As Dividends Become Scarcer, Will they Become More Valued?

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In the years that followed the 2008 financial crisis, ultra-low interest rates led many investors to seek income from sources outside the bond market, such as dividend-paying stocks. As interest rates have plummeted this year, we believe demand for dividend payers may swell once again. However, the COVID-19 crisis has led several companies to cut dividends. In our view, stocks that can maintain strong dividend policies may grow more attractive, as income-oriented investors chase fewer dividend payers. We believe dividend durability may be a key driver of performance for dividend ETFs in the months ahead.

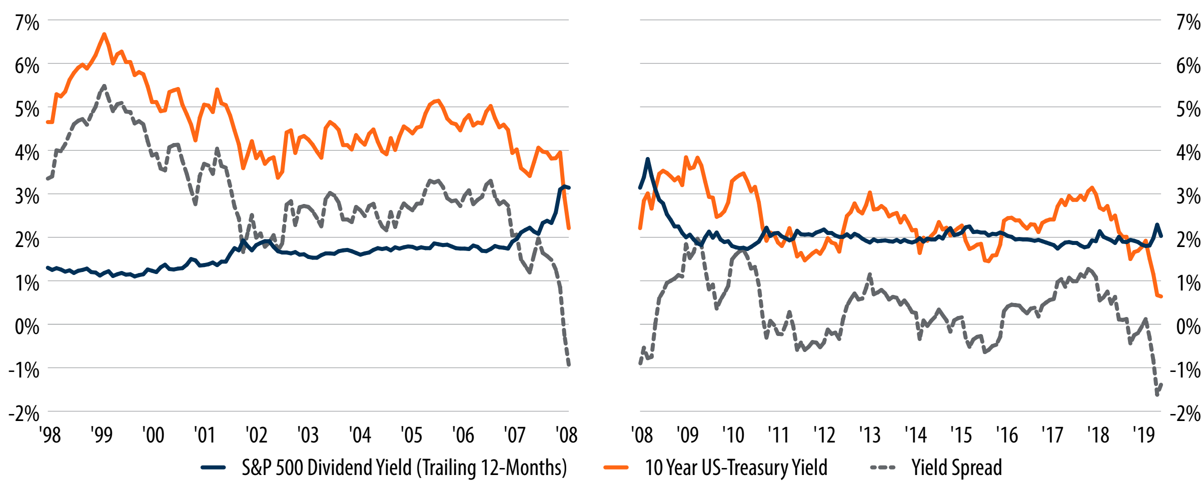
Low Interest Rates May Fuel Demand for Dividend ETFs

During the decade leading up to the 2008 financial crisis, the average 10-year US Treasury yield was roughly 3 percentage points higher than the average dividend yield for the S&P 500 index (see chart 1). That relationship changed in the years that followed thanks to the Federal Reserve's easing of monetary policy, which kept interest rates artificially low, as the average spread narrowed to just 0.4% from 2009-Q1 2020 (see chart 2). During that time, investors poured an estimated $108 billion into US-focused dividend ETFs.[1]

As interest rates across the yield curve have plummeted amid the COVID-19 crisis, we believe dividend ETFs may grow more attractive for income-oriented investors. As of 4/30/20, the trailing 12-month dividend yield for the S&P 500 Index (2.03%) was 1.39 percentage points higher than the 10-year US Treasury yield (0.64%).

S&P 500 Dividend Yield vs. 10-year US Treasury Yield

Chart 1: 1998 - 2008 Chart 2: 2008 - 2020



Source for Charts: Bloomberg.

Dividend Durability

One important caveat when considering dividend strategies for income is that dividends may be reduced or eliminated. Since investors often consider dividend cuts a sign that management is concerned about future growth or deteriorating fundamentals, US companies usually avoid them if possible. However, the unprecedented circumstances surrounding the COVID-19 crisis have led a growing number to decrease or suspend dividends over the past two months in order to preserve liquidity. According to S&P Dow Jones Indices, 36 stocks from the S&P 500 Index either decreased or suspended dividends in March and April, compared to just 4 during the prior 12-month period. On the other hand, the news surrounding dividends has not been all bad. In fact, 31 stocks from the S&P 500 Index initiated or raised dividends in March and April. Indeed, the crisis has begun to separate the wheat from the chaff, when it comes to dividend policies.

In our view, as demand for dividend-paying stocks picks up, those that maintain strong dividend policies in the months ahead may outperform those that don't. Below, we discuss a few ways that certain First Trust dividend ETFs may help identify stocks with more durable dividends.

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

First Trust Value Line® Dividend Index Fund (FVD)

FVD follows a rules-based strategy that was developed in 2003 and has since been stress-tested in a wide range of market environments. In our view, FVD's most important attributes related to durable dividends are:

- **Value Line® gives a Safety™ Ranking:** Only stocks ranked 1 or 2 (out of 5) for "Safety" qualify to be potential FVD holdings. Half of this score is determined by Value Line's quantitative assessment of a stock's financial strength, including various figures from its financial statements, while the other half is determined by how stable its price has been. In our view, this system provides a strong fundamental foundation upon which stable dividend policies may be built.
- **Monthly rebalancing:** FVD's underlying holdings are re-evaluated and rebalanced monthly. In a rapidly changing market environment, this may enable the ETF to react more quickly than dividend ETFs that rebalance less often. While its median annual turnover has been around 55% since 2003, the strategy has been much more active in volatile markets, such as 2008 (109% turnover) and 2009 (101% turnover). Over that 2-year period, FVD outperformed the S&P 500 Index by 11% and the Dow Jones US Select Dividend Index by 14%.

