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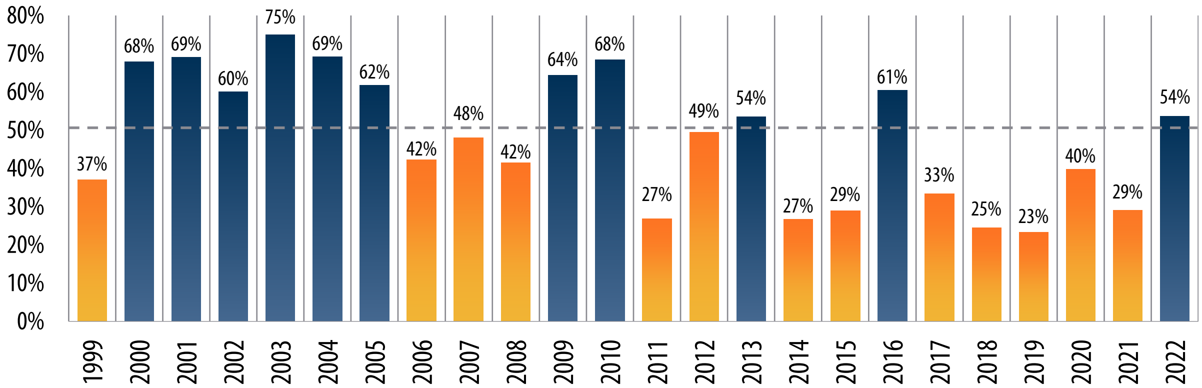
Is the Era of S&P 500 Index Invincibility Over?

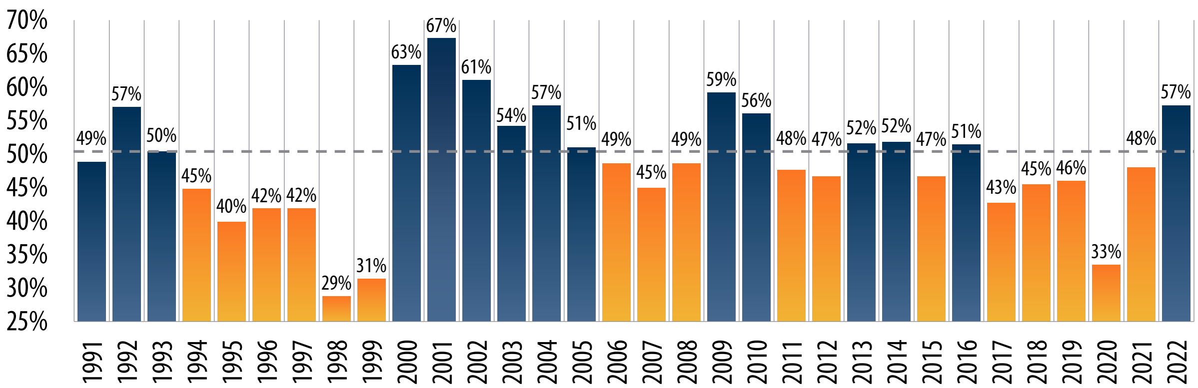
Over the past several years, the S&P 500 Index has seemed nearly invincible. From 2017-2021, the index outperformed an average of 70% of all US equity and sector exchange-traded funds (ETFs) each year (chart 1). Excess returns were scarce. However, as equities drew down in 2022, the pendulum began to swing in the opposite direction. For the first time since 2016, the S&P 500 Index underperformed more than half of all US equity ETFs. Interestingly, bear markets and/or recessions have historically marked changes in equity market leadership, which can last for several years. In our view, new market leadership may also correspond with more potential for generating excess returns with ETFs.

Chart 1: Percentage of Equity ETFs (US Equity and Sector) that Outperformed the S&P 500 Index



Source: Morningstar. 1/1/99-12/31/22. **Past performance is no guarantee of future results.**

Chart 2: Percentage of S&P 500 Members that Outperformed the S&P 500 Index



Source: Capital IQ. 12/31/90-12/31/22. **Past performance is no guarantee of future results.**

A Broader Equity Market May Provide More Opportunities for Excess Returns

We believe two key factors made the S&P 500 Index unusually difficult to beat in recent years. First, many of the index's top holdings posted exceptional returns. From 2016-2021, Apple (+552%), Microsoft (+482%), Alphabet (+266%), and Amazon (+345%) were each among the index's best performing decile.[1] Second, because the index is market capitalization weighted, allocations to these stocks increased significantly over time, magnifying their impact. On 12/31/16, these four stocks made up less than 10% of the S&P 500 Index.[2] By 12/31/21, their weightings had increased to nearly 21%.[3] During the same 5-year period (2017-2021), an average of 57% of S&P 500 Index constituents underperformed the index (chart 2). This narrow market corresponded with a scarcity of equity ETFs that managed to beat the index (chart 1).

Just as the seeds of a broader equity market in 2000-2005 were sown by a narrower market from 1994-1999, we think the narrowness of the equity market from 2017-2021 may produce a broader market in the years ahead (chart 2). On average, 62% of the S&P 500 Index's constituents underperformed the index from 1994-1999, but over the next 6 years (2000-2005), that average decreased to 41% as the dot-com crash and recession brought about a shift in market leadership.[4] If history repeats, we believe this may be good news for ETF investors, as market breadth and ETF outperformance have gone hand in hand. On average, the percentage of US equity and sector ETFs that outperformed the S&P 500 Index from 2000-2005 surged to 67%.[5] This pattern continued during the 2022 bear market, when many of the S&P 500 Index's largest constituents faltered and a higher percentage of its constituents outperformed the index, as well as a higher percentage of equity ETFs.

