The Return of Volatility and the Case for Earnings Quality

Author:

Ryan O. Issakainen, CFA
Senior Vice President
Exchange Traded Fund Strategist
First Trust Advisors L.P.

A Snapshot of Q3 Flows and Trends

Despite healthy net inflows totaling $44.8 billion in Q3, in line with $45 billion of net inflows in Q2, US-listed exchange-traded fund (ETF) assets declined by $132 billion for the quarter, to $1.99 trillion.[1] This quarter-over-quarter decline—the first since Q2 of 2013—was caused primarily by a correction in global equities. Nonetheless, domestic equity was the strongest category for the quarter, bringing in $22.8 billion in net inflows, marking the first quarter of positive net flows for the category in 2015. The taxable bond category followed close behind with roughly $22 billion in net inflows, compared to less than $1 billion of net inflows for the previous quarter. The alternative category also had a significant increase in net inflows at $4 billion, the majority of which came from leveraged long and inverse ETFs. The largest reversal in Q3 came from the international equity category, which suffered $1.3 billion in net outflows, after leading all categories for net inflows for the previous quarter with $46.5 billion. Sector equity ETFs also reversed course, with $2.6 billion in net outflows, compared to $2.4 billion of net inflows for the previous quarter.

Table 1[1]

US Category Group	Estimated Net Asset Flows Previous Quarter (Q2 2015)	Estimated Net Asset Flows Q3 2015
Allocation	$720,410,018	($133,597,486)
Alternative	$881,655,569	$4,024,043,604
Commodities	($1,692,716,753)	($561,415,379)
International Equity	$46,571,361,300	($1,300,647,998)
Municipal Bond	$709,268,198	$675,414,564
Sector Equity	$2,350,903,132	($2,670,979,071)
Taxable Bond	$944,052,284	$21,965,566,286
US Equity	($5,481,821,507)	$22,810,356,549

ETF Tax-Efficiency Highlighted

The relative tax-efficiency of ETFs compared to traditional open-end mutual funds is one benefit that is often overlooked, in our opinion. On an annual basis, both traditional mutual funds and ETFs are required to distribute net realized capital gains to shareholders. If a fund is held in a taxable account, shareholders must pay taxes on all such distributions. In 2014, 78% of traditional US equity open-end mutual funds made capital gains distributions, while only 8% of US equity ETFs did so. Even among index funds, ETFs were significantly more tax-efficient with 6% of funds making capital gains distributions compared to 65% of traditional US equity open-end index funds.[2]

Chart 1
Total US Equity Open-End Funds

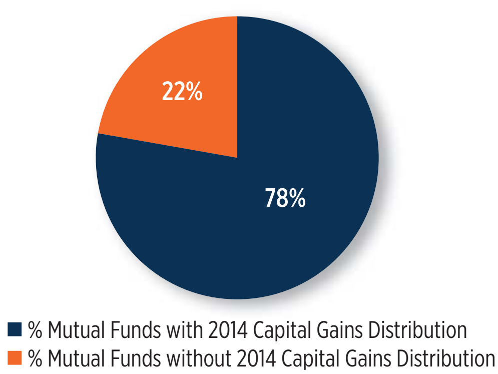
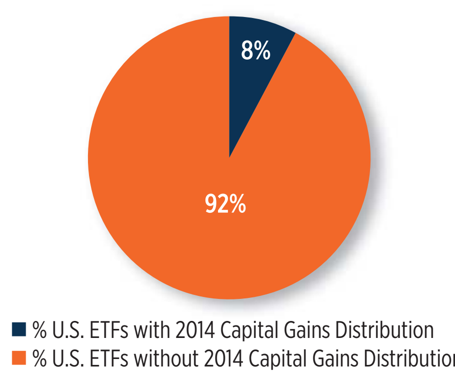


Chart 2
Total US Equity ETFs



The Importance of Earnings Quality and the Case for FTLS

During the past four years of the current bull market, which commenced on 3/9/09, both earnings growth and increasing valuations have been important drivers of US stock market performance. From 9/30/2011 through 9/30/2015, trailing 12-month earnings for the S&P 500 Index grew at a 6% rate, while the trailing P/E ratio for the index increased from under 13 times earnings to over 17 times earnings—much closer to the 15-year average of 17.8 times earnings (See Charts 3 and 4 on the following page).[3] Because valuations are much closer to historical averages than just a few years ago, we believe that investor attention may shift more heavily towards earnings growth over the next few years. This seems to have been the case over the past 12 months, as valuations have remained relatively stable, with the trailing-12 month P/E multiple for the S&P 500 Index decreasing slightly from 17.4 to 17.2.

