Inside First Trust ETFs

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2013 - A Strong Year for ETFs

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Strong ETF Net Inflows for 2013

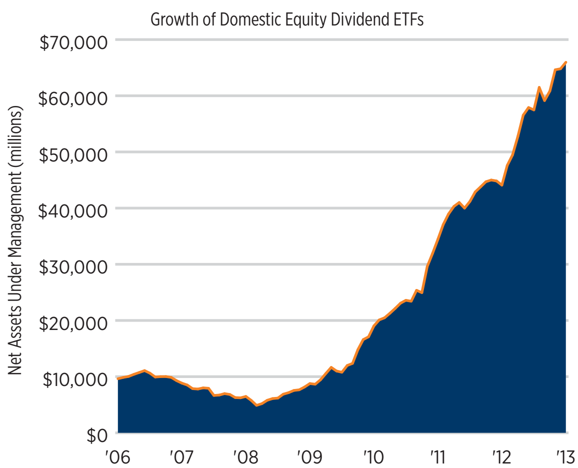
US-listed ETF[1] net inflows totaled $185.5 billion in 2013, setting a new record.[2] While the largest percentage of net inflows remained concentrated among a relatively small group of the 1521 US-listed ETFs, investors broadened their horizons more in 2013 than in previous years, as 312 ETFs had net inflows exceeding $100 million.

2013 was also a record-setting year for First Trust's ETF complex. Net inflows for the 79 First Trust ETFs totaled $8.2 billion in 2013, with 24 ETFs exceeding $100 million in net inflows, increasing ETF assets under management (AUM) at First Trust to $19.7 billion. As of 12/31/13, First Trust was the 9th largest sponsor of US-listed ETFs.

Strong Inflows Continued for Equity Income ETFs

Equity income remained a prominent theme for ETF net inflows in 2013, continuing a trend that began in March of 2009. From 3/31/09 to 12/31/13, assets in domestic equity income ETFs grew from $5 billion to over $65 billion.

Chart 1



Data from Bloomberg.
Includes US-listed Dividend Focused ETFs with >$100 million AUM, as of 12/31/13.

Generally speaking, investors in these ETFs were rewarded with solid returns during that stretch. However, looking ahead many equity income ETFs with overweight allocations to non-cyclical sectors may face headwinds in 2014, in our opinion, especially if mid- and long-term interest rates continue to trend higher. Investors with a preference for dividend-paying stocks, but concerns about rising interest rates, may consider reallocating assets from ETFs focused on high dividend yielding stocks to ETFs focused on dividend growth stocks.

Although equity income ETFs apply a variety of different strategies for constructing their respective portfolios, one common characteristic currently shared by many of these funds is a sector allocation that tends to overweight relatively high dividend yielding sectors with below average dividend growth (such as the utilities and consumer staples sectors), and underweight sectors with lower dividend yields but greater opportunity for dividend growth potential (such as the technology and financial sectors). As we discussed in last July's edition of "Inside First Trust ETFs," we believe that stocks with growing dividends may perform better than those lacking dividend growth during periods of rising interest rates. Indeed, this was the case in 2013, as the 10 year US Treasury yield increased by 137 basis points from 5/2/13-9/5/13. During that period, returns for the S&P 500 Utilities and Consumer Staples Sectors, were -9.4% and -2.8%, respectively, while returns for the S&P 500 Information Technology and Financial Sectors were +5.2% and +6.7%, respectively.

If interest rates continue trending higher in 2014 (First Trust economists forecast a 3.65% 10-year US Treasury yield by year-end), it may be prudent to consider repositioning equity income ETF assets to seek dividend growth. One ETF that may be considered by investors looking to increase exposure to dividend-paying technology companies is the First Trust NASDAQ Technology Dividend Index Fund (TDIV). For those seeking increased exposure to the financial sector, the First Trust NASDAQ® ABA Community Bank Index Fund (QABA) invests in a portfolio of community banks. We believe this segment of the financial sector is particularly well-positioned to benefit if the yield curve steepens in 2014. Finally, investors looking for a more diversified portfolio of stocks that have consistently increased dividends in the past, and may be well positioned to increase dividends in the future, may consider the First Trust NASDAQ Rising Dividend Achievers ETF (RDVY).

