Inside First Trust ETFs

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# Mergers and Acquisitions (M&A)

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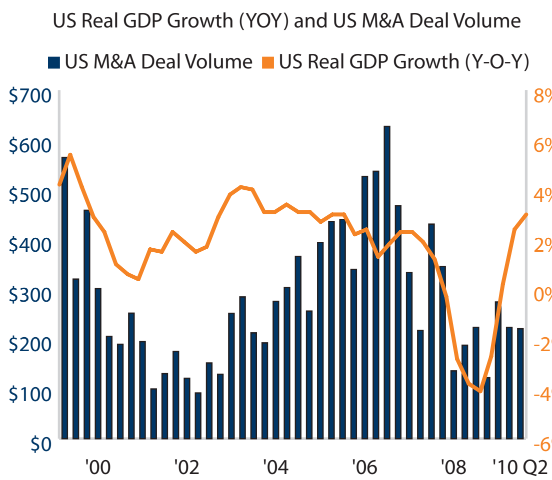
One noteworthy trend that began to develop during the summer of 2010 was an escalation of M&A activity. Although historically the weakest month of the year for such activity, August 2010 marked the most global M&A deal volume in a single month since the collapse of Lehman Brothers in September 2008, with 1813 deals announced worth over $230 billion, according to Bloomberg.

This escalation in M&A activity leads to two important questions for the months ahead. First, is the recent surge in M&A activity evidence of a new trend? And second, what segments of the market should ETF investors consider to potentially benefit from this trend?

**Chart 1**




Source: Bloomberg. Based on announced deals, and includes deals that are pending or have been completed.

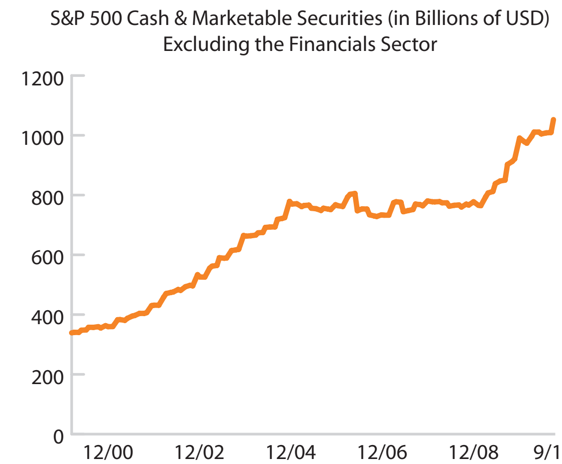
## Are Conditions Ripe for Continued M&A?

Regarding any specific M&A deal there are a number of unique factors that have little relevance to the overall marketplace. These often involve the "devil in the details" that determines whether or not a deal is ultimately successful. However, there is another set of factors which help increase the likelihood and desirability of M&A activity in the marketplace more broadly. For example, one can observe a historical relationship between improving GDP growth and M&A deal volume (Chart 1).

In addition to improving economic conditions, the potent combination of strong, cash-rich balance sheets with cheap borrowing costs for investment grade corporations could lead to further increases in M&A activity in the months ahead. As of 9/30/10, S&P 500 companies (excluding financials) held over $1 trillion in cash and marketable securities, a 33% increase from the $794 billion held just 18 months prior according to Bloomberg (Chart 2). Moreover, the average yield for the FINRA-Bloomberg Active US Investment Grade Corporate Bond Index was 4.31%, as of 9/30/10, compared to an average yield of 5.81% for the previous two years. In short, we believe strong corporations that want to make acquisitions are well positioned to finance those deals.

Another important consideration is whether financially strong companies are in a position to benefit from strategic acquisition. This summer provided several high-profile anecdotes that support that premise, from Sanofi-Aventis' interest in Genzyme as it seeks to replenish its drug pipeline, to the bidding war between Hewlett-Packard and Dell for a little-known company called 3PAR. The common thread running through these examples, along with countless other M&A deals, is the reality that companies chose to stockpile cash in the face of economic uncertainty, rather than investing that same cash to grow their businesses. Now that the economic recovery seems more certain, many of these cash-rich companies are playing "catch-up" through strategic acquisition.

**Chart 2**




Source: Bloomberg.

As prospective buyers survey the landscape, we believe there are scores of inexpensive M&A targets to consider, many of which could benefit from the additional access to capital and operating efficiencies that an acquiring company might have to offer. Conditions seem ripe for further M&A activity in the months ahead.

## Which First Trust ETFs are well-positioned to benefit from increased M&A activity?

**First Trust NYSE Arca Biotechnology Index Fund (FBT)**
One significant factor that may contribute to future M&A interest in the biotech sector is the looming reality of expiring patents for large pharmaceutical companies over the next few years. According to S&P Strategy Research, "the global pharmaceutical industry faces a cumulative loss of more than $100 billion in sales between 2011 and 2013 as generics encroach on a slew of patent-expired branded blockbuster drugs." Strategic acquisitions may provide the means for larger pharmaceutical companies to replenish their drug pipelines.

