Broad Commodity ETFs Gain Traction in Q2: Will the Trend Continue?

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Summary of Q2 2016 Estimated ETF Flows and Trends

Table 1

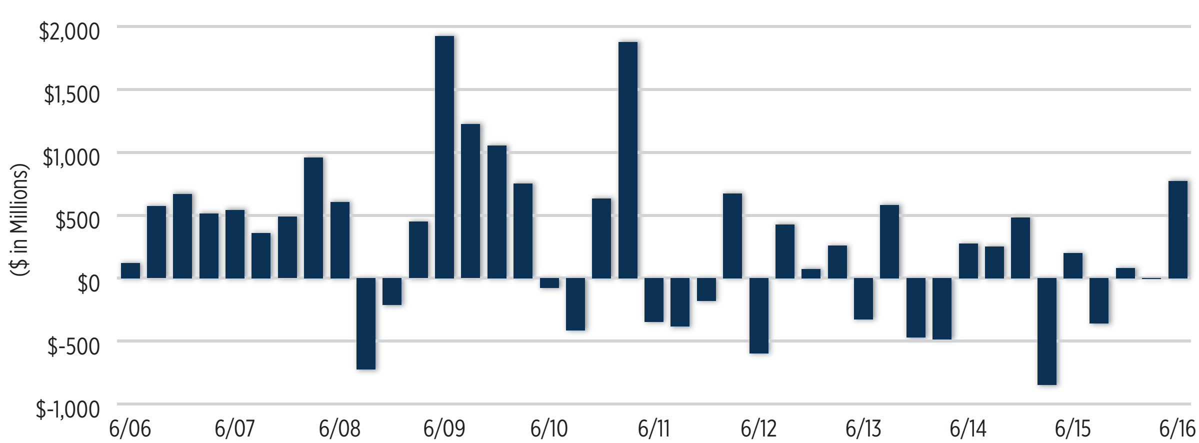
US Category Group	Total US-Listed ETF Assets (6/30/16)	Estimated Net Asset Flows Q2 2016	Estimated Net Asset Flows Previous Quarter (Q1 2016)
Allocation	$8,240,180,417	$345,313,522	($956,537,064)
Alternative	$45,501,717,638	$739,232,664	$3,309,197,755
Commodities	$73,350,197,329	$6,886,284,801	$9,379,268,460
International Equity	$419,650,258,835	($3,794,719,754)	($5,234,848,871)
Municipal Bond	$22,104,944,950	$1,536,454,947	$1,667,731,259
Sector Equity	$312,197,425,507	$3,349,163,295	($5,475,113,419)
Taxable Bond	$396,511,018,390	$13,111,259,062	$32,254,570,491
US Equity	$981,678,008,917	$12,027,267,494	($2,118,490,338)
Total	$2,259,233,751,983	$34,200,256,031	$32,825,778,273

Source: Morningstar, as of 6/30/16. Includes all US-listed exchange-traded funds, exchange-traded notes and other exchange-traded products.

- Overall US listed ETF net inflows totaled $34.2 billion in Q2, slightly accelerating from $32.8 billion in net inflows in the previous quarter.
- For the second quarter in a row, the strongest category for net asset flows was Taxable Bond ETFs, with $13.1 billion in net inflows in Q2.
- Flows into US Equity ETFs rebounded in Q2 with $12 billion in net inflows, reversing the $2.1 billion in net outflows from Q1. Flows into Sector Equity ETFs also rebounded in Q2 with $3.3 billion in net inflows, compared to $5.5 billion in net outflows in Q1.
- For the second straight quarter, Commodity ETFs had relatively strong net asset flows with $6.9 billion in net inflows, a large percentage of which came from precious metals ETFs. However, unlike Q1, the "broad commodity ETFs" subcategory also had a significant increase in net inflows, totaling $770 million. This represents the strongest level of net inflows for broad commodity ETFs since Q1 of 2011. (See Chart 1 below)
- International Equity ETFs reported net outflows totaling $3.8 billion in Q2, marking the second consecutive quarter for net outflows.

All net inflow and outflow numbers are estimates based on information provided by Morningstar.

Chart 1: Broad Commodity ETFs: Estimated Quarterly Net Asset Flows (6/30/06 - 6/30/16)



Source: Morningstar.

Broad Commodity ETFs Gain Traction in Q2: Will the Trend Continue?

The Bloomberg Commodity Index posted a 12.8% total return in Q2 of 2016, which was the strongest quarterly gain for the index since Q4 of 2010. Perhaps, then, we should not be too surprised by the rebound in net inflows for broad commodity ETFs that took place in Q2. After all, investors have a tendency to chase returns in all asset classes, including commodities. The question on the minds of many investors is whether commodities will resume the slide that produced negative total returns in each of the last five calendar years for the Bloomberg Commodity Index, or whether prices will continue to stabilize and move higher. Listed in Table 2, on the following page, are a few potential catalysts that we believe could result in higher or lower commodity prices.