AlphaDEX and "Smart Beta"

In our opinion, one of the most interesting developments in the ETF industry in 2013 was the growing acceptance of ETFs tracking alternative strategies for selecting and weighting stocks, often labelled as "smart beta" strategies by ETF industry pundits. Of course, not all smart beta strategies are equally smart, and many investors may decide to wait for some of the newcomers to develop longer-term track records before considering them.

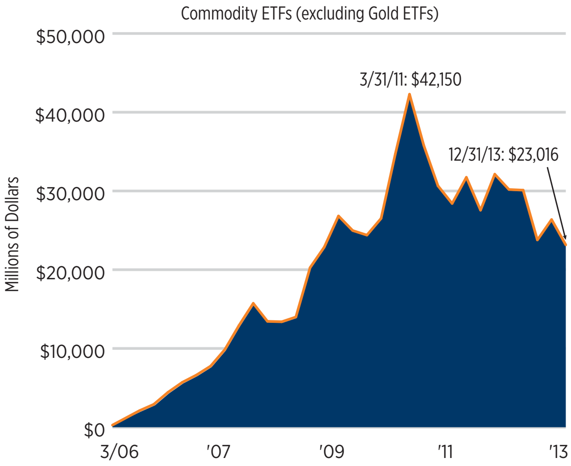
Among the First Trust ETF complex, however, the "smart beta" concept is not a new development. In May of 2007, the firm introduced the first 16 AlphaDEX ETFs, which were designed to seek better risk-adjusted returns than traditional index ETFs, by applying a consistent rules-based process for selecting and weighting stocks. From this group, 11 ETFs have received a 4 or 5 star rating from Morningstar (as of 12/31/13). (See Table 1 on Page 2). In 2011 and 2012, an additional 23 AlphaDEX ETFs were launched, expanding the AlphaDEX lineup beyond its initial focus on domestic stocks, to cover a variety of international markets, including a number of individual countries and regions around the globe.

Quietly, assets in the 39 AlphaDEX ETFs increased from $4.2 billion at the end of 2012 to $10.6 billion at the end of 2013.

Are Commodities Due for a Rebound?

Assets in commodity ETFs declined in 2013, the first calendar year since the introduction of the first gold ETF in 2004, with net outflows totaling $30.1 billion. The majority of these outflows came from gold ETFs, which collectively accounted for over $28 billion in net outflows. However, excluding gold ETFs, assets in other commodity ETFs have actually been trending lower since asset levels peaked in March of 2011 (See Chart 2).

Chart 2



Source: Index Universe and Bloomberg.
Includes Commodity ETPs with >$100 million, excluding leveraged and inverse ETPs.

Interestingly, 2013 marked the first instance since the inception of the DJ-UBS Commodity Total Return Index (on 12/31/1990) in which index returns were negative for three consecutive calendar years (2011-2013). In fact, the only other instance in which index returns were negative for two consecutive calendar years was 1997-1998. Following that stretch, index returns rebounded sharply in 1999 (+24.3%) and 2000 (+31.8%). While past recoveries in commodity prices do not imply a similar recovery this year, we believe commodities may be due for a rebound in 2014, particularly if US economic growth accelerates (First Trust economists forecast 3.0% real GDP growth for 2014), and the nascent European economic recovery continues to gain stronger footing.

ETF investors seeking to increase exposure to commodities may consider the First Trust Global Tactical Commodity Strategy Fund (FTGC). We believe this actively-managed ETF offers several distinct benefits versus other broad-based commodity index ETFs. First, unlike many commodity ETFs that issue schedule K-1s each year, FTGC offers tax reporting on a single form 1099. Second, while the volatility of commodity index ETFs has often been highly variable and unpredictable in the past, FTGC is actively-managed to seek a more stable level of risk. And lastly, FTGC has the flexibility to actively select futures contracts in order to potentially enhance roll yield[3] and total return, unlike many other futures-based commodity ETFs which follow strict rules for rolling futures contracts.

