Navigating Opportunities in Senior Loan and High Yield Corporate Bond ETFs

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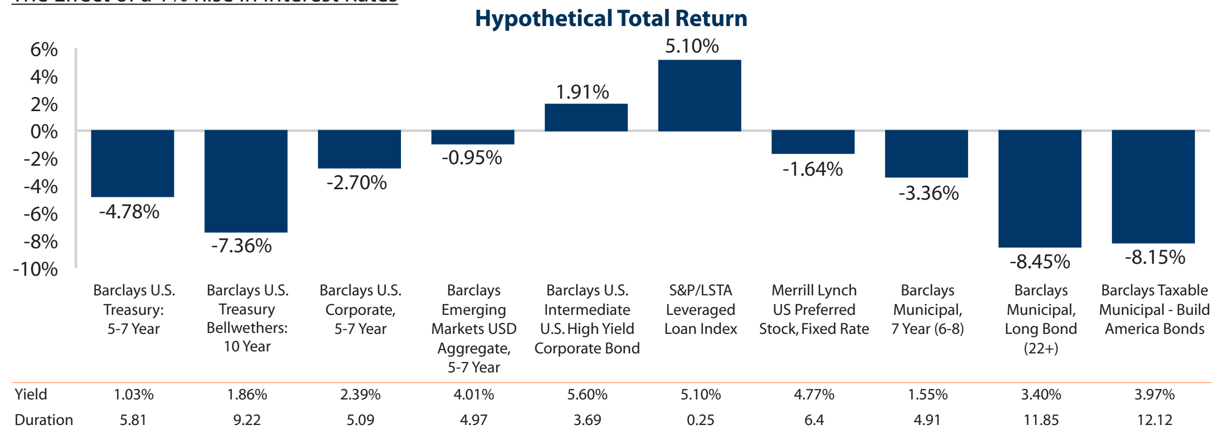
Investors needing to generate income in today's low interest rate environment are faced with distinct challenges in seeking to meet their return objectives, while balancing the risks to which they are exposed. This situation is complicated by the tendency for investors to focus on certain risks, while ignoring others. Case in point: many bond investors have been conditioned to focus primarily on credit risk—the risk that a bond issuer will fail to repay its debt with interest—while failing to consider how an increase in interest rates may cause a significant decline in the value of bonds that were assumed to be relatively "safe" (see chart below). This concept is particularly challenging for the present generation of investors whose experience over the past 30+ years has been in the context of a secular bull market for bonds, in which yields have consistently trended lower while bond prices have trended higher.

The Effect of a 1% Rise in Interest Rates



	Barclays U.S. Treasury: 5-7 Year	Barclays U.S. Treasury Bellwethers: 10 Year	Barclays U.S. Corporate, 5-7 Year	Barclays Emerging Markets USD Aggregate, 5-7 Year	Barclays U.S. Intermediate U.S. High Yield Corporate Bond	S&P/LSTA Leveraged Loan Index	Merrill Lynch US Preferred Stock, Fixed Rate	Barclays Municipal, 7 Year (6-8)	Barclays Municipal, Long Bond (22+)	Barclays Taxable Municipal - Build America Bonds
Yield	1.03%	1.86%	2.39%	4.01%	5.60%	5.10%	4.77%	1.55%	3.40%	3.97%
Duration	5.81	9.22	5.09	4.97	3.69	0.25	6.4	4.91	11.85	12.12

Source: Barclays and Bank of America/Merrill Lynch. The table illustrates hypothetical examples and does not represent the return on any particular investment. Data as of 3/31/13. Effective duration is used for the preferred index and modified adjusted duration for all others. The performance figures are for illustrative purposes only and do not account for all factors that may potentially impact returns. Index returns do not include 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.

Barclays U.S. Treasury: 5-7 Year contains securities in the Treasury Index with a maturity from 5 up to (but not including) 7 years. **Barclays U.S. Treasury Bellwethers: 10 Year** is an unmanaged index of U.S. Treasury bonds with 10 years' maturity. **Barclays US Corporate 5-7 years** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market. **Barclays EM USD Aggregate: 5-7 Year** is a flagship hard currency Emerging Markets debt benchmark that includes fixed and floating-rate US dollar-denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers. **Barclays Intermediate U.S. High Yield** is the Intermediate component of the U.S. Corporate High Yield index and covers the universe of fixed rate, non-investment grade debt. **Barclays Municipal Bond: 7 Year (6-8)** is the 7 Year (6-8) component of the Municipal Bond index. **Barclays Municipal Bond: Long Bond (22+)** is the Long Bond (22+) component of the Municipal Bond index. **Barclays Taxable Municipal - Build America Bonds** includes all direct pay Build America Bonds in the Barclays Capital Taxable Municipal Index. **The BofA Merrill Lynch Fixed Rate Preferred Securities Index** tracks the performance of fixed rate US dollar denominated preferred securities issued in the US domestic market. **The S&P/LSTA (Loan Syndications and Trading Association) U.S. Leveraged Loan Index** tracks the current outstanding balance and spread over LIBOR for fully funded term loans. **Duration** is a measure of its price sensitivity to interest rate movements based on the weighted average term to maturity of its interest and principal cash flows.