First Trust

Chart 3*
S&P 500 Index: Trailing 12-month Earnings/Share (3/9/09-9/30/15)

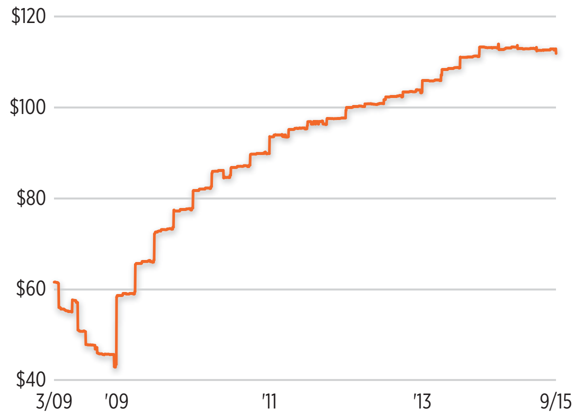


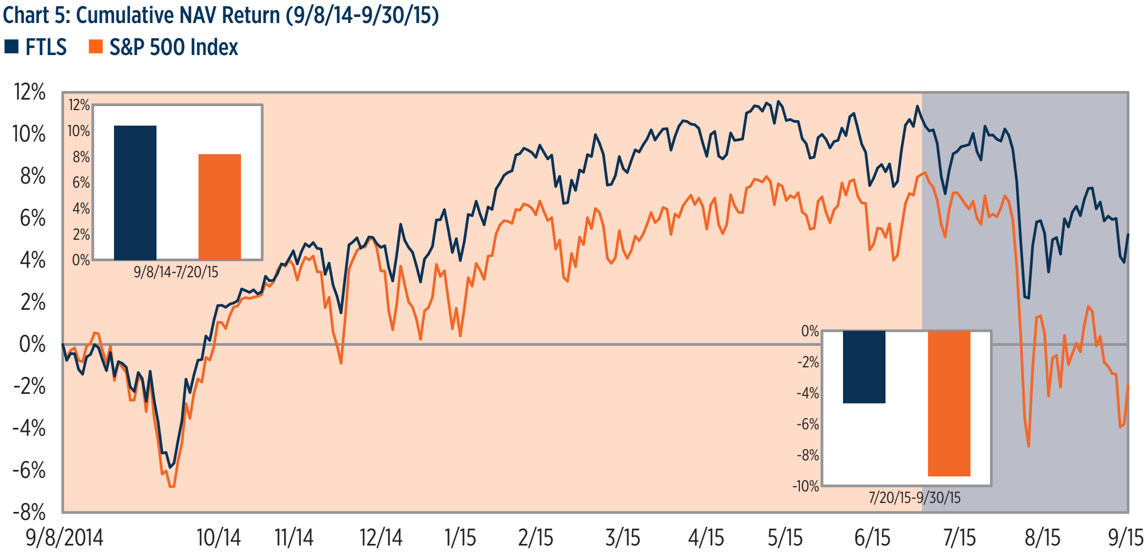
Chart 4*
S&P 500 Index: Price/Earnings (Trailing 12-Months) (3/9/09-9/30/15)

With investors more focused on companies' earnings and future earnings growth, as opposed to finding undervalued companies that may see their multiples expand, it may be an especially prudent time to dig deeper into companies' balance sheets and income statements. Comparisons with industry peers may help identify how aggressive or conservative a company's accounting assumptions are, which can serve as a measure of earnings quality.

Earnings quality analysis forms the primary basis by which stocks are selected for the First Trust Long/Short Equity ETF (FTLS). This actively managed ETF employs a long/short strategy, targeting approximately 70%-80% net market exposure.[4] One potential benefit of combining a short strategy with a traditional 100% long portfolio is that it enables the portfolio manager to bet against certain stocks that they expect to underperform, while investing in others they expect to outperform. The fund constructs its long portfolio by favoring stocks with high quality earnings, while concurrently shorting stocks with low quality earnings.

During its first year, FTLS produced compelling results. From inception on 9/8/14 through 9/30/15, FTLS posted a 4.9% average annual total return, compared to a -1.9% average annual total return for the S&P 500 Index. Importantly, the fund achieved much of this outperformance by mitigating losses on days in which the S&P 500 Index posted unusually large declines. While the S&P 500 lost more than 1.5% on 17 days, FTLS did so on only 5 days (9/8/2014-9/30/15). Moreover, not only did FTLS outperform when the S&P 500 Index was moving higher (9/8/14-7/20/15), it also outperformed when the index pulled back (7/20/15-9/30/15) (See Chart 5 below).

