Inside First Trust ETFs

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Robust Growth for Municipal Bond ETFs in 2015

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Summary of 2015 ETF Flows and Trends[1]

- US-listed ETF Assets stood at over $2.1 trillion on 12/31/15, a 6.7% increase from the end of 2014. Total estimated net inflows for the year were $245 billion, narrowly exceeding the record inflows of $242 billion from 2014.
- ETF categories with the largest percentage increase in total assets in 2015 were Municipal Bond ETFs (+30%), Taxable Bond ETFs (+16.5%), and International Equity ETFs (+16.4%).
- The strongest category of ETFs for net inflows in 2015 was International equity ETFs, with net inflows totaling over $105 billion. This was followed by Taxable Bond ETFs and US Equity ETFs, with net inflows totaling $58 billion and $52 billion, respectively.
- The ETF category with the largest percentage decrease in assets was Commodity ETFs (-17.2%). Interestingly, this decline was primarily driven by poor performance, as the category actually had $772 million in net inflows for the year.

Table 1

US Category Group	Total US-Listed ETF Assets (12/31/15)	Total Assets: Year-over-year % increase	2015 Estimated Net Asset Flows	Previous Quarter Estimated Net Asset Flows (Q3 2015)	Q4 2015 Estimated Net Asset Flows
Allocation	$8,130,419,033	11.9%	$1,554,490,773	($108,715,476)	$720,761,733
Alternative	$43,260,762,312	1.3%	$7,823,259,980	$4,042,821,326	($349,295,359)
Commodities	$46,145,223,569	-17.2%	$772,030,371	($516,194,621)	($233,665,653)
International Equity	$442,630,957,817	16.4%	$105,267,750,909	($1,295,950,306)	$22,239,385,054
Municipal Bond	$18,327,795,148	30.0%	$4,168,445,043	$675,402,023	$1,452,390,686
Sector Equity	$298,658,385,170	-1.9%	$15,814,912,155	($2,662,718,397)	$10,382,271,751
Taxable Bond	$335,704,105,275	16.5%	$58,190,498,058	$22,208,390,765	$14,226,000,672
US Equity	$942,518,654,921	3.7%	$51,575,094,853	$22,828,259,279	$46,841,345,150
Total	**$2,135,376,303,245**	**6.7%**	**$245,166,482,142**	**$45,171,294,593**	**$95,279,194,034**

A Snapshot of Q4 2015 ETF Flows and Trends

- Total net inflows in Q4 2015 totaled $95 billion, more than double net inflows in Q3 2015.
- US Equity ETFs had the strongest net inflows for the second quarter in a row with $46.8 billion.
- After Q3 2015's net outflows, International Equity ETFs had the second strongest net inflows in Q4 2015 with $22 billion.
- Sector equity ETFs also reversed course in Q4 2015, with net inflows totaling $10 billion, compared to net outflows totaling $2.6 billion in Q3 2015.
- Net inflows for Taxable Bond ETFs totaled $14 billion in Q4 2015, following a relatively strong Q3 2015 in which net inflows totaled $22 billion.
- The weakest categories for net flows in Q4 2015 were Alternative ETFs (-$349 million) and Commodities ETFs (-$234 million).

2015 First Trust ETFs Milestones

- First Trust remained the 6th largest sponsor of ETFs in 2015.
- The AlphaDEX family of ETFs finished 2015 with over $18 billion in AUM.
- The First Trust Dow Jones Internet Fund (FDN) became the largest First Trust ETF at $4.9 billion.
- First Trust actively-managed ETF assets finished the year at $2.9 billion, a 41% increase from the end of 2014. This group is comprised of 16 ETFs including:
  - the largest actively managed equity ETF (First Trust North American Energy Infrastructure Fund (EMLP) at $890 million).
  - the largest actively managed preferred securities ETF (First Trust Preferred Securities and Income ETF (FPE) at $582 million).
  - the largest actively managed high yield bond ETF (First Trust Tactical High Yield ETF (HYLS) at $559 million).

