Actively Managed Fixed Income ETFs Gain Marketshare

Author:

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

Summary of Q3 2017 ETF Flows and Trends[1]

- » Estimated net inflows for US-listed ETFs totaled $87 billion in Q3 2017, bringing total ETF assets to $3.17 trillion.
- » Taxable Bond ETFs received the greatest level of estimated net inflows, totaling $31.5 billion in Q3, slightly less than the previous quarter. Estimated net inflows for Municipal Bond ETFs totaled $1.4 billion in Q3, nearly matching flows from Q2.
- » International Equity ETFs received $24.7 billion in estimated net inflows in Q3, as flows decelerated from $57.0 billion in Q2. Year-to-date, the International Equity ETF category has received the greatest level of estimated net inflows, totaling $115 billion.
- » US Equity ETFs received $22.6 billion in estimated net inflows in Q3, accelerating from $15.3 billion in Q2, while sector equity ETFs received $5.5 billion in estimated net inflows, accelerating from $0.8 billion in Q2.
- » Commodities ETFs (+$0.6 billion), Allocation ETFs (+0.5 billion), and Alternatives ETFs (+$0.4 billion) each received positive estimated net inflows in Q3, although estimated net inflows for each were weaker than Q2.

Table 1

US Category Group	Total US-Listed ETF Assets (9/30/17)	Q3 2017 Estimated Net Asset Flows	Previous Quarter Estimated Net Asset Flows (Q2 2017)
Taxable Bond	$530,389,559,334	$31,477,449,245	$33,766,751,063
International Equity	$669,721,898,539	$24,693,237,872	$57,006,450,264
US Equity	$1,416,145,725,841	$22,563,159,355	$15,341,718,611
Sector Equity	$400,971,876,819	$5,531,194,817	$807,643,466
Municipal Bond	$27,899,854,846	$1,419,817,270	$1,456,905,230
Commodities	$66,534,117,930	$570,071,984	$860,495,615
Allocation	$12,182,654,739	$527,124,188	$625,748,078
Alternative	$47,952,644,899	$397,588,282	$1,728,256,326
Total	**$3,171,798,332,947**	**$87,179,643,013**	**$111,593,968,653**

Source: Morningstar, as of 9/30/17. Includes all US-listed exchange-traded funds, exchange-traded notes and other exchange-traded products.
All net inflow and outflow numbers are estimates based on information provided by Morningstar.

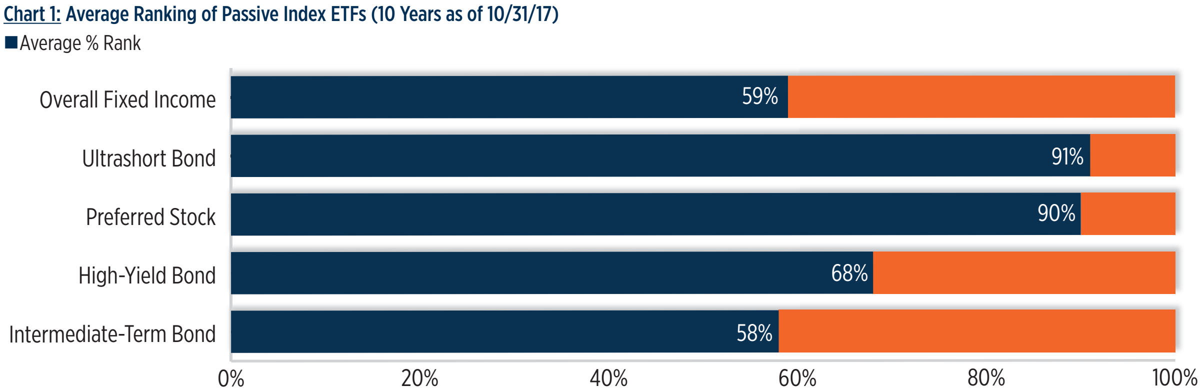
Since the launch of the first fixed income ETFs over 15 years ago, assets under management in these funds have exploded to over $558 billion, as of 9/30/17. While passive ETFs have accounted for the vast majority of this growth, actively managed fixed income ETFs have recently gained market share. Over the past five years, assets under management for actively managed fixed income ETFs have grown at a 33% annual rate, compared to 18% for passive fixed income ETFs, increasing market share to 5.6%, as of 9/30/17.[2] So far in 2017, approximately 7.6% of fixed income ETF net inflows have gone to actively managed funds.[2]

We believe the success of actively managed fixed income ETFs has been driven by two key factors. First, over the past decade, passive fixed income index ETFs have tended to underperform actively-managed peers. And second, many investors are coming to realize—correctly in our opinion—that actively managed fixed income ETFs are better equipped to manage risk than passive fixed income ETFs.

Historical Performance

Historical performance may be the simplest reason that passive fixed income ETFs have lost market share to actively managed fixed income ETFs. Over the past decade, the average passive fixed income ETF ranked in the bottom half of its Morningstar category (See Chart 1).[3] Passive fixed income ETFs fared especially poorly in certain narrower categories, such as Ultrashort Bonds and Preferred Stocks, in which the average passive ETF ranked in the bottom 10% of its peer group, as well as High Yield Bonds, in which the average passive ETF ranked in the bottom third of its peer group. However, passive ETFs have also suffered relative underperformance in certain "core" bond categories, such as Intermediate-Term Bonds, in which, the average passive ETF ranked worse than 58% of its peers.