In this newsletter, we will consider how senior loan and high yield corporate bond ETFs may be utilized by investors to pursue a higher level of income while seeking to mitigate the impact of rising interest rates. We'll discuss why we believe benchmark indices are flawed investment strategies for gaining exposure to these asset classes, and we'll highlight how First Trust utilizes active management to seek better risk-adjusted returns than passive senior loan and high yield corporate bond index ETFs.

The case for senior loan and high yield ETFs

Perhaps the most attractive attribute of high yield bonds and senior loans is the relatively high level of income offered by these securities compared to investment grade bonds. While the current low interest rate environment has made it increasingly difficult for investors to reinvest capital from recently matured (or called) bonds at interest rates adequate to meet return objectives, the S&P/LSTA Leveraged Loan Index and the Barclays US Intermediate High Yield Corporate Bond Index have yields of 5.1% and 5.6%, respectively, compared to the 2.4% yield for the Barclays US Investment Grade Corporate Bond, 5-7 Year Index (as of 3/31/13).

Additionally, senior loans and high yield corporate bonds may provide diversification benefits to fixed income portfolios due to the relatively low, and even negative, correlations between these asset classes and investment grade corporate bonds and US Treasuries (see matrix to the right).

10-Year Monthly Correlation Matrix[1]

	1	2	3	4
1	1.00			
2	0.53	1.00		
3	-0.41	0.37	1.00	
4	-0.21	0.59	0.85	1.00

1 Barclays US Treasury: 7-10 Year
2 Barclays US Corporate Investment Grade Index
3 S&P/LSTA US Leveraged Loan Index
4 Barclays Intermediate US High Yield Index

The low correlations between these asset classes are largely due to differences in their respective sensitivity to changes in interest rates and credit conditions. On the one hand, US Treasuries and investment grade corporate bonds are both highly sensitive to interest rate changes but less sensitive to credit conditions; on the other hand, senior loans and high yield corporate bonds tend to be quite sensitive to changes in credit conditions, but less sensitive to interest rate changes.

This has important implications as the US economy continues to strengthen, which will likely lead to rising interest rates in the future, resulting in falling bond prices. For example, following simple bond arithmetic, a hypothetical 1% increase in interest rates would result in an estimated 5.1% decline in the value of the Barclays US Investment Grade Corporate Bond, 5-7 Year Index, effectively wiping away 2 years' worth of interest income (as of 3/31/13, see chart above).

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

Senior loans tend to carry very little interest rate risk since they are typically structured as floating rate instruments; issuers are obligated to pay an interest rate that is pegged to a floating rate benchmark, notably LIBOR. For senior loan investors, credit risk is a much more important consideration. Prices are positively impacted by improving economic conditions and corporate fundamentals, which typically result in narrowing credit spreads, and negatively impacted by deteriorating conditions, which typically result in widening credit spreads.

Similarly, high yield corporate bonds are quite sensitive to credit conditions, but unlike senior loans, typically pay a fixed interest rate. As such, they are generally more exposed to interest rate risk than senior loans, but less so than investment grade bonds. The latter is due to the fact that interest rate increases often coincide with periods of relatively strong corporate fundamentals, wherein credit spreads are decreasing, thus offsetting some of the negative impact that rising interest rates have on bond prices.

Market cap weighted indices and risk-management

Over the past few years, ETFs have been a popular choice for investors looking to gain exposure to senior loans and high yield corporate bonds, with assets reaching $33.8 billion.[2] While the vast majority of these assets are invested in ETFs that track market-cap weighted benchmark indices, we believe this approach is fundamentally flawed.

Our primary complaint lies in the fact that an investor tracking these indices is effectively lending more capital to the most indebted issuers, and less to the least indebted issuers, irrespective of the borrowers' ability to repay their debts. We believe that such an approach is lacking in terms of risk-management.