First Trust Rising Dividend Achievers ETF (RDVY)

RDVY was designed to identify stocks that are well-positioned to raise dividends. While dividend increases may be less common than usual for the next few quarters, there are a few characteristics of this strategy that may also help identify stocks that are well-positioned to avoid dividend cuts, in our opinion.

- **High cash to debt ratio:** In order to qualify as one of RDVY's potential holdings, companies must have a cash to debt ratio greater than 50%. In our view, both sides of this ratio may impact the durability of a stock's dividend, especially if earnings decline. On the one hand, since interest on debt must be paid before dividends, companies with fewer liabilities may be better positioned to maintain dividends. On the other hand, strong cash reserves may provide a stopgap to help support dividend payments. As of 4/30/20, RDVY's median net debt to market cap was 1%, compared to 57% for the Dow Jones US Select Dividend Index, and its median cash & marketable securities was $5.0 billion, compared to $661 million for the Dow Jones US Select Dividend Index.[2]
- **Low dividend payout ratio:** RDVY screens for stocks with trailing 12-month dividend payout ratios below 65%. In our view, companies that pay less of their earnings in dividends may be more likely to maintain these payments if earnings decline. As of 4/30/20, RDVY's median dividend payout ratio was 29%, compared to 60% for the Dow Jones US Select Dividend Index.

First Trust NASDAQ Technology Dividend Index Fund (TDIV)

TDIV invests roughly 80% of its assets in dividend-paying technology stocks, and roughly 20% in dividend-paying telecommunications stocks. Interestingly, while tech stocks accounted for roughly 17.1% of the S&P 500 index's total dividend over the past year—the largest of any sector—it remains the largest underweight for most dividend ETFs.[3] This conundrum stems from a tendency of dividend strategies to screen for stocks with longstanding dividend policies—sometimes extending back multiple decades—and stocks with the highest dividend yields. While few technology stocks meet either criteria, we believe the sector is currently among the best-positioned for dividend durability. While the COVID-19 crisis has negatively impacted the earnings outlook for most companies, society's dependence on the products and services provided by many technology companies has remained relatively strong amid shelter-in-place orders. Moreover, TDIV is well-positioned, based on several of the metrics discussed above including:

- **High cash reserves:** The weighted average cash & marketable securities for TDIV is $38.1 billion. While this figure is somewhat skewed by Microsoft and Apple, which hold $134 billion and $206 billion, respectively, TDIV's weighted average excluding these two heavyweights is $10.7 billion, as of 4/30/20.
- **Low net debt to market cap:** TDIV's median net debt to market cap was 9%, as of 4/30/20.
- **Low dividend payout ratio:** TDIV's median dividend payout ratio was 44%, as of 4/30/20.

If the period that followed the 2008 financial crisis is any indication, the US Federal Reserve may be exceedingly hesitant to raise interest rates any time soon. As the economy emerges from the COVID-19 crisis, and as investors seek opportunities to generate income, we believe stocks with strong and healthy dividend policies may play a more prominent role in investors' portfolios. While fears of dividend cuts lurk in the background, we believe dividend ETFs positioned for dividend durability may outperform those that focus on maximizing dividend yield.

[1] Source: First Trust and FactSet.

[2] Net debt measures a company's total debt minus its cash and marketable securities.

[3] Compared to the S&P 500.

Performance Summary (%)

As of 3/31/20	Inception Date	Net Expense Ratio	Gross Expense Ratio^	1 Year	5 Year	10 Year	Since Fund Inception
FVD Performance*	8/19/03	0.70%	0.71%				
FVD Net Asset Value (NAV)				-12.57	5.25	9.75	8.32
FVD Market Price				-12.60	5.23	9.75	8.32
Value Line® Dividend Index**				-11.86	6.08	10.63	N/A
Dow Jones U.S. Select Dividend™ Index**				-21.70	2.73	8.91	N/A
S&P 500 Index**				-6.98	6.73	10.53	8.06
RDVY Performance*	1/6/14	0.00%	0.50%				
RDVY Net Asset Value (NAV)				-12.54	4.80	N/A	6.05
RDVY Market Price				-12.51	4.81	N/A	6.06
NASDAQ US Rising Dividend Achievers Index**				-12.14	5.35	N/A	6.60
Dow Jones U.S. Select Dividend™ Index**				-21.70	2.73	N/A	4.66
TDIV Performance*	8/13/12	0.00%	0.50%				
TDIV Net Asset Value (NAV)				-5.13	8.41	N/A	10.66
TDIV Market Price				-5.21	8.30	N/A	10.65
NASDAQ Technology Dividend Index℠**				-4.51	9.11	N/A	11.37
S&P 500 Information Technology Index**				10.43	17.05	N/A	16.91
S&P 500 Index**				-6.98	6.73	N/A	10.60

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 0.70% per year, at least until April 30, 2021 for FVD.

*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. FVD's 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℠.

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 security owned by a fund, fund shares or securities in general may fall in value. There can be no assurance that the fund's investment objective will be achieved. The outbreak of the respiratory disease designated as COVID-19 in December 2019 has caused significant volatility and declines in global financial markets, which have caused losses for investors. The impact of this COVID-19 pandemic may be short term or may last for an extended period of time, and in either case could result in a substantial economic downturn or recession.

The funds may invest in a concentrated portfolio which involves additional risks including limited diversification.

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

A fund may invest in securities issued by companies concentrated in a particular industry or sector which involves additional risks including limited diversification.

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. These risks may be heightened for securities of companies located in, or with significant operations in, emerging market countries. A fund may invest in depositary receipts which may be less liquid than the underlying shares in their primary trading market.

TDIV is classified as "non-diversified" and may invest a relatively high percentage of their assets in a limited number of issuers. As a result, the funds 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.

There is no guarantee that any issuer will declare dividends in the future, or that, if declared, they will remain at current levels or increase over time.

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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