Inside First Trust ETFs
May 2017 ■ Vol. 31

The Value of Dividend Growth

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Summary of Q1 2017 ETF Flows and Trends

- Estimated net inflows for US-listed exchange-traded funds (ETFs) totaled $134 billion in Q1 2017, setting a new record for the second straight quarter.
- Equity ETFs received the lion's share of estimated net inflows during Q1 2017. While the overall strongest category for estimated net asset flows was US Equity ETFs, with $44.8 billion in estimated net inflows, International Equity ETFs and Sector Equity ETFs also had strong showings, with $33.5 billion and $18.0 billion of estimated net inflows, respectively.
- Taxable Bond ETFs received the second highest level of estimated net inflows in Q1 2017, with $33.9 billion. This marked a $21 billion increase from Q4 2016, which had been the weakest quarter for Taxable Bond ETFs in 2016. Estimated net inflows for Municipal Bond ETFs slowed to $0.7 billion in Q1 2017, compared to $1.3 billion in Q4 2016.
- Both Commodities ETFs and Alternatives ETFs received estimated net inflows in Q1 2017, totaling $1.1 billion and $1.6 billion, respectively, after both faced estimated net outflows in Q4 2016.

Table 1

US Category Group	Total US-Listed ETF Assets (3/31/17)	Q1 2017 Estimated Net Asset Flows	Previous Quarter Estimated Net Asset Flows (Q4 2016)
Allocation	$10,377,158,075	$162,781,930	$965,690,934
Alternative	$44,650,833,757	$1,625,412,488	($2,823,777,912)
Commodities	$64,091,597,141	$1,050,371,016	($7,351,712,270)
International Equity	$529,267,979,349	$33,509,566,124	$15,106,184,470
Municipal Bond	$24,782,140,197	$718,131,483	$1,338,763,108
Sector Equity	$377,419,035,213	$17,977,494,731	$22,108,625,016
Taxable Bond	$460,454,403,171	$33,854,546,260	$12,873,147,728
US Equity	$1,296,860,452,778	$44,802,687,263	$84,638,664,582
Total	**$2,807,903,599,681**	**$133,700,991,295**	**$126,855,585,656**

Source: Morningstar, as of 3/31/17. 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.

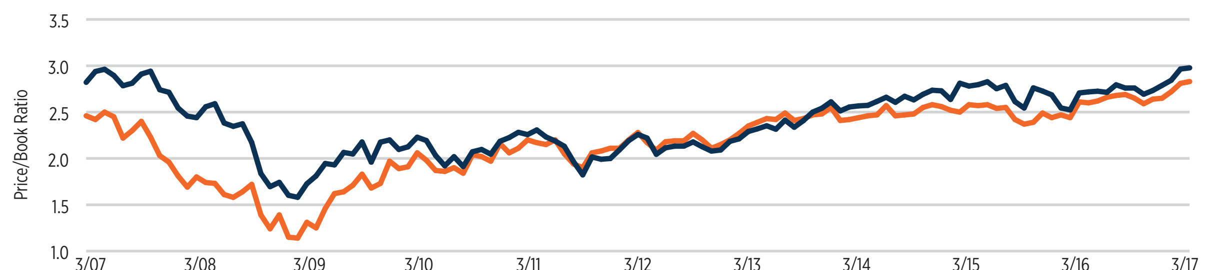
Dividend ETFs have grown in popularity over the past several years, accumulating over $118 billion, among 47 ETFs, as of 3/31/17.[1] Overall, these ETFs have performed quite well. Of the 28 dividend ETFs rated by Morningstar, a remarkable 24 have an overall 4- or 5-star rating as of 3/31/17.[2] Each of these funds follows a distinct, rules-based index methodology, producing a range of different portfolio characteristics. However, since the majority of these strategies are designed to seek high dividend yielding stocks, they tend to favor certain non-cyclical sectors in which those stocks are most often found. While strategies favoring steady, high dividend-yielding stocks performed well in the context of an ultra-low interest rate environment, we believe these types of stocks may underperform when rates rise, as higher bond yields compete for investor dollars. In such contexts, we believe strategies focused on stocks with rising dividend payments may prove to be an attractive alternative to high-yielding stocks with low dividend growth.

Diminishing Value in Dividends?

Traditionally, dividend yield has often been regarded as a useful metric for identifying relatively inexpensive stocks. More recently, however, valuations of dividend ETFs have increased relative to broad market benchmarks based on other measures of value, such as price/book (See Chart 1 below). The 10-year average price/book ratio for dividend ETFs was 11.5% lower than the S&P 500 Index over the decade ending on 3/31/17 (See Chart 2 on the following page).