ETF investors looking to benefit from potential acquisition premiums that could accompany future M&A deals in the biotech industry should avoid ETFs that follow a market-cap weighted methodology, as returns will be biased toward the largest biotech companies, while severely underweighting their small and medium size peers. Conversely, an equal-weighted methodology, as is found in the First Trust NYSE Arca Biotechnology Index Fund, provides investors with more balanced exposure to the industry, including increased weightings in some of the smaller biotech companies that we believe are more likely to be acquisition targets.

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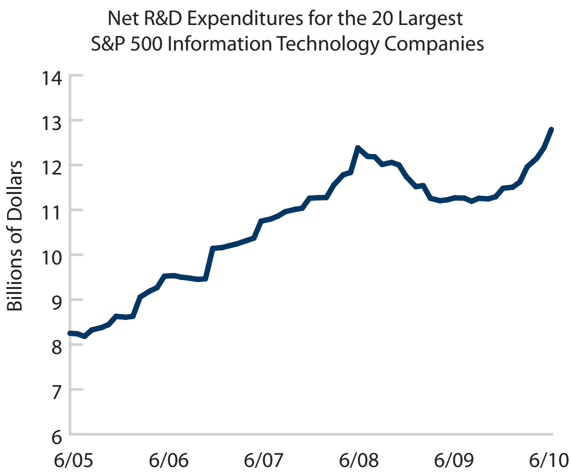
**First Trust Technology AlphaDEX Fund (FXL)**
While stockpiling cash over the past two years, many large-cap technology companies reduced R&D spending, effectively diminishing their capacity for new innovation to drive future growth (Chart 3). By 6/30/10, the 20 largest tech companies in the S&P 500 had nearly a quarter trillion dollars in cash on their balance sheets, a 47% increase from 2 years prior. For many of these companies, strategic acquisitions may provide an efficient way to bridge the gap in innovation, particularly in new business segments they wish to expand.

**Chart 3**




Source: Bloomberg.

ETF investors looking to benefit from further M&A activity in the technology sector may wish to avoid ETFs that follow market-cap weighted technology indexes, as these tend to severely underweight the smaller tech companies that we believe are more likely to be acquired. The First Trust Technology AlphaDEX Fund invests in the index which provides exposure to 85 technology companies from the Russell 1000 that have been screened and weighted using First Trust's proprietary AlphaDEX methodology. This methodology reduces the top-heavy exposure that often characterizes index funds, as weightings in the underlying index are determined by investment merit, rather than size.

**First Trust Dow Jones Select MicroCap Index Fund (FDM)**
ETF investors looking to participate in the M&A theme, while avoiding the sector concentration found in the previous two ideas, may wish to consider the First Trust Dow Jones Select MicroCap Index Fund. In addition to their size, one of the most compelling reasons microcap stocks make attractive M&A targets is the fact that they are still relatively cheap. Unlike small-cap stocks, which have begun to expand their earnings multiples, the average P/E ratio for FDM is 8.6, versus 16.3 for the S&P Small Cap 600 Index (as of 8/31/10). Moreover, the potential improvements in scale, operating efficiencies, and access to capital could provide meaningful benefits to microcap companies, particularly at a time when they are generally more leveraged than in recent years.

## Final Thoughts

One aspect of the recent increase in M&A activity that should not be overlooked is the evidence this trend provides that the market will not ignore value indefinitely. Despite the fact that anxiety may cause investors to avoid stocks in the near-term, the long-term value of a company is ultimately derived from the cash flow and earnings it generates over time. The stunning reality that acquiring companies were willing to pay an average premium of about 40% for U.S. companies in deals announced in August is evidence that corporations appear to be eager to capitalize on a number of great values. Of course, there can be no assurance that any of the companies in any of the ETFs will be acquired, or that any such acquisition will occur at a premium to the stock price.

## RISKS

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.

A fund's return may not match the return of the index. A fund may not be fully invested at all times. Securities held by a fund will generally not be bought or sold in response to market fluctuations and the securities may be issued by companies concentrated in a particular industry or sector. A fund may invest in small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies.

Investors buying or selling fund shares on the secondary market may incur customary brokerage commissions. 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, shares may only be redeemed directly from the fund by authorized participants, in very large creation/redemption units.

You should be aware that an investment in a portfolio which is concentrated in a particular sector involves additional risks, including limited diversification.

FBT is concentrated in stocks of companies in the biotechnology sector. The companies engaged in the biotechnology sector are subject to fierce competition, substantial research and development costs, governmental regulations, pricing constraints, and their products and services may be subject to rapid obsolescence.

FXL is concentrated in stocks of companies in the technology sector. The companies engaged in the technology sector are subject to fierce competition, high research and development costs, and their products and services may be subject to rapid obsolescence.

With the exception of FDM, the funds are classified as "non-diversified." A non-diversified fund generally may invest a larger percentage of its assets in the securities of a smaller number of issuers. As a result, the fund may be more susceptible to the risks associated with these particular companies, or to a single economic, political or regulatory occurrence affecting these companies.

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.

***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.***