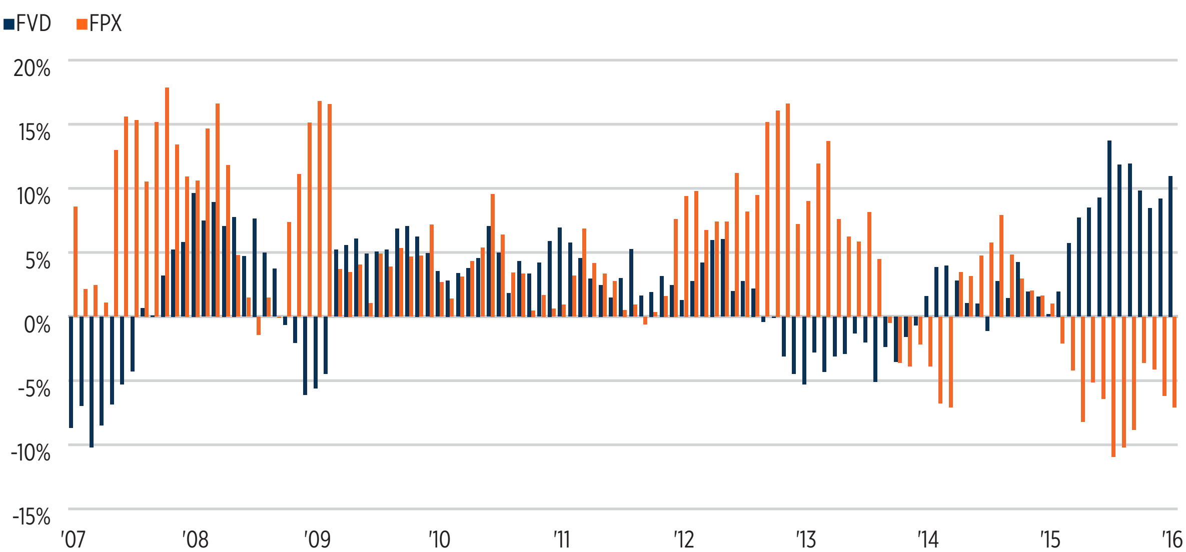
There are several statistics that help illustrate the complementary performance of FVD and FPX over the past decade. For example, consider their respective market risk (or beta) and volatility (or standard deviation). While FPX had a higher beta and more volatile returns than the S&P 500 Index, FVD had a lower beta and less volatile returns than the S&P 500 Index. An investment advisor seeking to allocate a level of risk similar to that of the S&P 500 Index could have done so by blending an allocation between these two ETFs.

Another way to evaluate risk and return is to consider upside and downside capture ratios. The former measures returns relative to a benchmark during months when benchmark returns were positive, while the latter measures returns relative to a benchmark during months when benchmark returns were negative. Here again, we see a complementary pattern of returns as FPX captured nearly 120% of the S&P 500 Index's upside, compared to just 86.5% for FVD; however, FVD greatly outperformed during months in which the S&P 500 Index was negative, capturing just 75.1% of the downside, compared to 109% for FPX.

Diversifying Alpha

As indicated in Table 2 above, both FVD and FPX successfully produced better risk-adjusted returns (or positive alpha) than the S&P 500 Index over the past 10 years. In our opinion, this is particularly interesting when one considers the timing in which positive alpha was captured during rolling 12-month intervals (see Chart 1 below). In several 12-month periods, both ETFs produced positive alpha: FVD did so 73.4% of the time, and FPX did so 79.8% of the time. However, periods in which neither fund generated positive alpha were quite rare, occurring less than 4% of the time. Once again, we believe this bolsters the case for considering FVD and FPX as complementary holdings.

Chart 1: Alpha – Rolling 12-Month Periods (12/31/07 - 12/31/16)[4]



Source: Morningstar. Past performance is not a guarantee of future results.