Looking back at 2013—a year during which the ETF industry celebrated its 20th anniversary—it's striking how much ETFs have evolved. Gone are the days that investors can safely assume that a given ETF tracks a traditional market-cap weighted benchmark index. Today, ETFs invest in a variety of asset classes, utilizing an assortment of strategies, involving both passive and active management. Understanding the most important differences between various ETFs now requires more work than in previous years. However, the reward for portfolio managers and financial advisors that are willing to spend more time to evaluate their options is a whole new set of tools with which to build better client portfolios.

Table 1 **Overall Morningstar Rating™ as of 12/31/2013§**

★★★★★

First Trust Consumer Staples AlphaDEX® Fund (FXG)
Among 24 funds in the Consumer Defensive category. This fund was rated 4 stars/24 funds (3 years), 5 stars/21 funds (5 years).

First Trust Large Cap Value AlphaDEX® Fund (FTA)
Among 1056 funds in the Large Value category. This fund was rated 4 stars/1056 funds (3 years), 5 stars/947 funds (5 years).

First Trust Mid Cap Core AlphaDEX® Fund (FNX)
Among 345 funds in the Mid-Cap Blend category. This fund was rated 4 stars/345 funds (3 years), 5 stars/298 funds (5 years).

First Trust Multi Cap Value AlphaDEX® Fund (FAB)
Among 364 funds in the Mid-Cap Value category. This fund was rated 4 stars/364 funds (3 years), 5 stars/306 funds (5 years).

★★★★

First Trust Energy AlphaDEX® Fund (FXN)
Among 98 funds in the Equity Energy category. This fund was rated 3 stars/98 funds (3 years), 4 stars/75 funds (5 years).

First Trust Financials AlphaDEX® Fund (FXO)
Among 86 funds in the Financial category. This fund was rated 4 stars/86 funds (3 years), 4 stars/82 funds (5 years).

First Trust Health Care AlphaDEX® Fund (FXH)
Among 122 funds in the Health category. This fund was rated 3 stars/122 funds (3 years), 5 stars/110 funds (5 years).

First Trust Industrials/Producer Durables AlphaDEX® Fund (FXR)
Among 29 funds in the Industrials category. This fund was rated 3 stars/29 funds (3 years), 4 stars/26 funds (5 years).

First Trust Large Cap Core AlphaDEX® Fund (FEX)
Among 1355 funds in the Large Blend category. This fund was rated 3 stars/1355 funds (3 years), 5 stars/1215 funds (5 years).

First Trust Materials AlphaDEX® Fund (FXZ)
Among 127 funds in the Natural Resources category. This fund was rated 4 stars/127 funds (3 years), 4 stars/103 funds (5 years).

First Trust Small Cap Core AlphaDEX® Fund (FYX)
Among 609 funds in the Small Blend category. This fund was rated 4 stars/609 funds (3 years), 4 stars/551 funds (5 years).

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 ftportfolios.com.

[1]For the sake of clarity, this newsletter uses the term "ETF" to refer to all exchange-traded products (1940 Act exchange-traded funds, exchange-traded notes, commodity exchange-traded securities, etc.).

[2]All net flows data was acquired from Bloomberg.

[3]Because futures contracts expire, an investor utilizing futures contracts to maintain exposure to a given commodity must periodically "roll" these contracts by closing out positions approaching expiration and reestablishing positions in later dated contracts. The profit or loss attributable to this process is known as "roll yield." Roll yield is negative when an investor rolls the proceeds from contracts nearing expiration into more expensive, later-dated futures contracts; Roll yield is positive when an investor rolls the proceeds from contracts nearing expiration into cheaper, later-dated futures contracts.

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

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.

ETF Characteristics

The funds list and principally trade their shares on The NASDAQ Stock Market LLC.

QABA's return may not match the return of the NASDAQ OMX® ABA Community Bank Index℠. TDIV's return may not match the return of the NASDAQ Technology Dividend Index℠. RDVY's return may not match the return of the NASDAQ US Rising Dividend Achievers Index℠. The funds may not be fully invested at times. 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 the fund by authorized participants, in very large creation/redemption units.

Risk Considerations

The funds' shares will change in value and you could lose money by investing in the funds. The funds are subject to market risk.

QABA, TDIV and RDVY may invest in small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies.

