Inside First Trust ETFs

May 2021 | Vol. 47

Author:

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

Co-author:

Andrew Hull
Associate ETF Strategist
First Trust Advisors L.P.

Diversifying Risk Management with Target Outcome ETFs®– Buffer Series

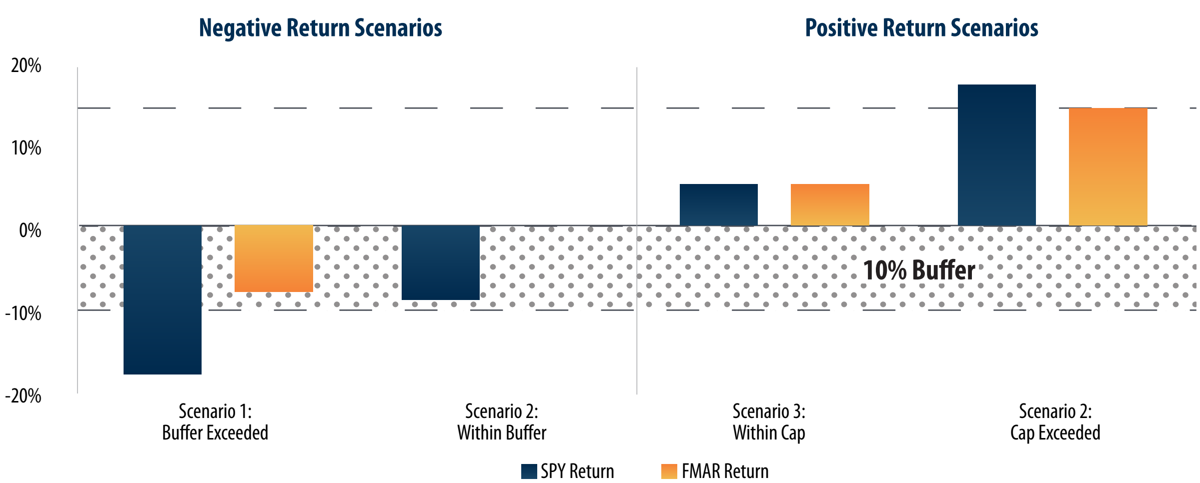
In recent years, the ETF industry has flourished as a proliferation of new strategies has provided investment professionals with a more robust set of tools for managing their clients' wealth. Factor-based, thematic, and actively managed ETFs have grown rapidly, as investors' appetites have expanded beyond ETFs tracking more traditional benchmarks. Among the newest generation of ETFs, those employing "buffered" strategies have seen some of the strongest growth in 2021, with year-to-date net inflows accounting for $871 million of the category's $6.6 billion in total assets under management (as of 3/31/21). As the fastest growing provider of buffered ETFs—known as Target Outcome ETFs® – Buffer Series (Buffer ETFs)—First Trust believes the popularity of this category is poised to explode in the coming years as investment professionals and their clients grow more familiar with how they work, the potential advantages of employing these strategies within an ETF wrapper, and the role they may play within clients' portfolios.

What are Buffer ETFs?

Buffer ETFs enjoy many of the most popular features of traditional ETFs, including intraday liquidity, portfolio transparency, and tax-efficiency. But unlike traditional ETFs, Buffer ETFs utilize options[1] to provide exposure to a reference asset—such as the S&P 500 Index, the Nasdaq 100 Index, the MSCI EAFE Index, or even gold—while offering some degree of protection against downside participation. Effectively, the cost of this limited downside protection is financed by capping upside returns over a set period, referred to as an outcome period. The ETF itself is perpetual, so after one outcome period ends, a new outcome period begins, and the terms of the ETF are reset based on prevailing market conditions.

To illustrate a range of potential outcomes, consider the four hypothetical scenarios presented in the diagrams below for the FT CBOE Vest U.S. Equity Buffer ETF – March (FMAR). This ETF provides exposure to the SPDR® S&P 500® ETF Trust (SPY) with an upside cap of 14.2%, and a buffer against the first 10% of losses for SPY over the 12-month outcome period (3/22/21-3/18/22). Based on these terms, if SPY were to decline by 18% over the outcome period, as in the first hypothetical scenario, FMAR's expected return would be -8%, since the first 10% of losses are protected. In the second hypothetical scenario, FMAR's expected return would be flat since SPY declined by less than 10%. In the third hypothetical scenario, FMAR's expected return would be equivalent to that of SPY, since it appreciated less than the cap. Finally, in the fourth hypothetical scenario, FMAR's expected return would be equivalent to the 14.2% cap, since SPY appreciated more than the cap.