Minimal Portfolio Overlap

Finally, FVD and FPX have tended to have minimal portfolio overlap, since FVD's underlying index tends to select more seasoned stocks, while FPX's underlying index selects recently issued stocks. As of 12/31/16, the ETFs shared just one common holding. Moreover, the ETFs' underlying sector allocations tend to vary with one another. As of 12/31/16, the ETFs share an overweight or underweight bias relative to the S&P 500 Index in just 3 of 11 Global Industry Classification Standard (GICS) sectors.

While actively managed large-cap US equity mutual funds have struggled to consistently outperform benchmark indices over the past decade, a surprisingly high percentage of passively managed large-cap US equity index ETFs have been successful in doing so. However, even the most successful of these ETFs have faced multiple periods of short-term underperformance. For this reason, we believe that identifying complementary ETFs, which have provided both long-term outperformance, while also tending to underperform in different market environments—such as FVD and FPX—can be very useful for investors seeking to generate more consistent alpha.

You should consider a fund's investment objectives, risks, and charges and expenses carefully before investing. Contact First Trust Portfolios L.P. at 1-800-621-1675 or visit www.ftportfolios.com to obtain a prospectus or summary prospectus which contains this and other information about a fund. The prospectus or summary prospectus should be read carefully before investing.

[1]Based on Morningstar data, as of 12/31/16. Includes all exchange-traded funds, exchange-traded notes, and other exchange-traded products.

[2]Including actively-managed open-end funds classified by Morningstar as Large-Cap Blend, Large-Cap Growth, or Large-Cap Value, with inception dates before 12/31/06. 26.5% (66/249) of US Large Cap Blend funds outperformed S&P 500 Index, 17.0% (52/306) of US Large-cap Growth funds outperformed S&P 500 Growth Index, and 54.9% (128/233) of US Large Cap Value funds compared to S&P 500 Value Index. This data does not include 664 mutual funds that either were liquidated or were merged into other funds during this period. If one were to assume that all 664 funds would have underperformed over the past 10 years (an unrealistic assumption in our opinion), the percentage of outperforming mutual funds would drop to just 17% (246/1452). According to Morningstar data.

[3]Including passively-managed ETFs classified by Morningstar as Large-Cap Blend, Large-Cap Growth, or Large-Cap Value, with inception dates before 12/31/06. 62% (13/21) of US Large Cap Blend ETFs outperformed S&P 500 Index, 50% (6/12) of US Large-cap Growth ETFs outperformed S&P 500 Growth Index, and 76% (16/21) of US Large Cap Value ETFs compared to S&P 500 Value Index. This data does not include 9 ETFs that either were liquidated or were merged into other funds during this period. If one were to assume that all 9 ETFs would have underperformed over the past 10 years (an unrealistic assumption, in our opinion), the percentage of outperforming ETFs would drop to 56%. According to Morningstar data.

[4]Alpha calculated in rolling 12-month periods, stepped forward 1-month, from 12/31/07-12/31/16.

Diversification does not guarantee a profit or protect against loss.

Past performance is not a guarantee of future results and there is no assurance that the events or improvements mentioned herein will continue.

ETF Characteristics

The funds list and principally trade their shares on the NYSE Arca, Inc.

An index fund's return may not match the return of the applicable index. Securities held by an index fund will generally not be bought or sold in response to market fluctuations.

Investors buying or selling fund shares on the secondary market may incur customary brokerage commissions. Market prices may differ to some degree from the net asset value of the shares. Investors who sell fund shares may receive less than the share's net asset value. Shares may be sold throughout the day on the exchange through any brokerage account. However, unlike mutual funds, shares may only be redeemed directly from a fund by authorized participants, in very large creation/redemption units. If a fund's authorized participants are unable to proceed with creation/redemption orders and no other authorized participant is able to step forward to create or redeem, fund shares may trade at a discount to the fund's net asset value and possibly face delisting.

