Inside First Trust ETFs

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2014: Halftime Trends for ETFs

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Asset flows for the ETF industry gained steam during the second quarter of 2014, as net inflows totaled $61.8 billion, bringing the total for the first half of 2014 to $74.3 billion.[1] Net inflows for the first half of 2014 were dominated by international equity ETFs (+$24.5 billion), sector ETFs (+$22.1 billion), and taxable bond ETFs (+$22.1 billion). Conversely, net asset flows remained negative for commodity ETFs during the first half of 2014 (-$459 million). In this newsletter, we'll take a closer look at each of these categories, highlighting various opportunities among the First Trust family of ETFs.

International Equity ETFs

Net asset flows for international equity ETFs accelerated dramatically from the first quarter (+$1.5 billion) to the second quarter (+$22.9 billion). Within this group, European equity ETFs attracted the strongest net inflows during both quarters, totaling $13.5 billion for the first half of 2014. This continued a trend that emerged in 2013 when net inflows for European equity ETFs totaled $21.9 billion.

Despite significant imbalances in the distribution of Europe's economic recovery among constituent nations, and mounting geopolitical concerns, many ETF investors remain bullish on European stocks. This positive outlook is bolstered by the European Central Bank's commitment to keep interest rates low for an "extended period of time"[2], the region's return to positive economic growth (Chart 1), a declining unemployment rate (Chart 2), and steadily improving consumer confidence (Chart 3).

Chart 1[3]
Europe: GDP Growth Rate (YoY)

Chart 2[4]
Europe: Unemployment Rate

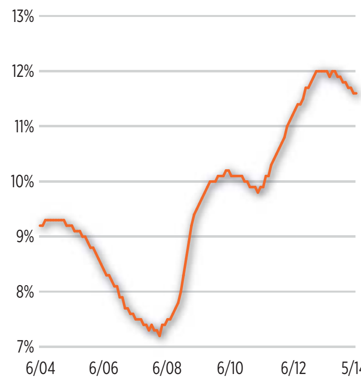
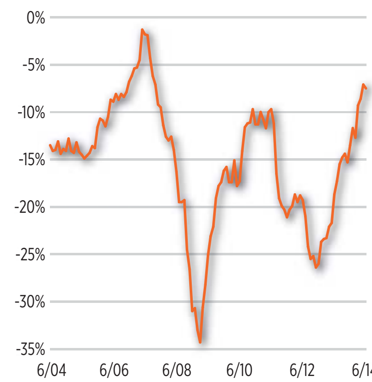


Chart 3[5]
Europe: Consumer Confidence



Data from Bloomberg.

For ETF investors seeking exposure to Europe:

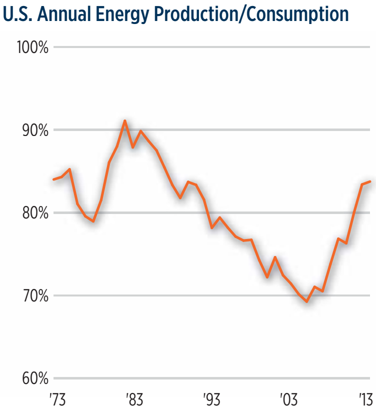
- » The First Trust Europe AlphaDEX® Fund (FEP) provides broad exposure to European equities. This ETF tracks an index which employs the AlphaDEX® methodology to select and weight a portfolio of 200 stocks from the S&P Europe BMI universe.
- » The First Trust STOXX® European Select Dividend Index Fund (FDD) provides exposure to a portfolio of 30 high dividend-yielding stocks selected from a universe encompassing 18 European countries.

Sector ETFs

As a category, sector ETFs also received strong net inflows during the first half of 2014, exceeding $11 billion in both quarters. Among this group, energy-related ETFs attracted the strongest net inflows, as traditional equity energy ETFs received $5.4 billion and energy Master Limited Partnership (MLP) ETFs received $2.3 billion. While energy MLP ETFs also garnered strong net inflows from investors in 2013 at $4.4 billion, net inflows for traditional equity energy ETFs had been relatively weak in 2013 at $1.1 billion.

Renewed interest in the energy sector, which tends to perform better during periods of positive economic growth, is supported by several factors. The boom in US energy production, particularly for unconventional shale plays, has continued to gain steam over the past several years. According to the US Department of Energy, total US energy production satisfied nearly 84% of domestic energy consumption in 2013, compared to 70% in 2004 (Chart 4). Meanwhile, as the proportion of domestic production to consumption continues to grow, the Obama administration has begun to loosen a ban on crude oil exports that originally began in the 1970s, following the Arab oil embargo. While the initial Commerce Department ruling that lifted the ban on exports of ultra-light oil known as condensate only applied to two companies, a broader loosening of restrictions could allow energy producers to potentially sell oil at higher prices overseas.[7]

Chart 4[6]
U.S. Annual Energy Production/Consumption



Data from U.S. Energy Information Administration.

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

First Trust

ETF investors seeking exposure to the energy sector have several options:

» The First Trust Energy AlphaDEX® Fund (FXN) provides broad exposure to the energy sector. This ETF tracks an index which employs the AlphaDEX® methodology to construct a portfolio of energy companies selected from the Russell 1000 Index.
» The First Trust ISE-Revere Natural Gas Index Fund (FCG) is an equal-weighted equity ETF that provides exposure to companies that generate a substantial portion of their revenues from the exploration and production of natural gas.
» The First Trust North American Energy Infrastructure Fund (EMLP) is an actively managed ETF that provides exposure to energy MLPs and other publically-traded securities related to energy infrastructure.
» The First Trust NASDAQ® Clean Edge® Green Energy Index Fund (QCLN) is an ETF that provides exposure to companies engaged in the manufacturing, development, distribution, and installation of emerging clean-energy technologies.
» The First Trust ISE Global Wind Energy Index Fund (FAN) is an ETF that provides exposure to companies involved in the wind energy industry.