Hypothetical Return Scenario Outcomes[2]



The Outcome Period Values may only be realized for an investor who holds shares for the outcome periods shown.

Important: The examples are based on hypothetical reference asset returns, do not reflect actual investment results and are not a guarantee of future results. The returns shown do not account for payment of fees and expenses so the actual return would be lower.

Importantly, these hypothetical scenarios assume a holding period that encompasses the entire outcome period. If an investor buys ETF shares after the beginning of an outcome period, potential return scenarios will reflect prevailing market conditions and current option pricing. To help calculate these terms, First Trust's website provides a tool that shows updated terms throughout the trading day. Similarly, if an investor sells ETF shares before the end of the outcome period, they may be worth more or less than the reference asset, based on the current value of the underlying options.

Potential ETF advantages

While the underlying strategies employed by Buffer ETFs have been utilized by institutional investors for many years, we believe there are several potential advantages offered by using such strategies within an ETF. For example, Buffer ETFs offer daily portfolio transparency, disclosing which options positions are held by the fund. This provides more transparent pricing and helps market makers facilitate intraday trading for the ETF. Moreover, Buffer ETFs do not carry issuer credit risk.

Buffer ETFs are also perpetual investments that can be held over long periods of time. Although the underlying options contracts have an expiration date, new options positions are seamlessly implemented at the end of each outcome period and are priced based on prevailing market conditions. ETFs may also utilize certain portfolio management techniques, such as in-kind exchanges, to pursue tax efficiency.

What role can Buffer ETFs play?

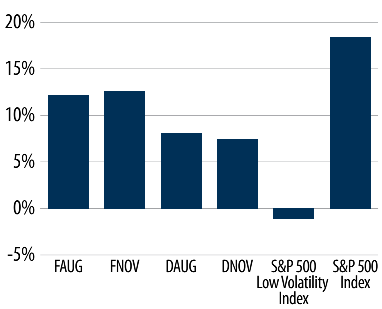
Investment professionals have begun to utilize Buffer ETFs in several interesting ways. One of the most intriguing, in our view, is to provide another layer of risk management, beyond traditional modern portfolio theory. One critique of modern portfolio theory that reemerged in 2020 is that it assumes that correlations between asset classes remain relatively stable, and that by combining asset classes with historically low or negative correlations—such as stocks and bonds—one can reduce overall portfolio volatility. However, while correlations may be fairly durable under most circumstances, they may deteriorate during periods of severe drawdowns, when the benefits of diversification are needed most. For example, during the week after the World Health Organization officially declared Covid-19 a pandemic in 2020, the S&P 500 Index declined by 12.5%, while the Bloomberg Barclays US Aggregate Bond Index posted a loss of over 4.0% (3/11/20-3/18/20). Both were down.

On the other hand, the risk management provided by Buffer ETFs is not dependent on historical correlations, but rather on the downside buffer provided by options contracts. By providing layers of risk management, investment professionals may help their clients to feel more confident staying the course when the market sells off.

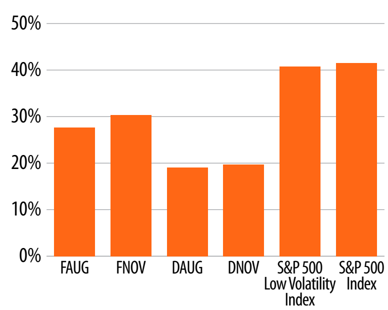
Buffer ETFs are also being used to replace or complement factor-based low volatility ETFs. Because many low volatility ETFs favor the stability of mature, slow growth stocks, they often thrive in markets characterized as "risk off" and vice versa. Buffer ETFs may also be less volatile due to the options strategies described above, even while returns are linked to indices with stronger "growth" characteristics, such as the S&P 500 Index or Nasdaq 100 index.

2020 was an especially difficult year for many low volatility indices, such as the S&P 500 Low Volatility Index, which not only underperformed the S&P 500 Index, it did so with a higher standard deviation and larger maximum drawdown than the benchmark. On the other hand, the two FT CBOE Vest US Equity Buffer ETFs (FAUG and FNOV, which have downside buffers from 0% to -10%) and two FT CBOE Vest US Equity Deep Buffer ETFs (DAUG and DNOV, which have downside buffers from -5% to -30%) that began trading prior to 2020 (thus providing full calendar year returns) all had significantly lower standard deviation and significantly smaller maximum drawdowns than the benchmark (see charts).