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

Table 2

Potential Catalysts for Higher Commodity Prices	Potential Catalysts for Lower Commodity Prices
Technical: Mean reversion could lead to higher prices following the 58% decline from peak (4/29/11) to trough (1/20/16) for the Bloomberg Commodity Index.	**Technical:** Potential retracement lower following Q2 2016 rally.
Global central banks could succeed in stoking inflation.	Global central banks stimulus policies could fail as deflation pressures mount.
Weakening US Dollar: US Dollar could weaken if the US Dollar Index ($96.14, as of 6/30/16) drifted closer to its 10-year average ($82.75).	**Strengthening US Dollar:** Foreign investors may continue to funnel capital to the US in search of a safe haven or higher interest rates.
Demand for commodities from Emerging Markets could accelerate.	Unforeseen economic weakness could lead to reduced demand for commodities.
Weather-Related: Potential supply disruptions (i.e. hurricanes prevent normal drilling for natural gas).	**Weather-Related:** Potential excess supply (i.e. unusually warm winter results in less consumption of natural gas).
Potential geopolitical turmoil in commodity producing regions, reducing production.	Technological innovation could continue to increased production, resulting in excess supply.

The unpredictable nature of many of the potential catalysts for higher or lower commodity prices listed above is an important reminder of how difficult it is to predict near-term price movements of commodities. As such, we believe that many investors may be better off making strategic policy allocations to commodities, with periodic rebalancing, instead of trying to "time the market".

A strategic allocation to commodities may provide two important, and sometimes interrelated benefits to an investment portfolio, serving to potentially enhance diversification, while also providing a hedge against unexpected inflation. Over the past 15 years, the correlation between commodities and bonds has been 0.04, and the correlation between commodities and US stocks has been 0.38.[1] While the relationship between commodities and US stocks is stronger than that of commodities and bonds (between which there is almost no relationship), it remains weak enough to provide meaningful diversification benefits, in our opinion. This is due to the fact that certain market forces impact commodity prices differently than stock prices.

One example which may help to illustrate this point is the impact that an unexpected rise or spike in raw materials' prices may have on the earnings of a manufacturing company. If commodity prices were to increase beyond what a manufacturer is able to pass along to its customers, its profit margins could get squeezed, potentially resulting in a hit to its earnings. In such situations, an allocation to commodities may help to offset a potential decline in the price of the manufacturers' stock.

Active or Passive?

While the majority of commodity ETFs track passive indices, we believe that the actively managed approach employed by the First Trust Global Tactical Commodity Fund (FTGC) may provide several important benefits:

- **Actively managed volatility:** While most passively managed broad commodity ETFs accept whatever level of risk is reflected by a relatively static underlying commodity index, FTGC seeks to target a more stable level of risk, by regularly adjusting its portfolio allocations. We believe this approach may provide investment advisors a more predictable way to determine what level of risk to allocate to commodities.
- **Selection of commodities in order to seek robust diversification:** While certain commodities tend to be highly correlated to one another, the relationship between other commodities is much weaker. For example, one would typically expect the correlation between two energy-related commodities to be higher than the correlation between an energy commodity and an agricultural commodity. FTGC's commodity allocation seeks robust diversification by including meaningful allocations to a diverse portfolio of commodities, many of which are absent from passive indices.
- **Actively Manage Roll-Yield:** As futures contracts expire, it is necessary to roll from one contract to another, in order to maintain exposure to a given commodity. However, futures contracts for a given commodity may have meaningfully different prices, depending on the date at which the contract comes due. In contrast to many passively managed commodity ETFs, which maintain exposure to front-month futures contracts, we believe that active management can add value by selecting and rolling exposure to futures contracts that are expected to produce the greatest total returns.
- **Tax reporting:** Tax reporting for FTGC is provided on a Form 1099, unlike many other commodity ETFs, which report taxes via schedule K-1s.

We are encouraged to see investors have once again begun to "test the waters" for broad commodity ETFs, as indicated by the strength of estimated net asset flows in Q2. While commodity returns for the five-year period ending in December of 2015 were dismal, we believe that the longer-term benefits that commodities have historically provided still warrant consideration for many investors. For those seeking exposure to commodities, we believe that the actively managed strategy employed by FTGC provides meaningful enhancements versus passively managed commodity ETFs.

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]Source: Bloomberg. "Commodities" are represented by the Bloomberg Commodity Index, "US stocks" are represented by the S&P 500 Index, and "bonds" are represented by the Barclays U.S. Aggregate Bond Index.

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

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. One of the principal risks of investing in the fund is market risk. The trading prices of commodities futures, fixed income securities and other instruments fluctuate in response to a variety of factors. The fund'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 may be more volatile over short-term periods than other investment options because of the fund's significant use of financial instruments that have a leveraging effect.

The fund 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. There can be no assurance that the fund's investment objective will be achieved.

The fund does not invest directly in futures instruments. Rather, it invests 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.

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 the fund. 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.

The fund regularly purchases and sells commodity futures contracts to maintain a fully invested position. This frequent trading may increase the amount of commissions or mark-ups to broker-dealers that the fund pays when it buys and sells contracts, which may detract from the fund's performance.

The fund 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.

The fund, through the subsidiary, will engage in trading on commodity markets outside the U.S. Trading on such markets is not regulated by any U.S. government agency and may involve certain risks not applicable to trading on U.S. 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.

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

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.

First Trust Advisors L.P. is registered as a commodity pool operator and commodity trading advisor and is also a member of the National Futures Association.

Definitions

Correlation measures the similarity of performance of two assets. Correlation is measured on a scale ranging between -1 and +1. +1 means that the two investments have moved in perfect tandem with each other. Alternatively, -1 means that when one security moves in one direction, the other security will move in the opposite direction. The **Bloomberg Commodity Index** is made up of exchange-traded futures on physical commodities and represents 20 commodities, which are weighted to account for economic significance and market liquidity. The **Barclays U.S. Aggregate Bond Index** covers the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass throughs), ABS, and CMBS. The **S&P 500 Index** is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance.