Consider the Less Expensive Defensive Trade

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Summary of 2018 ETF Flows and Trends[1]

- Total US-listed ETF assets dropped to $3.40 trillion at the end of 2018, a -1.2% decline from the end of 2017. Total estimated net flows for the year were $313 billion, roughly $152 billion slower than 2017's record-setting flows. The slight dip in assets was due to performance, not capital flows.
- Total assets increased in four ETF categories, including Municipal Bond ETFs (+21.3%), Taxable Bond ETFs (+12.4%), Allocation ETFs (+0.8%), and US Equity ETFs (+0.4%).
- US Equity ETFs had the strongest estimated net inflows in 2018 (+$143 billion), followed by Taxable Bond ETFs (+$91 billion), and International Equity ETFs (+$60 billion). No ETF category had estimated net outflows in 2018.

Table 1

	Total US-Listed ETF Assets		Estimated Net Asset Flows		
US Category Group	**As of 12/31/2018**	**Year-over-year % change**	**2018 Total**	**Q4 2018**	**Prior Quarter (Q3 2018)**
US Equity	$1,574,810,320,084	0.4%	$143,321,624,534	$54,106,719,892	$50,360,802,141
International Equity	$665,880,334,663	-9.2%	$60,014,433,281	$36,399,601,355	$1,819,126,343
Taxable Bond	$615,962,583,247	12.4%	$90,993,930,167	$24,181,939,494	$23,460,110,625
Sector Equity	$386,228,446,917	-10.3%	$4,841,786,535	($22,795,945,533)	$15,420,562,540
Commodities	$64,326,701,506	-4.4%	$852,325,076	$2,315,491,423	($3,119,347,858)
Alternative	$44,565,455,690	-12.0%	$5,073,934,539	$1,518,622,420	$1,199,173,830
Municipal Bond	$36,043,264,491	21.3%	$6,849,116,432	$3,264,475,770	$816,766,039
Allocation	$12,476,715,215	0.8%	$1,279,877,321	$575,206,094	$386,725,819
Total	**$3,400,293,821,813**	-1.2%	**$313,227,027,885**	**$99,566,110,915**	**$90,343,919,479**

A Snapshot of Q4 2018 ETF Flows and Trends[1]

- Overall, estimated net inflows for US listed ETFs totaled $100 billion in Q4 2018.
- Estimated net flows in equity-related ETFs were mixed in Q4, with US Equity ETFs seeing the strongest net inflows of any category (+$54 billion), followed by International Equity ETFs (+$36 billion). Sector Equity ETFs were the only category with estimated net outflows in Q4 (-$23 billion).
- Fixed income ETFs also fared relatively well in Q4, as estimated net inflows for Taxable Bond ETFs were $24 billion, slightly outpacing Q3's total, and Municipal Bond ETF flows accelerated to over $3 billion, accounting for nearly half of 2018's total.
- Commodities, Alternatives, and Allocation ETFs all had positive estimated net flows in Q4.

Source: Morningstar, as of 12/31/18. 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.

The sell-off in US equities in Q4 offered few places to hide as the S&P 500 Index declined by roughly 20% from its all-time high in September. Considering this drawdown, many investment advisors have begun seeking ways to position equity allocations more defensively. Unsurprisingly, quarterly net inflows for ETFs tracking low-volatility indices reached an all-time high in Q4, totaling $5 billion.[2] Total returns for the low volatility factor were considerably better than the broader market in Q4, at -8.8%, compared to -15.4% for the Russell 1000 Equal Weight Index, and -13.5% for the S&P 500 Index.[3] While hindsight may tempt investors to increase exposure to low volatility strategies heading into 2019, we believe relative valuations for many of these stocks may be stretched. Below, we discuss some of the pros and cons of low volatility strategies. We then highlight two multi-factor ETFs that combine low volatility with other defensive characteristics—such as high dividend yield and high quality—at more reasonable valuations.