However, the average discount was much greater during the first few years of the last decade, averaging 22% from 3/31/07-3/31/10. As the era of ultra-low interest rates wore on in subsequent years, many investors found high dividend yielding stocks to be an attractive alternative to bonds, and dividend ETFs grew more expensive. Only time will tell if valuation discounts will return for dividend ETFs, but if they do, this may result in a period of relative underperformance for these strategies.

Chart 1: Price/Book Ratio: Average Dividend ETF vs. S&P 500 Index (3/31/07 - 3/31/17)



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.

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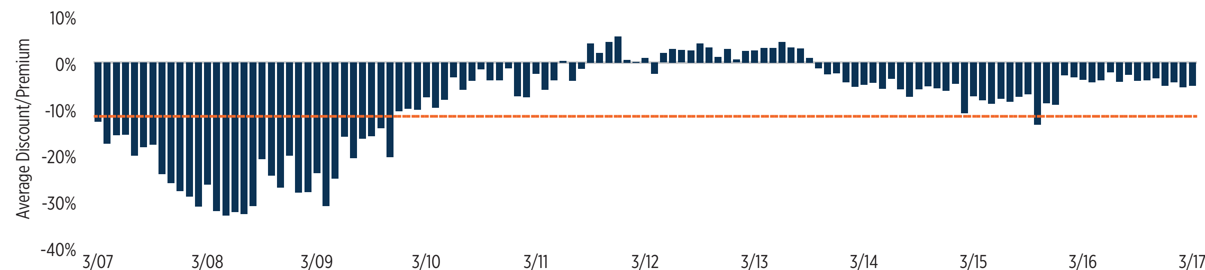
Chart 2: Premium/Discount Based on Price/Book: Average Dividend ETF vs. S&P 500 Index (3/31/07 - 3/31/17)

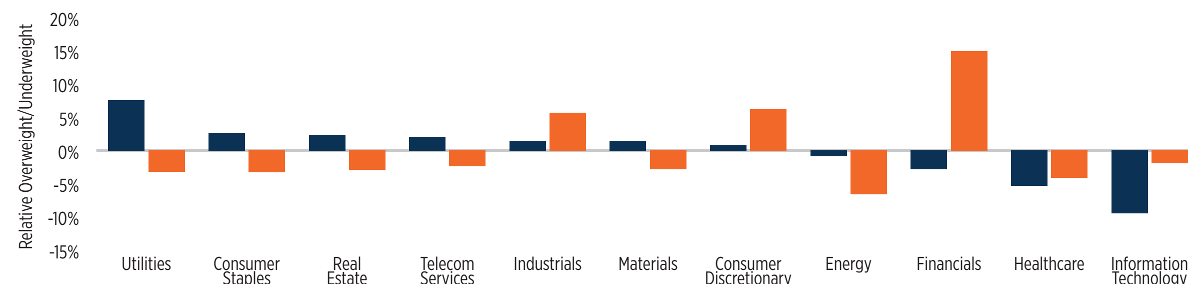


Source: Morningstar. Past performance is not a guarantee of future results.

Sector Biases for Dividend ETFs

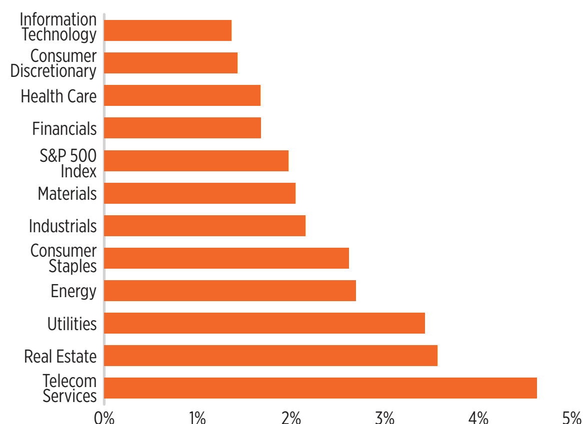
Although sector allocations do vary from one dividend ETF to another, these funds tend to share similar sector biases. On average, dividend ETFs favor relatively high dividend yielding sectors, with relatively low dividend growth, such as utilities, consumer staples, and telecom services (See Charts 3, 4, and 5 below). These overweight allocations generally come at the expense of sectors with lower dividend yields but stronger dividend growth trends, such as information technology and financials.

Chart 3: Sector Allocations Relative to S&P 500 Index (As of 3/31/17)



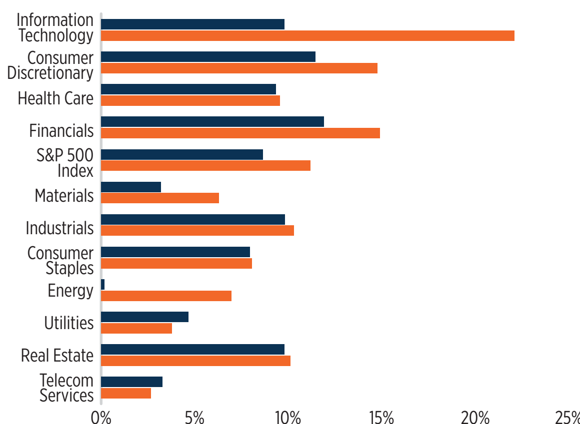
Source: Morningstar. Past performance is not a guarantee of future results.

