Inside First Trust ETFs

July 2015 ■ Vol. 24

Strategy ETFs Continue to Gain Ground

Author:

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

A Snapshot of Q2 Flows and Trends

Total assets for US-listed exchange-traded funds (ETFs) increased to $2.2 trillion at the end of the second quarter of 2015, according to Morningstar, with estimated net asset flows for the quarter totaling $45 billion. International equity ETFs was the strongest category for the second quarter in a row, with net inflows totaling $46.5 billion, followed by equity sector ETFs, with net inflows totaling $2.3 billion (see Table 1). US equity ETFs was the weakest category for the second quarter in a row, with net outflows totaling $5.5 billion. However, similar to Q1, outflows from a single ETF, which totaled $14.5 billion in Q2, swamped the category, which otherwise received approximately $9 billion in net inflows.

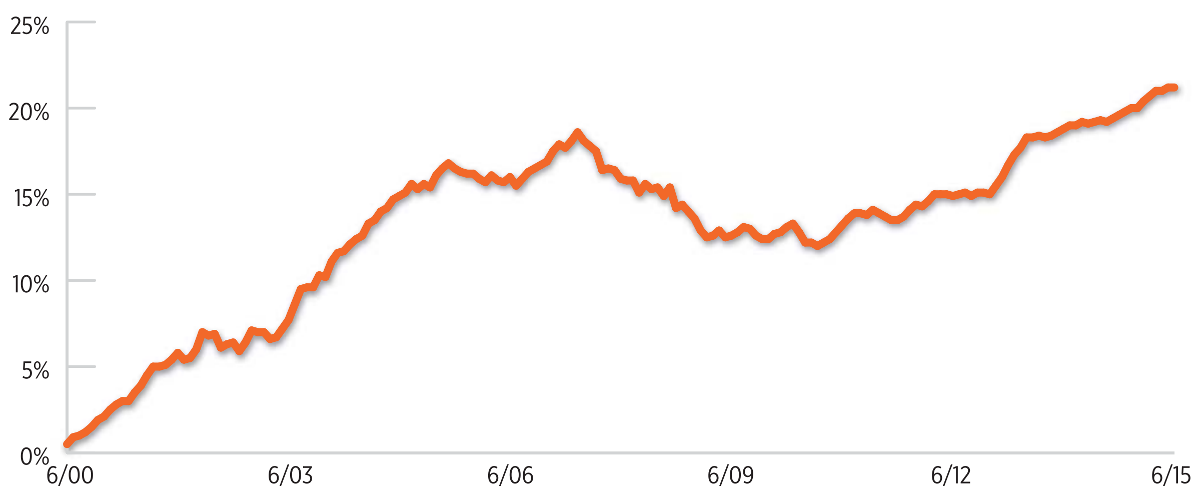
Table 1

ETF Asset Category	Estimated Net Asset Flows Previous 4 Quarters (4/1/2014 - 3/31/2015)	Estimated Net Asset Flows Q2 2015	Q2 2015 "Strategic Beta" Net Asset Flows
Allocation	$2,494,968,457	$684,243,871	$81,530,138
Alternative	$5,161,620,383	$882,673,832	$10,131,290
Commodities	$1,663,934,375	($1,692,714,067)	$21,104,289
International Equity	$79,326,665,061	$46,511,412,787	$10,905,927,624
Municipal Bond	$4,040,718,069	$701,372,198	N/A
Sector Equity	$37,832,745,014	$2,345,105,892	$1,529,521,106
Taxable Bond	$60,971,794,074	$935,902,596	$102,752,720
US Equity	$97,130,912,770	($5,498,391,646)	$2,308,715,238

Source: Morningstar.

Interestingly, the subset of ETFs from each category labeled by Morningstar as “strategic beta” received positive net inflows across the board. This group, often referred to as “smart beta”, includes ETFs that track indexes aimed at enhancing returns or minimizing risk relative to traditional market-cap weighted benchmarks. “Strategic beta” net inflows totaled $15 billion in the second quarter, bringing assets to $450 billion, and reaching a new high water mark with over 21% of total ETF assets under management (see Chart 1). The strongest strategic beta categories during the quarter were international equity ETFs, with net inflows totaling $10.9 billion, US equity ETFs, with net inflows totaling $2.3 billion, and equity sector ETFs, with net inflows totaling $1.5 billion.

Chart 1: "Strategic Beta" ETF Assets as a % of Total ETF Assets (June 2000 - June 2015)



Source: Morningstar.

Questions to Ask Your "Smart Beta" ETF

One of the most common complaints we hear from investment advisors attempting to evaluate "smart beta" ETFs is that the category itself lacks cohesion. ETFs employing a variety of different strategies, with a wide range of risks and objectives, have been given this label simply because they do not track traditional market-cap weighted benchmark indices. Alternatively, we believe advisors are better off judging ETFs on the basis of their own underlying strategies, rather than attempting to treat "smart beta" ETFs as a category. The following presents a few questions we believe investors should ask as they begin this process, using as a model First Trust's AlphaDEX family of ETFs, which is comprised of 41 funds with $20.9 billion in assets-under-management (as of 6/30/15).