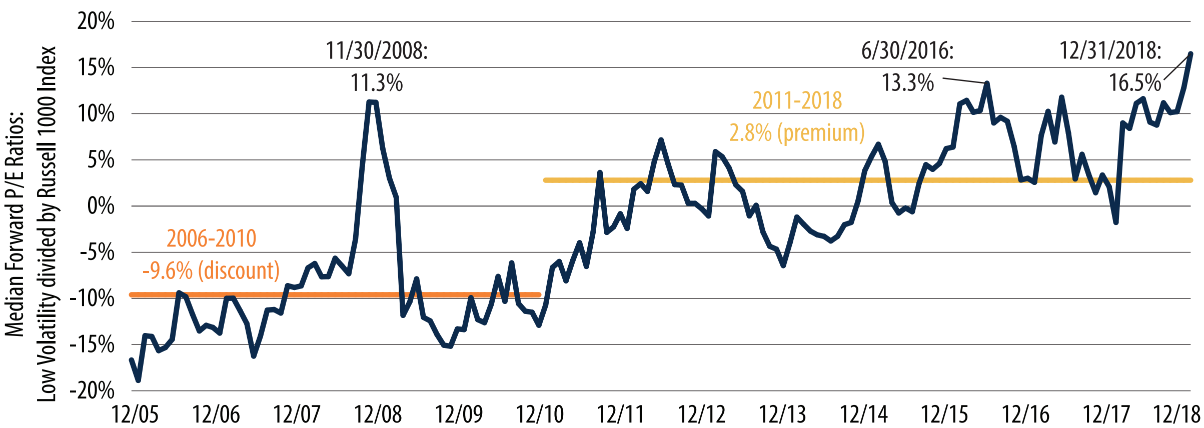
Why Low Volatility?

One of the fundamental assumptions of an efficient market is that a stock's level of risk should correspond with its expected future return. Hence, riskier, more volatile stocks should generally produce higher returns over time than safer, less volatile stocks. However, academic literature tracing back several decades has shown that this assumption does not always hold true. In fact, over many time periods, less volatile stocks have outperformed riskier stocks, on both an absolute and risk-adjusted basis. For example, over the past 20 years (ending on 12/31/18), while the S&P 500 Index produced a 5.6% average annual return with a 14.5% standard deviation, the low volatility factor produced a 9.9% average annual return with an 11.6% standard deviation. Granted, both the S&P MidCap 400 Index and S&P SmallCap 600 Index also outperformed during this period, with 9.0% and 9.3% average annual returns, respectively, but both also bore significantly more risk than the S&P 500 Index, with standard deviations of 16.7% and 18.4%, respectively.

Why Not?

While the merits of low volatility strategies have become widely accepted in recent years, with US equity low volatility ETF assets totaling over $30 billion, some have begun to question whether low volatility's popularity may eventually lead to its demise.[4] One commonly held theory to explain the outperformance of less volatile stocks in the past is that investors may over-invest in high-risk stocks, seeking the potential for outsized returns, while neglecting boring low-risk stocks. Consequently, less volatile stocks may become undervalued compared to riskier stocks. However, if this theory is true, some have argued that future outperformance of low volatility strategies may be harder to come by, since valuations of less volatile stocks have tended to be higher than the broader market in recent years.

Chart 1: Relative Valuations: Median Forward P/E Ratio of Low Volatility Factor divided by Median Forward P/E Ratio of Russell 1000 Index

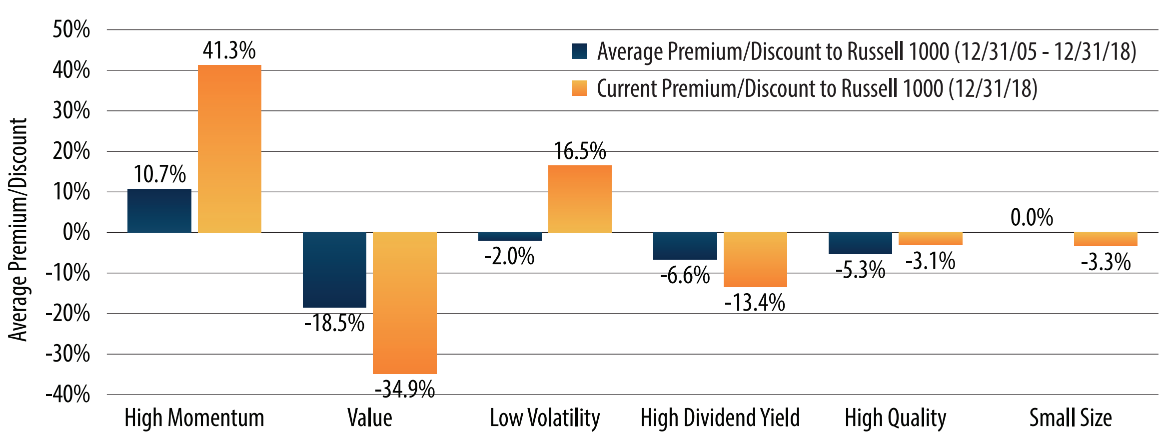


Source: FactSect and Clarifi & Capita IQ PIT data. For illustrative purposes only and does not represent any actual investment. All of the indices are unmanaged, statistical composites that cannot be purchased directly by investors.