[1]Based on Morningstar data, as of 12/31/15

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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The Case for an Actively Managed Municipal Bond ETF

The ETF category with the strongest percentage asset growth in 2015 was Municipal Bond ETFs, increasing by 30% year-over-year, as of 12/31/15. While nearly 99% of this growth was attributed to passively managed index ETFs, we believe there is a compelling case to be made for active management in this category. In particular, the actively managed strategy employed by the First Trust Managed Municipal ETF (FMB) seeks to add value versus passive municipal bond ETFs by addressing sector, credit, and interest rate risks, while seeking to provide a competitive level of income.

One key strategy employed by FMB to potentially enhance its yield is to overweight lower-rated investment grade bonds. As of 12/31/15, the fund allocated 26.65% to A rated bonds, and 28.28% to BBB rated bonds. We believe this segment of the municipal bond market is attractive, not only because of the potentially higher coupons that may be offered, but also because lower-rated investment grade municipal bonds have had an admirable track record of avoiding defaults. In fact, according to Moody's, from 1974-2014, the average 10-year cumulative default rate for A and Baa (equivalent to BBB rating) rated municipal bonds was 0.06% and 0.37%, respectively—both of which were actually lower than AAA rated corporate bonds (See Table 2). When combined with First Trust's active credit analysis, we believe there are many opportunities to be found among lower-rated investment grade municipal bonds.

Table 2

Moody's Average 10-Year Cumulative Default Rates from 1970 – 2014[2] Corporate vs. Municipal

Rating	Corporate	Municipal
AAA	0.48%	0.00%
AA	0.99%	0.01%
A	2.72%	0.06%
Baa	4.41%	0.37%
Ba	18.69%	4.11%
B	39.16%	17.48%
Caa	63.77%	16.88%

Another facet of FMB's actively managed strategy has been to overweight revenue bonds, many of which have offered more attractive coupons than similarly rated general obligation (GO) bonds. While conventional wisdom has often been that revenue bonds are riskier than GO bonds (which helps explain their higher coupons), such generalizations have been called into question by recent high profile events, such as the 2013 bankruptcy filing by the city of Detroit. As the US population ages, and more workers approach retirement, we believe underfunded pension liabilities have the potential to cause chronic issues for certain GO municipal bonds in the future. In contrast, we believe these same demographic trends may actually be supportive for certain types of revenue bonds, such as those issued by hospitals and senior living facilities. Navigating among these risks and opportunities is a key potential benefit of active management.

Managing risk is a critical component of FMB's actively managed strategy. The fund may seek to proactively avoid certain bonds, or even certain sectors that are believed to have deteriorating credit quality, for example, unlike many passively managed municipal bond ETFs, whose underlying indices may wait to remove a bond until after a credit downgrade has occurred. Similarly, active management allows FMB to address interest rate risk. While bond maturities and duration for passively managed municipal bond ETFs are essentially a function of when and for how long municipalities borrowed funds, FMB's allocation can be altered to shorten or lengthen duration, based on expected changes in interest rates. As of 12/31/15, the fund had an effective duration[3] of 6.15 years.

While Municipal Bond ETFs remain one of the smaller categories of ETFs, this segment grew faster than any other in 2015 on a percentage basis. As the population ages, and more investors seek tax-free income to help fund their retirement needs, we expect continued growth in future years. While the lion's share of municipal bond ETF assets are currently invested in passively managed funds, we believe investors seeking a competitive level of tax-free income, with a focus on risk management, may find actively managed ETFs, such as FMB, to be a compelling alternative.

[2]Source: Moody's Investors Service, Special Comment: U.S. Municipal Bond Defaults and Recoveries, 1970-2014; Municipal Market Advisors (MMA), YTD through 9/30/15.

[3]A measure of a bond's sensitivity to interest rate changes that reflects the change in a bond's price given a change in yield.