Chart 1: Average Ranking of Passive Index ETFs (10 Years as of 10/31/17)



Source: Morningstar. Past performance is not a guarantee of future results.

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

First Trust

Risk-management is Paramount

In our opinion, one crucial factor that has contributed to the relative underperformance of many passive fixed income ETFs is their inability to manage certain types of risk, such as credit risk and interest rate risk, among others.

Credit Risk

Credit risk refers to the possibility that a bond issuer may be unable to make timely payments of interest and principal over the life of a bond. Passive ETFs address credit risk indirectly, relying on the analysis of credit rating agencies, whose ratings help determine if a bond is eligible for a fund's underlying index. In this way, investors can select either investment grade or below investment grade credit exposure. Indices generally assign weightings in proportion to the market value of constituent bonds, meaning more indebted companies have a greater representation in the index. Since the objective of a passive ETF is to track its underlying index as closely as possible, it is generally not the task of a passive fund manager to decide which index securities to own or avoid on the basis of credit risk.

In contrast, actively managed ETFs may independently assess the creditworthiness of a bond by rigorously analyzing the fundamentals and collateral of its issuer, to determine if the bond offers adequate potential return compensation for risk, or whether it may be too risky for a given strategy. Because credit fundamentals may evolve more quickly than bond ratings, active managers are incentivized to be proactive in managing credit risk, rather than waiting for bond rating agencies to change their assessment of a bond's credit quality.

The significance of credit risk is most readily apparent for ETFs that invest in below investment grade securities, such as high-yield bonds or senior loans, but its importance extends to funds that invest in higher quality securities as well. Credit fundamentals are not static, and often change over the life of a bond. Hence, today's investment grade bond may be tomorrow's junk bond, and vice versa. We believe that one of the most important ways that actively managed ETFs can add value versus passive ETFs is by managing credit risk.

Interest Rate Risk

Interest rate risk is another important consideration for fixed income investors, since the price of fixed-coupon securities generally moves in the opposite direction as interest rates, sending prices either lower when rates rise or higher when rates fall. For better or worse, passive fixed income ETFs generally reflect the interest rate risk characteristics of their underlying indices. Importantly, interest rate risk within an index can change over time. For example, in a period of persistently low interest rates, many companies opt to refinance their debt to lock in a lower interest rate. A bond's interest rate risk is a function of both its interest rate (yield) and maturity. Therefore, as interest rates fall, an index's interest rate risk generally increases.

On the other hand, actively managed fixed income ETFs may employ various measures to manage interest rate risk. For example, to protect against rising interest rates, an active manager may choose to invest in securities with shorter maturities, or floating-rate coupons, in order to decrease a portfolio's sensitivity to interest rate movements. Or, if interest rates are expected to shift higher or lower for bonds of different maturities, an active manager may choose to tailor a portfolio's exposure to certain key rates.

Credit risk and interest rate risk are two significant risk factors for fixed income investments, but there are many others that investors should consider. While active managers differ in process, skill, and experience, we believe that the ability to navigate multiple dimensions of risk is a worthwhile feature of actively managed fixed income ETFs, which has played a critical role in their success.

The vital question today is how important risk management will be going forward. While the future remains unknown, considering today's narrow credit spreads, low interest rates, onerous, evolving regulatory environment, and extraordinary central bank policies around the world, we believe that active management is more important than ever.

[1] Morningstar is the data source for all ETF flows data discussed in this report.

[2] Source: Morningstar. As of 9/30/17.

[3] Including all ETFs categorized by Morningstar as either "Fixed Income" or "Tax Preferred", with at least 10-years of performance history, as of 9/30/17.

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

Investors buying or selling fund shares on the secondary market may incur customary brokerage commissions. 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 a fund by authorized participants, in very large creation/redemption units. If a fund's authorized participants are unable to proceed with creation/redemption orders and no other authorized participant is able to step forward to create or redeem, fund shares may trade at a discount to the fund's net asset value and possibly face delisting.

Risk Considerations

A fund's shares will change in value, and you could lose money by investing in a fund. There can be no assurance that a fund's investment objective will be achieved.

An index fund's return may not match the return of the applicable index. Securities held by an index fund will generally not be bought or sold in response to market fluctuations.

Actively managed funds are subject to management risk because the advisor or sub-advisor will apply investment techniques and risk analyses that may not have the desired result.

Fixed-income securities may be subject to credit risk, call risk, income risk, interest rate risk, prepayment risk, extension risk and zero coupon risk. These risks could result in the decline in the value of a security held by a fund, a decline in a fund's income, increased volatility as interest rates rise or fall, and an adverse impact on fund performance. These risks may be heightened for high-yield securities.

Income from municipal bonds could be declared taxable and all or a portion of a fund's otherwise exempt interest dividends may be taxable to investors subject to the federal alternative minimum tax.

Please be aware that each fund listed is subject to various risks depending on the fund's investment objectives. For a complete description of relative risks for a specific fund, please obtain and carefully read the appropriate First Trust prospectus by visiting www.ftportfolios.com or calling 1-800-621-1675.

The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, First Trust is not undertaking to give advice in any fiduciary capacity within the meaning of ERISA and the Internal Revenue Code. First Trust has no knowledge of and has not been provided any information regarding any investor. Financial advisors must determine whether particular investments are appropriate for their clients. First Trust believes the financial advisor is a fiduciary, is capable of evaluating investment risks independently and is responsible for exercising independent judgment with respect to its retirement plan clients.

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.