TDIV is concentrated in stocks of companies in the technology sector. You should be aware that an investment in a portfolio which is concentrated in a particular sector involves additional risks, including limited diversification. 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.

TDIV also invests in companies in the telecommunications sector. The companies engaged in the telecommunications sector are subject to fierce competition, government regulations, substantial research and development costs, and their products and services may be subject to rapid obsolescence.

An investment in a fund containing equity securities of foreign issuers is subject to additional risks, including currency fluctuations, political risks, withholding, the lack of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be heightened for securities of companies located in, or with significant operations in, emerging market countries.

TDIV invests in securities of non-U.S. issuers. Such securities are subject to higher volatility than securities of domestic issuers. Because the fund's NAV is determined on the basis of U.S. dollars and the fund invests in foreign securities, you may lose money if the local currency of a foreign market depreciates against the U.S. dollar. Additionally, the fund invests in depositary receipts, usually in the form of ADRs or GDRs. Investment in ADRs or GDRs may be less liquid than the underlying shares in their primary trading market.

QABA is concentrated in the securities of NASDAQ® listed community banks as defined by the index which involves additional risks, including limited diversification. These companies are subject to certain risks, including the adverse effects of volatile interest rates, economic recession, increased competition from new entrants in the field, and potential increased regulation. The financial performance of these companies may also be highly dependent upon the business environment in certain geographic regions of the U.S. and may be adversely impacted by any downturn or unfavorable economic or employment developments in their local markets and the U.S. as a whole. These companies may also be subject to interest rate risks and changes in monetary policy as their earnings are largely dependent upon their net interest income and lending risks that could further increase because of increases in interest rates and/or economic weakness.

The trading prices of commodities futures, fixed income securities and other instruments fluctuate in response to a variety of factors. FTGC's net asset value and market price may fluctuate significantly in response to these factors. As a result, an investor could lose money over short or long periods of time. In addition, the net asset value of the fund over short-term periods may be more volatile than other investment options because of the fund's significant use of financial instruments that have a leveraging effect. There is no guarantee that any leveraging strategy the fund employs will be successful.

The value of commodities and commodity-linked instruments typically is based upon the price movements of a physical commodity or an economic variable linked to such price movements. The prices of commodities and commodities-linked instruments may fluctuate quickly and dramatically and may not correlate to price movements in other asset classes. An active trading market may not exist for certain commodities. Each of these factors and events could have a significant negative impact on FTGC. All futures and futures-related products are highly volatile. Price movements are influenced by a variety of factors. The value of commodities, commodity-linked instruments, futures and futures-related products may be affected by changes in overall economic conditions, changes in interest rates, or factors affecting a particular commodity or industry, such as production, supply, demand, drought, floods, weather, political, economic and regulatory developments.

FTGC will not invest directly in futures instruments. Rather, it will invest in a wholly-owned subsidiary, which will have the same investment objective as the fund, but unlike the fund, it may invest without limitation in futures instruments. The subsidiary is not registered under the 1940 Act and is not subject to all the investor protections of the 1940 Act. Thus, the fund, as an investor in the subsidiary, will not have all the protections offered to investors in registered investment companies.

FTGC's strategy may frequently involve buying and selling portfolio securities to rebalance the fund's exposure to various market sectors. Higher portfolio turnover may result in the fund paying higher levels of transaction costs and generating greater tax liabilities for shareholders.

FTGC is subject to management risk because it is an actively managed portfolio. The advisor will apply investment techniques and risk analyses that may not have the desired result.

FTGC currently intends to effect most creations and redemptions, in whole or in part for cash, rather than in-kind securities. As a result, the fund may be less tax-efficient than if it were to sell and redeem its shares principally in-kind.

FTGC, through the subsidiary, will engage in trading on commodity markets outside the United States. Trading on such markets is not regulated by any United States government agency and may involve certain risks not applicable to trading on United States exchanges. The fund holds investments that are denominated in non-U.S. currencies, or in securities that provide exposure to such currencies, currency exchange rates or interest rates denominated in such currencies. Changes in currency exchange rates and the relative value of non-U.S. currencies may affect the value of the fund's investments and the value of the fund's shares. Commodity futures contracts traded on non-U.S. exchanges or with non-U.S. counterparties present risks because they may not be subject to the same degree of regulation as their U.S. counterparts.