Chart 5: Cumulative NAV Return (9/8/14-9/30/15)



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.

The current bull market in US stocks is the third longest in history. We believe that investors can potentially benefit from a long/short approach to stock selection at this stage of the bull market, especially if market breadth starts to narrow moving forward. The strategy employed by FTLS doesn't simply rely on earnings quality analysis as a way to potentially select the best performing stocks in the near term; the fund seeks long-term, risk-adjusted outperformance by also utilizing earnings quality analysis to help identify which stocks may be more at risk of underperformance, in order to short or steer clear of those stocks.

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] Morningstar Direct. Includes all US-listed exchange-traded funds, exchange-traded notes and other exchange-traded products.

[2] Morningstar Direct. This summary is not intended to be tax or legal advice. This summary cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. This summary is being used to support the promotion or marketing of the transactions herein. The taxpayer should consult an independent tax advisor.

[3] Bloomberg. Admittedly, when including the decade of the 1990s, the average P/E multiple for the S&P 500 Index over the past 25 years jumps to 19.6 times earnings.

[4] For example, this could be achieved by combining a 100% long portfolio and a 20%-30% short portfolio.

*Data from Bloomberg.

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

FTLS lists and principally trades its shares on the NYSE Arca, Inc.

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 fund's shares will change in value, and you could lose money by investing in the fund. One of the principal risks of investing in the fund is market risk. Market risk is the risk that a particular security owned by the fund, fund shares or securities in general may fall in value. The fund is subject to management risk because it is an actively managed portfolio. In managing the fund's investment portfolio, the advisor will apply investment techniques and risk analyses that may not have the desired result. There can be no assurance that the fund's investment objective will be achieved.

The fund may invest in small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies. Equity securities prices fluctuate for several reasons, including changes in investors' perceptions of the financial condition of an issuer or the general condition of the stock market.

An investment in a fund containing securities of non-U.S. issuers is subject to additional risks, including currency fluctuations, political risks, withholding, the lack of adequate financial information, and exchange control restrictions impacting non-U.S. issuers. The fund may invest in depositary receipts which may be less liquid than the underlying shares in their primary trading market.

Alternative investments may employ complex strategies, have unique investment and risk characteristics and may not be suitable for all investors.

Shorting may result in greater gains or greater losses. Short selling creates special risks which could result in increased volatility of returns. Because losses on short sales arise from increases in the value of the security sold short, such losses are theoretically unlimited.

The fund may effect a portion of creations and redemptions for cash rather than in-kind securities. As a result, the fund may be less tax-efficient.

The fund currently has fewer assets than larger funds, and like other relatively new funds, large inflows and outflows may impact the fund's market exposure for limited periods of time.

The fund may invest in the shares of other ETFs, and therefore, the fund's investment performance and risks may be related to the investment performance and risks of the underlying ETFs. In general, as a shareholder in other ETFs, the fund bears its ratable share of the underlying ETF's expenses, and would be subject to duplicative expenses to the extent the fund invests in other ETFs.

The use of futures and other derivatives can lead to losses because of adverse movements in the price or value of the underlying asset, index or rate, which may be magnified by certain features of the derivatives. These risks are heightened when the fund's portfolio managers use derivatives to enhance the fund's return or as a substitute for a position or security, rather than solely to hedge (or offset) the risk of a position or security held by the fund.

The fund 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 fund. First Trust Advisors L.P. is an affiliate of First Trust Portfolios L.P., the fund's distributor.

» Performance Summary as of 9/30/15 (%)

	Quarter	YTD	1 Year	3 Years	5 Years	10 Years	Since Inception
FTLS Performance*							
Net Asset Value (NAV)	-2.49	0.60	6.38	—	—	—	4.93
Market Price	-2.43	0.21	6.34	—	—	—	4.99
Index Performance							
S&P 500 Index**	-6.44	-5.29	-0.61	—	—	—	-1.85

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.

FTLS inception date is 9/8/2014.Expense ratio: 1.17%. Management fees are 0.95% and leverage costs are 0.22%. Leverage costs include expenses associated with short sales transactions.

*__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 S&P 500 Index is the fund's benchmark.__ The index does 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.

» Definitions

The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance.

"Long" and "short" are investment terms used to describe ownership of securities. To buy securities is to "go long." The opposite of going long is "selling short." Short selling is an advanced trading strategy that involves selling a borrowed security. Short sellers make a profit if the price of the security goes down and they are able to buy the security at a lower amount than the price at which they sold the security short.

Not FDIC Insured • Not Bank Guaranteed • May Lose Value