Low Volatility Valuations in Context

During the five calendar years prior to the launch of the first low volatility ETFs (2006-2010), the low volatility factor traded at an average discount of almost 10% to the Russell 1000 Index, despite a notable premium during the sharp equity market decline in Q4 2008 and Q1 2009 (see Chart 1). In the eight calendar years since the first low volatility ETFs were launched (2011-2018), the low volatility factor traded at an average premium of nearly 3% to the Russell 1000 Index. Especially during periods of market turbulence, investors have been willing to pay up for the perceived safety of low volatility stocks. As of 12/31/18, the low volatility factor had a 19.1 median forward P/E ratio, compared to 16.4 for the Russell 1000 Index, representing a 16.5% premium. In the wake of Q4's equity sell-off, investment advisors must weigh whether or not higher relative valuations are warranted for less volatile stocks.

Chart 2: Factor Valuations Relative to Russell 1000 Index (Median Forward P/E)



Source: FactSect and Clarifi & Capita IQ PIT data. For illustrative purposes only and does not represent any actual investment. All of the indices are unmanaged, statistical composites that cannot be purchased directly by investors.

[1]Based on Morningstar data, as of 12/31/18. Includes all US-listed exchange-traded funds, exchange-traded notes, and other exchange-traded products.

[2]Source: Morningstar, First Trust. Including the 11 passive US equity ETFs with "low volatility" or "minimum volatility" in the funds' name, as of 12/31/18.

[3]Data source: Clarifi & Capita IQ PIT data. We recognize that there are different ways of defining certain factors. For the purposes of this newsletter, the following definitions apply: The low volatility factor is based on volatility over the previous 1 year (252 trading days). The high momentum factor is based on relative performance over the previous 1 year. The value factor is based on price to book ratio. The high dividend yield factor is based on trailing 12-month dividend yield. The high quality factor is based on return on equity. The small size factor is based on equity market capitalization. Each factor portfolio selects the top 30% from a universe of the 1,000 largest US firms with at least $1 million in average daily volume over the last 3 months. Stocks are then equally weighted, and rebalanced monthly.

[4]Source: Morningstar, First Trust, as of 12/31/18.

[5]Standard Deviation is a measure of price variability (risk). Downside capture is a measure of a fund's returns relative to its benchmark during periods in which benchmark returns are negative. Upside capture is a measure of a fund's returns relative to its benchmark during periods in which benchmark returns are positive.

[6]We have included full month performance from 6/30/13 to 12/31/18, which reflects the fund's current strategy. On June 4, 2013, the fund's underlying index changed to The Capital Strength Index℠ (the fund's current underlying index) from the Credit Suisse U.S. Value Index, Powered by HOLT™. On June 18, 2010, the fund's underlying index changed to the Credit Suisse U.S. Value Index, Powered by HOLT™ from the Deutsche Bank CROCI® US+ Index™.

Less Expensive Defensive Factors

While the low volatility factor has become more expensive than its long-term average, we believe other defensive factors, such as high dividend yield and high quality, offer more reasonable valuations. Since 12/31/05, both have tended to trade at cheaper valuations than the Russell 1000 Index, with a 6.6% average discount for the high dividend yield factor and a 5.3% average discount for the high quality factor (see Chart 2 on the previous page). As of 12/31/18, the high dividend-yield factor portfolio traded at a steep 13.4% discount, while the high-quality factor portfolio traded closer to its long-term average. Lastly, although it's not necessarily a defensive factor, we would also note that the value factor is currently trading at a steep discount to its long-term average.

Alternatives to Expensive Defensive ETFs

Investment advisors seeking ETFs with less expensive defensive attributes may wish to consider the First Trust Value Line Dividend Index Fund (FVD) and the First Trust Capital Strength ETF (FTCS), both of which provide exposure to multiple defensive factors, such as low volatility, high quality, and high dividend yield.

FVD screens its portfolio monthly to include stocks with a Value Line® Safety™ Ranking of #1 of #2 (the two highest scores) and a dividend yield higher than that of the S&P 500 Index, excluding stocks with a market cap below $1 billion. The Value Line Safety Ranking System is an assessment of stocks' volatility over the previous five years (favoring less volatile stocks), as well as "Financial Strength," which includes several measures of quality, such as a company's debt-to-capital ratio, returns on capital, and consistency of sales and profits (among others). In contrast to many low volatility strategies, FVD's 16.4 median forward P/E ratio was in line with the Russell 1000 Index, as of 12/31/18.