First Trust

What is the objective of the underlying strategy?

In order to judge how successful a strategy might be, we believe it's important to first identify what it's trying to accomplish. So-called "smart beta" ETFs have a wide range of objectives, ranging from maximizing dividend income, to increasing or decreasing market risk, to seeking exposure to other specific characteristics. The objective of the strategy employed by First Trust's AlphaDEX ETFs is to seek better risk-adjusted returns than traditional benchmark indices, while maintaining a relatively high degree of correlation to those benchmarks.

From what universe of stocks are potential holdings selected?

We believe it's important to know what sort of holdings a strategy might include. On the one hand, a broad universe may produce certain unexpected exposures or biases; on the other hand, a narrow universe may limit the level of exposure to certain characteristics sought by a strategy. The universe of stocks for each AlphaDEX strategy is established by the holdings of traditional benchmark indices. For example, the universe of potential holdings for the First Trust Large Cap Core AlphaDEX Fund (FEX) is established by the S&P 500 Index. This is intended to prevent each AlphaDEX strategy from "drifting" into other categories.

How are stocks selected?

While some strategies include all potential holdings from a given universe, others select a smaller group, based on a variety of characteristics. The AlphaDEX strategy selects holdings based on a scoring model designed to favor certain factors that, when combined, have historically been associated with better risk-adjusted returns.

The AlphaDEX strategy scores "value" stocks based on three separate factors: price-to-book ratio, price-to-cash flow ratio, and return on assets. The first two factors attempt to identify whether a stock is cheap or expensive compared to other stocks in the universe, relative to certain fundamental measures (book value and cash flow). The model scores "cheap" stocks higher than "expensive" stocks in order to seek to capitalize on the so-called "value" anomaly, which is the tendency of cheap stocks to deliver better risk-adjusted returns—and expensive stocks to deliver worse risk-adjusted returns—than predicted by the efficient market hypothesis. The third factor, return on assets, provides an indication of efficiency and balance sheet quality. Its purpose in the model is to bias the strategy in favor higher quality stocks.

The AlphaDEX strategy scores "growth" stocks based on five separate factors: three-month price appreciation, six-month price appreciation, twelve-month price appreciation, one-year sales growth, and price-to-sales ratio. The first three factors measure momentum over various time periods, scoring high momentum stocks better than low momentum stocks. This is done to seek to capitalize on the so-called "momentum" anomaly, which is the tendency for stocks that have performed best in the recent past to outperform over the next three to twelve months. In addition to momentum, the growth model includes one-year sales growth in order to favor stocks whose momentum is supported by a measure of underlying fundamental revenue growth. Lastly, price-to-sales is included in order to deemphasize more expensive high-momentum stocks.

How are weightings assigned?

A variety of weighting methodologies have been applied to "smart beta" ETFs, ranging from equal-weighting to weightings based on certain fundamental characteristics, such as earnings or dividends. The AlphaDEX strategy uses the scoring model described above to assign portfolio weightings which results in weighting higher scoring stocks over lower scoring stocks.

How often is the strategy reapplied and the portfolio rebalanced?

Many "smart beta" strategies have higher turnover and more frequent rebalancing than traditional market-cap weighted benchmark indices. The AlphaDEX strategy is reapplied, and holdings are rebalanced, on a quarterly basis for domestic funds, and a semi-annual basis for international funds. As stock prices and company fundamentals shift over time, we believe this is necessary in order for the strategy to continue favoring relatively cheap, high-quality value stocks, and reasonably priced, high-momentum growth stocks.

Of course, the questions listed above are meant only to be a starting point for those attempting to get their arms around a continually expanding and evolving universe of so-called "smart beta" ETFs. Beyond these questions are many others pertaining to how well the risks and objectives of different ETFs align with those of individual investors. For these questions, we believe investment advisors should play an essential role, evaluating the function that each ETF provides in the context of a diversified investment portfolio, and overall financial plan.

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

A fund's return may not match the return of the index. Securities held by a 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 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 funds by authorized participants, in very large creation/redemption units.

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, sector or country. A fund may invest in small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies.

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. These risks may be heightened for securities of companies located in, or with significant operations in, emerging market countries.

A fund may invest in depositary receipts which may be less liquid than the underlying shares in their primary trading market. A fund may effect a portion of creations and redemptions for cash, rather than in-kind securities. As a result, a fund may be less tax-efficient.

The funds are classified as "non-diversified" and may invest a relatively high percentage of their assets in a limited number of issuers. As a result, the funds 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.

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