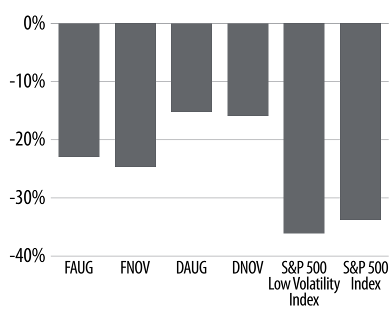
2020 Total Returns



2020 Standard Deviation



2020 Max Drawdown



Source: Morningstar.

We believe the growth of Buffer ETFs is just getting started. Investment professionals are growing more comfortable with how these strategies work, and how they may be used to help their clients achieve their goals. Clients gain additional layers of risk management and benefit from the liquidity, transparency, and tax-efficiency of ETF investing. First Trust currently has a broad lineup of Buffer ETFs available with various buffer levels and reference assets to fit a variety of client objectives. For additional educational resources, planning tools, and details on specific First Trust Target Outcome ETFs®, visit www.ftportfolios.com.

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.

[1]Options are contracts between two parties that provide the owner of the option the right to buy (call option) or sell (put option) a reference asset at a predetermined price on or before a specific date. Option sellers collect a premium in exchange for the obligation to buy or sell the reference asset.

[2]Each hypothetical scenario refers to expected returns before fees and expenses. Upside cap is 14.2% before fees and expenses, and 13.35% after fees and expenses, excluding brokerage commissions, trading fees, taxes and extraordinary expenses not included in the fund's management fee.

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.

Risk Considerations

The funds have characteristics unlike many other traditional investment products and may not be appropriate for all investors.

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 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.

If a reference asset experiences gains during a target outcome period, a fund will not participate in those gains beyond the cap. In the event an investor purchases fund shares after the first day of a target outcome period and the fund has risen in value to a level near to the cap, there may be little or no ability for that investor to experience an investment gain on their fund shares. Similarly, in the event an investor purchases fund shares after the first day of a target outcome period, the buffer the fund seeks to provide may not be available. A shareholder may lose their entire investment.

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.

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 COVID-19 pandemic may last for an extended period of time and will continue to impact the economy for the foreseeable future.

In managing a fund's investment portfolios, the advisor will apply investment techniques and risk analyses that may not have the desired result. There can be no assurance that a fund's investment objectives will be achieved.

A fund may be a constituent of one or more indices or models which could greatly affect a fund's trading activity, size and volatility.

The use of options and other derivatives can lead to losses because of adverse movements in the price or value of the underlying asset, index or rate, which may be magnified by certain features of the derivatives.

The funds may invest in FLEX Options that reference an ETF, which subjects the funds to certain of the risks of owning shares of an ETF as well as the types of instruments in which the reference ETF invests.

Because the funds may hold FLEX Options that reference the index and/or reference ETFs, the funds have exposure to the equity securities markets.

The FLEX Options held by the funds will be exercisable at the strike price only on their expiration date. Prior to the expiration date, the value of the FLEX Options will be determined based upon market quotations or other recognized pricing methods.

There can be no guarantee that a liquid secondary trading market will exist for the FLEX Options and FLEX options may be less liquid than exchange-traded options.

The funds' investment strategy is designed to deliver returns that match the reference asset if a fund's shares are bought on the day on which a fund enters into the FLEX Options (i.e., the first day of a target outcome period) and held until those FLEX Options expire at the end of the target outcome period. If an investor does not hold its fund shares for an entire target outcome period, the returns realized by that investor may not match those a fund seeks to achieve. In the event an investor purchases fund shares after the first day of a target outcome period or sells shares prior to the expiration of the target outcome period, the value of that investor's investment in fund shares may not be buffered against a decline in the value of the reference asset and may not participate in a gain in the value of the reference asset up to the cap for the investor's investment period.

A new cap is established at the beginning of each target outcome period and is dependent on prevailing market conditions. As a result, the cap may rise or fall from one target outcome period to the next and is unlikely to remain the same for consecutive target outcome periods.

A fund that effects all or a portion of its creations and redemptions for cash rather than in-kind may be less tax-efficient.