Past performance is not a guarantee of future results and there is no assurance that the events or improvements mentioned herein 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 fund lists and principally trades its shares on The Nasdaq Stock Market LLC.

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. 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 objectives will be achieved.

The fund is subject to market risk. Market risk is the risk that a particular security owned by the fund or shares of the fund in general may fall in value. The values of municipal securities held by the fund may be adversely affected by local political and economic conditions and developments.

Municipal bonds are subject to numerous additional risks, including credit risk, income risk, interest rate risk, call risk and zero coupon bond risk. Credit risk is the risk that an issuer of a security will be unable or unwilling to make dividend, interest and/or principal payments when due and that the value of a security may decline as a result. Income risk is the risk that income from the fund's fixed income investments could decline during periods of falling interest rates. Interest rate risk is the risk that the value of the securities in the fund will decline because of rising market interest rates. Call risk is the risk that performance could be adversely impacted if an issuer calls higher-yielding debt instruments held by the fund. Zero coupon bond risk is the risk that zero coupon bonds may be highly volatile as interest rates rise or fall because they do not pay interest on a current basis.

Income from municipal bonds held by the fund could be declared taxable because of, among other things, unfavorable changes in tax laws, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. All or a portion of the fund's otherwise exempt-interest dividends may be taxable to those shareholders subject to the federal alternative minimum tax.

The fund may invest in high yield securities, or "junk" bonds, which are subject to greater market fluctuations and risk of loss than securities with higher ratings, and therefore, may be highly speculative. The market for high yield securities is smaller and less liquid than that for investment grade securities.

Participation interests in municipal leases pose special risks because many leases and contracts contain "non-appropriation" clauses that provide that the governmental issuer has no obligation to make future payments under the lease or contract unless money is appropriated for this purpose by the appropriate legislative body.

The fund currently intends to 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 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.

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

» Performance Summary (%)	Inception Date	Net Expense Ratio	Gross Expense Ratio^	Quarter	YTD	1 Year	Since Inception
FMB Performance as of 12/31/15*	5/13/14	0.50%	0.65%				
Net Asset Value (NAV)				1.91	3.84	3.84	5.18
After Tax Held				1.46	2.48	2.48	3.86
After Tax Sold				1.11	2.19	2.19	3.36
Market Price				2.19	4.15	4.15	5.38

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.

^First Trust has contractually agreed to waive management fees of 0.15% of average daily net assets until March 1, 2017.

***After Tax Held** returns represent return after taxes on distributions. Assumes shares have not been sold. **After Tax Sold** returns represent the return after taxes on distributions and the sale of fund shares. Returns do not represent the returns you would receive if you traded shares at other times. **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. After-tax returns are calculated using the historical highest individual federal marginal income tax rates and do not reflect the impact of state and local taxes. Actual after-tax returns depend on the investor's tax situation and may differ from those shown. The after-tax returns shown are not relevant to investors who hold their fund shares through tax-deferred arrangements such as 401(k) plans or individual retirement accounts.

30-Day SEC Yield†	2.16%
Unsubsidized 30-Day SEC Yield#	2.16%
Taxable Equivalent Yield‡	3.82%

†30-day SEC yield is calculated by dividing the net investment income per share earned during the most recent 30-day period by the maximum offering price per share on the last day of the period and includes the effects of fee waivers and expense reimbursements.

#The unsubsidized 30-day SEC yield is calculated the same as the 30-day SEC yield, however it excludes contractual fee waivers and expense reimbursements.

‡The taxable equivalent yield is for illustrative purposes only. This information illustrates approximately what you would have to earn on taxable investments to equal the tax-exempt estimated current return using the highest federal tax bracket for 2015. This information is based on present law as of the date of publication and does not account for any proposed changes in tax rates. This information does not account for limitations on deductions, the alternative minimum tax or taxes other than Federal personal income tax.

Not FDIC Insured • Not Bank Guaranteed • May Lose Value