[1]Bloomberg.12/30/16-12/31/21.
[2,3]FactSet. 12/30/16-12/31/21.
[4,5]Capital IQ. 12/31/90-12/31/22.

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The Hunt for Excess Returns

If equity returns continue to broaden, we believe more opportunities for excess returns among ETFs may emerge over the next several years. In our opinion, investors seeking outperformance should consider equally weighted ETFs, factor-based ETFs, and sector/thematic ETFs.

Equally Weighted ETFs

We believe equally weighted ETFs are the simplest solution for avoiding the top-heavy concentration found in many market-cap weighted ETFs. For example, the First Trust NASDAQ-100 Equal Weighted Index Fund (QQEW) invests in the same 100 stocks as the market-cap weighted Nasdaq 100 Index. However, QQEW assigns a 1% weighting to portfolio holdings each quarter. For reference, the Nasdaq 100 Index allocated 41% to its top 5 holdings, as of 12/31/22.[6]

Similarly, the First Trust Dow 30 Equal Weight ETF (EDOW) invests in the same 30 stocks as the Dow Jones Industrial Average, rebalancing its portfolio quarterly. On the other hand, the Dow Jones Industrial Average is a price-weighted index, meaning that underlying share prices determine index weightings. As a result of this unusual weighting methodology, the Dow Jones Industrial Average allocated 34% to its top 5 holdings, as of 12/31/22.[7]

Factor-Based ETFs

In our opinion, certain factor-based ETFs—often referred to as "strategic beta" funds—may also benefit from a broader equity market. These ETFs favor a variety of characteristics that have historically produced above average returns over time. For example, the First Trust Large Cap Core AlphaDEX® ETF (FEX) screens for value, momentum, and profitability when selecting stocks and assigning portfolio weightings. Stocks that score better for these metrics have larger allocations, while the worst scoring stocks are eliminated. Based on this methodology, the top 10 holdings of the S&P 500 Index made up just 1.3% of FEX, as of 12/31/22.[8]

The First Trust Value Line® Dividend Fund (FVD) is another factor-based ETF that may benefit from a broader equity market, in our opinion. This ETF invests in an equally weighted portfolio of stocks that have been ranked 1 or 2 (out of 5) for Safety™ by Value Line, which also have a higher than average dividend yield than the S&P 500 Index. In our opinion, equity markets may reward stable, high quality, dividend-paying stocks with stronger relative performance during periods of slowing economic growth.

Sector or Thematic ETFs

Finally, sector and thematic ETFs may be utilized to narrowly focus on specific segments of the equity market, many of which are not well-represented in the S&P 500 Index. For example, the First Trust NYSE®Arca® Biotechnology Fund (FBT) is an equally weighted ETF that invests in 30 leading biotechnology stocks. As we've written about recently, we believe the biotechnology industry is not only well positioned within a sector that tends to behave more defensively, but also is poised to benefit from a wave of innovation facilitated by other technological advances, such as artificial intelligence/machine learning and cloud computing. However, FBT's holdings represented just 2% of the S&P 500 Index, as of 12/31/22.

After a decade of outstanding relative returns, we believe cracks in the myth of S&P 500 Index invincibility are starting to form. That doesn't mean the index will be easy to beat. But if equity market performance continues to broaden, we believe there will be more opportunities for investment professionals to generate excess returns with ETFs in the years ahead.

[6] Factset. As of 12/31/22.

[7,8] Bloomberg. As of 12/30/22.

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.

Risks

You could lose money by investing in a fund. An investment in a fund is not a deposit of a bank and is not insured or guaranteed. There can be no assurance that a fund's objective(s) will be achieved. Investors buying or selling shares on the secondary market may incur customary brokerage commissions. Please refer to each fund's prospectus and SAI for additional details on a fund's risks. The order of the below risk factors does not indicate the significance of any particular risk factor.

ETF shares may only be redeemed directly from a fund by authorized participants in very large creation/redemption units. Fund shares may trade at a discount to net asset value and possibly face delisting.

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. In February 2022, Russia invaded Ukraine which has caused and could continue to cause significant market disruptions and volatility within the markets in Russia, Europe, and the United States. The hostilities and sanctions resulting from those hostilities could have a significant impact on certain fund investments as well as fund performance. The COVID-19 global pandemic and the ensuing policies enacted by governments and central banks have caused and may continue to cause significant volatility and uncertainty in global financial markets. While the U.S. has resumed "reasonably" normal business activity, many countries continue to impose lockdown measures. Additionally, there is no guarantee that vaccines will be effective against emerging variants of the disease.

A fund's return may not match the return of its underlying index. A fund invests in securities included in the index regardless of investment merit and the securities held by a fund will generally not be bought or sold in response to market fluctuations.

Securities of non-U.S. issuers are 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.

Securities of small- and mid-capitalization companies may experience greater price volatility and be less liquid than larger, more established companies. Large capitalization companies may grow at a slower rate than the overall market.

A fund with significant exposure to a single asset class, country, region, industry, or sector may be more affected by an adverse economic or political development than a broadly diversified fund.

Stocks with growth characteristics tend to be more volatile than certain other stocks and their prices may fluctuate more dramatically than the overall stock market.

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.

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