High portfolio turnover may cause a fund's performance to be less than expected.

A fund may be subject to the risk that a counterparty will not fulfill its obligations which may result in significant financial loss to a fund.

As the use of Internet technology has become more prevalent in the course of business, the fund has become more susceptible to potential operational risks through breaches in cyber security.

Large inflows and outflows may impact a new fund's market exposure for limited periods of time.

The funds intend to qualify as "regulated investment companies" ("RICs"), however, the federal income tax treatment of certain aspects of the proposed operations of the funds are not entirely clear. If, in any year, the funds fail to qualify as RICs under the applicable tax laws, the funds would be taxed as ordinary corporations.

The funds are classified as "non-diversified" and may invest a relatively high percentage of its 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.

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.

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, the Internal Revenue Code or any other regulatory framework. Financial professionals are responsible for evaluating investment risks independently and for exercising independent judgment in determining whether investments are appropriate for their clients.

Cboe® is a registered trademark of Cboe Exchange, Inc., which has been licensed for use in the name of the funds. The funds are not sponsored, endorsed, sold or marketed by Cboe Exchange, Inc. or any of its affiliates ("Cboe") or their respective third-party providers, and Cboe and its third-party providers make no representation regarding the advisability of investing in the funds and shall have no liability whatsoever in connection with the funds.

The funds are not sponsored, endorsed, sold or promoted by SPDR® S&P 500® ETF Trust, PDR, or Standard & Poor's® (together with their affiliates hereinafter referred to as the "Corporations"). The Corporations have not passed on the legality or suitability of, or the accuracy or adequacy of, descriptions and disclosures relating to the funds or the FLEX Options. The Corporations make no representations or warranties, express or implied, regarding the advisability of investing in the funds or the FLEX Options or results to be obtained by the funds or the FLEX Options, shareholders or any other person or entity from use of the SPDR® S&P 500® ETF Trust. The Corporations have no liability in connection with the management, administration, marketing or trading of the funds or the FLEX Options.

Definitions

The **S&P 500 Index** is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. The returns shown are price only. The **MSCI EAFE Index** is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The **Nasdaq 100 Stock Index** includes 100 of the largest domestic and international non-financial companies listed on the Nasdaq Stock Market based on market capitalization. The **Bloomberg 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, ABS, and CMBS. The **S&P 500 Low Volatility Index** measures performance of the 100 least volatile stocks in the S&P 500. Investors cannot invest directly in an index.

Performance Summary (%)

As of 3/31/21	Inception Date	Expense Ratio	1 Month	YTD	1 Year	Since Fund Inception
DAUG Performance*	11/6/2019	0.85%				
NAV			1.83	2.17	21.47	8.84
After Tax Held			1.83	2.17	21.47	8.84
After Tax Sold			1.09	1.29	12.71	6.76
Market Price			1.66	1.81	20.39	8.56
Index Performance**						
S&P 500® Index			4.24	5.77	53.71	20.07
DNOV Performance*	11/15/2019	0.85%				
NAV			2.03	2.25	21.46	8.39
After Tax Held			2.03	2.25	21.46	8.39
After Tax Sold			1.20	1.33	12.70	6.42
Market Price			1.85	2.04	20.70	8.21
Index Performance**						
S&P 500® Index			4.24	5.77	53.71	19.24
FAUG Performance*	11/6/2019	0.85%				
NAV			2.92	3.60	33.26	13.59
After Tax Held			2.92	3.60	33.26	13.59
After Tax Sold			1.73	2.13	19.69	10.42
Market Price			2.80	3.49	32.83	13.48
Index Performance**						
S&P 500® Index			4.24	5.77	53.71	20.07
FNOV Performance*	11/15/2019	0.85%				
NAV			3.07	3.54	35.32	13.90
After Tax Held			3.07	3.54	35.32	13.90
After Tax Sold			1.82	2.10	20.91	10.65
Market Price			3.05	3.72	33.65	13.88
Index Performance**						
S&P 500® Index			4.24	5.77	53.71	19.24

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.

*__NAV__ returns are based on the fund's net asset value which represents the fund's net assets (assets less liabilities) divided by the fund's outstanding shares. **Market Price** returns are determined by using the midpoint of the national best bid offer price ("NBBO") as of the time that the fund's NAV is calculated. Returns are average annualized total returns, except those for periods of less than one year, which are cumulative.

**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.