Chart 4: GICS Sectors: Trailing 12-Month Dividend Yield (As of 3/31/17)



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

Chart 5: GICS Sectors: 3- and 5-Year Dividend Growth Rates (As of 3/31/17)



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

A Strategy for Seeking Dividend Growth

We believe the First Trust Rising Dividend Achievers ETF (RDVY) may be an attractive alternative to strategies favoring high dividend yielding stocks in the current market environment. RDVY tracks an index comprised of 50 dividend-paying stocks, for which recent dividend growth has been accompanied by underlying earnings growth, as well as capacity for future dividend increases.

The fund's underlying index methodology applies a series of screens to the 1000 largest stocks in the US, eliminating those for which:

1. Dividend payments over the previous 12 months are not greater than annual dividends paid three- and five-years prior.
2. Earnings in the most recent fiscal year are not positive, as well as greater than annual earnings from three fiscal years prior.
3. More than 65% of earnings over the previous 12 months have been paid out as dividends.
4. Cash-to-debt ratios are less than or equal to 50%.

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From this screened universe, the top 50 stocks are chosen on the basis of 5-year dividend growth, current dividend yield, and dividend payout ratio, subject to a 30% cap for any one sector. The index is reconstituted annually and rebalanced quarterly.

In our opinion, the logic of this model holds together well, as we believe: (1) Historical dividend increases demonstrate that management is willing to raise dividends. (2) In order for dividend growth to be sustainable, it must ultimately be supported by earnings growth. (3) Companies whose dividend policies lay claim to a smaller portion of earnings may have a greater ability to reinvest earnings in future growth opportunities. (4) Finally, both the numerator and the denominator of a company's cash-to-debt ratio may provide useful information about its ability to maintain dividend payments. On the one hand, in the event that earnings temporarily falter, a healthy cash buffer may bolster a company's ability to avoid cutting dividends. On the other hand, a company's level of indebtedness may hinder its ability to maintain dividend payments during an earnings downturn since bondholders have a higher claim on cash flows than stockholders.

Sector Biases Favoring Dividend Growth Trends

The strategy described above tends to produce a different set of sector biases than many other dividend ETFs. For example, the two largest overweight allocations for RDVY relative to the S&P 500 Index are to the Financials and Consumer Discretionary sectors, both of which have produced above average dividend growth over the past three and five years. RDVY's allocation to the Information Technology sector, which has also had above average growth over the past three and five years, is only slightly less than the S&P 500 Index, but considerably higher than the average dividend ETF.

On the other hand, RDVY has significantly smaller allocations to certain high-yielding sectors with lower dividend growth trends. The fund has no exposure to the Utilities or Telecom Services sectors, and is significantly underweight the Consumer Staples and Energy sectors, all of which had slower dividend growth than the S&P 500 Index over the past three and five years.

Relative Valuations

While valuations for many dividend ETFs have risen to the level of broad equity benchmarks, we believe that RDVY offers a more compelling value. As of 3/31/17, RDVY's 2.38 price/book ratio provided a 20% discount to the S&P 500 Index, and its 16.28 price/earnings ratio, provided a 23% discount to the S&P 500 Index.[3]

Dividend Growth or High Yield?

We believe investors may be well served by reevaluating some of the strategies that have worked best over the past decade, including dividend ETFs. While high dividend yield proved to be a very attractive attribute in the context of ultra-low interest rates, the allure may lessen as rates move higher. For investors seeking dividend income, we believe the First Trust Rising Dividend Achievers ETF (RDVY) provides an attractive alternative, favoring dividend growth over high dividend yield, with more reasonable valuations.

[1]"Dividend ETFs" are defined here to include all US-listed equity ETFs with at least 80% allocated to US stocks, with a name that incorporates the word "dividend" or "income".

[2]The Morningstar Rating™ for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods. ©2017 Morningstar, Inc. All Rights Reserved. The Morningstar Rating™ information contained herein: (1) is proprietary to Morningstar; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.

[3]Source: Morningstar.

You should consider the 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 the 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.

The fund's return may not match the return of the NASDAQ US Rising Dividend Achievers Index. Securities held by the 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 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. If the 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

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 stock owned by the fund, fund shares or stocks in general may fall in value. There can be no assurance that the fund's investment objective will be achieved.

The fund may invest in securities issued by companies concentrated in a particular industry. The 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. The fund may invest in depositary receipts which may be less liquid than the underlying shares in their primary trading market.

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.

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