Risk Considerations

A fund's shares will change in value, and you could lose money by investing in a fund. One of the principal risks of investing in a fund is market risk. Market risk is the risk that a particular stock owned by a fund, fund shares or stocks in general may fall in value. There can be no assurance that a fund's investment objective will be achieved.

A fund may invest in securities issued by companies concentrated in a particular industry. A fund may invest in small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies.

The stocks of companies that have recently conducted an initial public offering are often subject to price volatility and speculative trading. These stocks may have exhibited above-average price appreciation in connection with the initial public offering prior to inclusion in a fund. The price of stocks included in a fund may not continue to appreciate and their performance may not replicate the performance exhibited in the past.

FPX is classified as "non-diversified" and may invest a relatively high percentage of its assets in a limited number of issuers. As a result, the fund may be more susceptible to a single adverse economic or regulatory occurrence affecting one or more of these issuers, experience increased volatility and be highly concentrated in certain issuers.

First Trust Advisors L.P. is the adviser to the funds. First Trust Advisors L.P. is an affiliate of First Trust Portfolios L.P., the funds' distributor.

Performance Summary

As of 12/31/16	Inception Date	Quarter	YTD	1 Year	3 Year	5 Year	10 Year	Since Inception
FVD Performance*	8/19/03							
Net Asset Value (NAV)		4.46	19.94	19.94	12.08	14.66	8.19	9.93
Market Price		4.61	20.07	20.07	12.09	14.68	8.20	9.94
S&P 500 Index**		3.82	11.96	11.96	8.87	14.66	6.95	8.41
FPX Performance*	4/12/06							
Net Asset Value (NAV)		-0.24	6.70	6.70	6.86	18.61	10.31	10.65
Market Price		-0.08	6.86	6.86	6.89	18.65	10.33	10.67
S&P 500 Index**		3.82	11.96	11.96	8.87	14.66	6.95	7.56

Performance data quoted represents past performance. Past performance is not a guarantee of future results and current performance may be higher or lower than performance quoted. Investment returns and principal value will fluctuate and shares when sold or redeemed, may be worth more or less than their original cost. You can obtain performance information which is current through the most recent month-end by visiting www.ftportfolios.com.

On December 15, 2006, FVD acquired the assets and adopted the performance history of the First Trust Value Line® Dividend Fund, a closed-end fund. The investment goals, strategies and policies of FVD are substantially similar to those of the predecessor fund. Performance information for periods prior to December 15, 2006 is based on the performance history of the predecessor fund and reflects the operating expenses of the predecessor fund.

*__NAV__ returns are based on the fund's net asset value which represents the fund's net assets (assets less liabilities) divided by the fund's outstanding shares. **Market Price** returns are based on the midpoint of the bid/ask spread on the stock exchange on which shares of the fund are listed for trading as of the time that the fund's NAV is calculated. Returns are average annualized total returns, except those for periods of less than one year, which are cumulative. The funds' performance reflects fee waivers and expense reimbursements, absent which performance would have been lower. FVD has a gross expense ratio of 0.74% and a net expense ratio of 0.70%. Expenses are capped contractually at 0.70% per year, at least until May 19, 2017. FPX has a gross expense ratio of 0.60% and a net expense ratio of 0.60%. Expenses are capped contractually at 0.60% per year, at least until May 19, 2017.

The **S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Indexes do not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown. Indexes are unmanaged and an investor cannot invest directly in an index.

Standard Deviation is a measure of price variability (risk). **Alpha** is an indication of how much an investment outperforms or underperforms on a risk-adjusted basis relative to its benchmark. **Beta** is a measure of price variability relative to the market. **Sharpe Ratio** is a measure of excess reward per unit of volatility. **Upside and Downside Capture** measure performance relative to an index during periods of market strength and weakness. An upside capture ratio over 100 indicates a fund has generally outperformed the benchmark during periods of positive returns for the benchmark. Meanwhile, a downside capture ratio of less than 100 indicates that a fund has lost less than its benchmark in periods when the benchmark has been negative.