Over the past 15 years, FVD produced an 8.8% average annual return, with an 11.7% standard deviation, compared to the S&P 500 Index's 7.8% average annual return with a 13.5% standard deviation. Much of this outperformance can be attributed to the fund's relatively low downside capture ratio, which was just 74.1%, while still maintaining a 87.1% upside capture ratio. Of course, past performance is not a guarantee of future returns.[4,5]

FTCS selects its portfolio from a universe of 500 of the largest US stocks, screened quarterly for high-quality attributes, including: at least $1 billion in cash or short-term investments, a long-term debt to market cap ratio less than 30%, and a return on equity greater than 15%. From this group, 50 stocks with the lowest combined short-term (3-month) and long-term (12-month) realized volatility are selected. While FTCS's 17.2 median forward P/E ratio is slightly higher than the Russell 1000 Index, it remains notably cheaper than the low volatility factor, as of 12/31/18.

Since 6/30/13, FTCS has produced an 11.3% average annual return with a 10.6% standard deviation, compared to the S&P 500 Index's 10.7% average annual return with a 10.9% standard deviation. During this stretch, FTCS had a downside capture ratio of 86.7%, with an upside capture ratio of 95.8%. Past performance is not a guarantee of future returns.[4,5,6]

Over the past several years, the low volatility factor has become a widely-accepted defensive strategy, which has often worked quite well, especially in market drawdowns. However, given the recent run-up in relative valuations, we believe investment advisors seeking to position portfolios more defensively may be better-served by more reasonably priced defensive strategies, such as FVD and FTCS. While both ETFs screen for low volatility, they also screen for other attributes that tend to work well in turbulent markets.

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

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.

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

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.

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

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.

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Performance Summary (%)

As of 12/31/18	Inception Date	Net Expense Ratio	Gross Expense Ratio^	1 Year	5 Year	10 Year	Since Fund Inception
FTCS Performance*	7/6/06	0.61%	0.61%				
FTCS Net Asset Value (NAV)				-4.09	9.10	14.30	8.95
FTCS Market Price				-4.24	9.08	14.38	8.96
The Capital Strength Index℠**				-3.53	9.81	N/A	N/A
S&P 500 Index**				-4.38	8.49	13.12	7.82
FVD Performance*	8/19/03	0.70%	0.72%				
FVD Net Asset Value (NAV)				-3.44	8.87	12.53	9.17
FVD Market Price				-3.50	8.85	12.62	9.17
Value Line® Dividend Index**				-2.73	9.73	13.43	N/A
Dow Jones U.S. Select Dividend™ Index**				-5.94	8.49	12.26	N/A
S&P 500 Index**				-4.38	8.49	13.12	8.35

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.

^Expenses are capped contractually at 0.65% per year, at least until April 30, 2019 for FTCS; and at 0.70% per year, at least until April 30, 2019 for FVD.

*On June 4, 2013, FTCS's underlying index changed from the Credit Suisse U.S. Value Index, Powered by HOLT™ to The Capital Strength Index℠. On June 18, 2010, FTCS's underlying index changed from the Deutsche Bank CROCI® US+ Index™ to the Credit Suisse U.S. Value Index, Powered by HOLT™. Therefore, FTCS's performance and historical returns shown for the periods prior to these dates are not necessarily indicative of the performance that the fund, based on its current index, would have generated. On December 15, 2006, FVD acquired the assets and adopted the performance history of the First Trust Value Line® Dividend Fund, a closed-end fund. The investment goals, strategies and policies of the fund are substantially similar to those of the predecessor fund. Performance information for periods prior to December 15, 2006 is based on the performance history of the predecessor fund and reflects the operating expenses of the predecessor fund. **NAV** returns are based on the fund's net asset value which represents a fund's net assets (assets less liabilities) divided by a fund's outstanding shares. **Market Price** returns are based on the midpoint of the bid/ask spread on the stock exchange on which shares of a fund are listed for trading as of the time that a fund's NAV is calculated. Returns are average annualized total returns, except those for periods of less than one year, which are cumulative. The funds' performance reflects fee waivers and expense reimbursements, absent which performance would have been lower.

Indexes do not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown. Indexes are unmanaged and an investor cannot invest directly in an index. The **S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. The **Dow Jones U.S. Select Dividend™ Index** consists of 100 widely-traded, dividend-paying stocks derived from the Dow Jones U.S.Total Market Index℠.