Moreover, index-based approaches to investing in senior loans and high yield bonds may expose investors to credit risk for which they are not being adequately compensated. For example, from 1920-2011, the average annual default rate for BB and B rated bonds was 1.07% and 3.42%, respectively, while the annual default rate for CCC rated bonds averaged 13.77% over the same time period.[3] This large increase in defaults does not necessarily suggest that investors should avoid CCC rated securities altogether, in our opinion, since these issues may offer relatively high total returns. However, in light of the historical volatility associated with CCC rated credits and their respective default rates, the risk of investing broadly in the lowest-quality category of high yield bonds, without additional credit analysis, typically outweighs the benefits, in our opinion. As of 3/31/13, the two largest high yield bond index ETFs allocated between 11%-12% to CCC or lower rated bonds, and the largest senior loan index ETF allocated more than 16% to CCC rated issues.[4]

Actively managed senior loan and high yield ETFs

In light of the risks and opportunities that are available for senior loan and high yield investors, First Trust offers two actively managed ETFs: the First Trust Senior Loan Fund (FTSL) and the First Trust High Yield Long/Short ETF (HYLS). Both follow a rigorous and disciplined investment process wherein the underlying assets are selected based on an evaluation of the macro-economy, industry trends, consistency of cash flows, collateral coverage, and management quality; portfolio construction focuses on relative value within a risk management framework. We believe this process provides added value to investors versus passive index-based ETFs.

From our perspective, senior loan ETFs and high yield corporate bond ETFs both present appealing alternatives to investment grade bonds. In addition to offering relatively attractive yields, we believe the current environment of modest economic growth, with low default rates, and generally sound corporate health is supportive of below-investment grade credit performance. Moreover, while credit spreads have steadily narrowed over the past 18 months, we believe investors are still being fairly compensated for taking credit risk. Looking forward, however, as economic conditions evolve, investors may benefit from reevaluating positions in index-based high yield and senior loan ETFs, in favor of actively managed strategies that may be better equipped for risk management.

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

[1] Zephyr StyleADVISOR monthly data, 3/31/03-3/31/13

[2] As of 3/31/13, according to Bloomberg

[3] Standard & Poor's

[4] Standard & Poor's and Bloomberg
Current default rates may vary from their historical average and there can be no assurance that default rates will not rise in the future.

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 each fund. The prospectus or summary prospectus should be read carefully before investing.

ETF Characteristics and Risks

The funds list and principally trade their shares on the NASDAQ Stock Market LLC.

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.

Senior floating rate loans are usually rated below investment grade but may also be unrated. As a result, the risks associated with these loans are similar to the risks of high yield fixed income instruments. High yield securities are subject to greater market fluctuations and risk of loss than securities with higher ratings.

The funds are subject to management risk because they have an actively managed portfolio. In managing the funds' investment portfolios, the advisor will apply investment techniques and risk analyses that may not have the desired result. There can be no guarantee that the funds will meet their investment objectives.

The funds are subject to market risk. Market risk is the risk that a particular security owned by the funds or shares of the funds in general may fall in value.

Senior Loan and high-yield securities are subject to numerous risks, including credit risk, interest rate risk, income risk, prepayment risk, economic recession, deterioration of the junk bond market, possible downgrades and defaults of interest and/or principal. These securities are issued by companies that may have limited operating history, narrowly focused operations, and/or other impediments to the timely payment of periodic interest and principal at maturity.

Lower-quality debt tends to be less liquid than higher-quality debt. HYLS may invest in Distressed Securities and many Distressed Securities are illiquid or trade in low volumes and thus may be more difficult to value.

The funds invest in securities of non-U.S. issuers. Such securities are subject to higher volatility than securities of domestic issuers.

Companies that issue loans tend to be highly leveraged and thus are more susceptible to the risks of interest deferral, default and/or bankruptcy. Loans are subject to pre-payment risk. The degree to which borrowers prepay loans may be affected by general business conditions, the financial condition of the borrower and competitive conditions among loan investors, among others. The fund may not be able to reinvest the proceeds received on terms as favorable as the prepaid loan.

The funds currently intend to effect a significant portion of creations and redemptions for cash, rather than in-kind securities. As a result, the funds may be less tax-efficient than if they were to sell and redeem their shares principally in-kind.

In times of unusual or adverse market, economic, regulatory or political conditions, HYLS may not be able, fully or partially, to implement its short selling strategy.

FTSL is classified as "non-diversified." A non-diversified fund generally may invest a larger percentage of its assets in the securities of a smaller number of issuers. As a result, the fund may be more susceptible to the risks associated with these particular issuers, or to a single economic, political or regulatory occurrence affecting these 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.

Not FDIC Insured • Not Bank Guaranteed • May Lose Value