FTGC may be subject to the forces of the "whipsaw" markets (as opposed to choppy or stable markets), in which significant price movements develop but then repeatedly reverse, which could cause substantial losses to the fund.

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 funds 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., the investment adviser of FTGC, is registered as a commodity pool operator and commodity trading advisor and is also a member of the National Futures Association.

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.

This material is not intended to be relied upon as investment advice or recommendations.

Quarter End Performance (as of 12/31/2013)				NAV Total Returns (%)			Market Price Total Returns (%)		
	Fund Inception	Net Expense Ratio	Gross Expense Ratio^	1 Year	5 Years	Since Inception	1 Year	5 Years	Since Inception
TDIV	8/13/12	N/A	0.50%	28.47	N/A	17.90	28.56	N/A	18.02
QABA	6/29/09	0.60%	0.89%	32.49	N/A	14.22	33.53	N/A	14.39
RDVY	1/6/14	N/A	0.50%	N/A	N/A	N/A	N/A	N/A	N/A
FTGC	10/22/13	N/A	0.95%	N/A	N/A	-2.43	N/A	N/A	-2.37
FXG	5/8/07	0.70%	0.71%	45.46	19.55	10.18	45.47	19.47	10.18
FXN	5/8/07	0.70%	0.74%	29.62	14.16	3.87	29.77	13.96	3.86
FXO	5/8/07	0.70%	0.72%	36.12	17.95	2.20	35.77	17.83	2.17
FXH	5/8/07	0.70%	0.71%	41.97	25.15	13.27	41.91	25.11	13.27
FXR	5/8/07	0.70%	0.74%	43.08	19.77	5.17	42.98	19.76	5.17
FXZ	5/8/07	0.70%	0.73%	29.10	22.04	8.22	29.34	22.22	8.23
FEX	5/8/07	0.66%	0.66%	33.48	18.23	5.41	33.64	18.23	5.42
FTA	5/8/07	0.67%	0.67%	33.14	19.10	5.71	33.25	18.98	5.72
FNX	5/8/07	0.66%	0.66%	35.72	21.31	8.14	35.82	21.33	8.15
FYX	5/8/07	0.70%	0.70%	40.28	19.76	7.07	40.65	19.82	7.08
FAB	5/8/07	0.70%	0.76%	36.61	20.79	6.90	36.91	20.74	6.93

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^Expenses are capped contractually at 0.60% per year, at least until April 30, 2014 for QABA; capped contractually at 0.70% per year, at least until November 30, 2014 for FXG, FXN, FXO, FXH, FXR, FXZ, FEX, FTA, FNX, FYX, and FAB.

The expense ratio for TDIV, RDVY and FTGC are expressed as a unitary fee.

NAV total returns are based on the fund's net asset value (NAV). NAV represents the fund's net assets (assets less liabilities) divided by the fund's common shares outstanding. Fund shares are purchased and sold on an exchange at their share price rather than NAV. **Market Price** returns are based on the midpoint of the bid/ask spread. Returns are average annualized total returns, except those for periods of less than one year, which are cumulative. The fund's performance reflects fee waivers and expense reimbursements, absent which performance would have been lower.

§The Morningstar Rating™ is provided for exchange-traded funds ("ETFs") with at least a three-year history. Ratings are based on the ETF's Morningstar Risk-Adjusted Return measure which accounts for variation in monthly performance, placing more emphasis on downward variations and rewarding consistent performance. An ETF's risk-adjusted return includes a brokerage commission estimate. PLEASE NOTE, this estimate is subject to change and the actual brokerage commission an investor pays may be higher or lower than this estimate. Morningstar compares each ETF's risk-adjusted return to the open-end mutual fund rating breakpoints for that category. Consistent with the open-end mutual fund ratings, the top 10% of ETFs in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. The overall rating for an ETF is based on a weighted average of the ETF's 3, 5, and 10 year rating. The determination of an ETF's rating does not affect the retail open end mutual fund data published by Morningstar. Past performance is no guarantee of future results. The Morningstar Rating™ information contained herein: (1) is proprietary to Morningstar; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

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