Taxable Bond ETFs

The third strongest ETF category for net asset flows during the first half of 2014 was taxable bond ETFs, which totaled $21.1 billion. Notably, the three strongest groups in this category were intermediate-term bond ETFs, long-term government bond ETFs, and corporate bond ETFs (Table 1 below).

Table 1

Taxable Bond ETF Net Flows	1st Half 2014	2013
Intermediate-Term Bond ETFs	$4,979,495,551	$149,630,317
Long-Term Government Bond ETFs	$4,064,919,371	($1,230,527,723)
Corporate Bond ETFs	$3,369,460,613	($7,669,750,477)

The strength of net inflows for taxable bond ETFs in categories with longer durations[8] reflected a renewed willingness on the part of investors to accept increased interest rate risk. This marked a reversal from 2013, when many of these categories had net outflows. This new disposition may be due to the easing of intermediate- and long-term interest rates during the first half of 2014, which sent bond prices higher. From 12/31/13 through 6/30/14, the yield on 10-year US Treasuries decreased by 0.50% from 3.03% to 2.53%, while the yield on 30-year US Treasuries decreased by 0.61% from 3.97% to 3.36%.

While intermediate- and long-term bonds play an important role in enhancing diversification for investment portfolios, we believe investors should not be complacent about interest rate risk in the months ahead. In our opinion, declining yields during the first half of 2014 may reflect a flight to safety in light of the weaker-than-expected -2.9% US real GDP growth rate in the first quarter. First Trust economists believe that an unusually rough winter was primarily to blame for this stall in economic growth. If growth accelerates during the rest of 2014, US Treasury yields may increase as well. By year end, First Trust forecasts 10-year US Treasury yields to reach 3.25%, and 30-year US Treasury yields to reach 4.05%.

Investors may choose to prepare for a potential increase in interest rates by reducing interest rate risk and potentially taking more credit risk in their bond allocations. ETF investors may consider the following ETFs from the First Trust ETF lineup:

» The First Trust Senior Loan Fund (FTSL) is an actively managed ETF which invests primarily in first lien senior floating-rate bank loans. Interest rate risk tends to be minimal for these securities due to their floating rate interest payments, while credit risk tends to be a more important consideration since borrowers' credit ratings tend to be below-investment grade. As of 6/30/14, the fund's weighted average effective duration was 0.75 years.
» The First Trust Tactical High Yield ETF (HYLS) is an actively managed ETF that invests primarily in fixed-rate bonds issued by below-investment grade issuers. As of 6/30/14, HYLS had a -11.79% weight in US Treasury securities resulting from the fund's short position in US Treasury securities, which served to shorten the portfolio's effective duration and reduce interest rate risk. As of 6/30/14, the fund's net weighted average effective duration was 3.17 years[9].
» The First Trust Preferred Securities and Income ETF (FPE) is an actively managed ETF that invests primarily in preferred securities. As of 6/30/14, the fund allocated 70.9% of its portfolio to fixed-to-floating rate securities[10], which tend to have shorter durations than fixed rate securities. As of 6/30/14, the fund's weighted average effective duration was 4.47 years.
» The First Trust Managed Municipal ETF (FMB) is an actively managed ETF that invests primarily in municipal debt securities which pay interest that is exempt from regular federal income taxes. As of 6/30/14, the fund's weighted average effective duration was 6.84 years.

Commodity ETFs

The weakest category of ETFs for net asset flows during the first half of 2014 was commodity ETFs, with net outflows totaling $459 million. However, this was a relatively small total compared to 2013's net outflows which totaled $29.8 billion. Overall, precious metals ETFs were the strongest group during the first half of 2014 with net inflows totaling $228 million, despite $654 million in net outflows in the second quarter, which largely offset $882 million in net inflows in the first quarter. Broad commodity ETFs had the strongest net inflows in the second quarter, totaling $268 million.

As we've discussed in recent ETF newsletters and blog posts, we believe there are compelling reasons for investors to consider increasing allocations to this relatively unloved asset class. First, following a prolonged period of weak returns, we believe commodities may be due for a rebound. Second, commodities may provide a hedge against inflation. And third, the US economy may be entering (or already in) the phases of the business cycle during which exposure to a broad portfolio of commodities is most useful (namely the second half of expansions and the first half of recessions).

For ETF Investors seeking exposure to a broad portfolio of commodities:

» The First Trust Global Tactical Commodity Strategy Fund (FTGC) is an actively managed ETF that provides exposure to a diversified portfolio of commodity futures. Unlike many other commodity ETFs, which issue K-1 tax forms, this fund intends to report taxable gains and losses on a Form 1099.

[1]The source for all estimated net asset flows data in this newsletter is Morningstar Direct.

[2]Recently reaffirmed by Mario Draghi, President of the European Central Bank, during a press conference in Frankfurt on July 3, 2014.

[3]Eurozone GDP Chain Linked 2005 Prices (SWDA, YoY%). SWDA is seasonally and working day adjusted ("working day" adjustments seek to smooth out the differences in business or trading days between different months).

[4]Eurostat Unemployment Rate- Eurozone (Seasonally Adjusted%).

[5]European Commission Consumer Confidence Indicator- Eurozone (Seasonally Adjusted, %Balance/Diffusion Index).

[6]June 2014 Monthly Energy Review, US Energy Information Administration.

[7]"U.S. Ruling Loosens Four-Decade Ban on Oil Exports," The Wall Street Journal, June 24, 2014.

[8]Weighted average effective duration is a measure of a bond's sensitivity to interest rate changes that reflects the change in a bond's price given a change in yield.

[9]Includes short positions. A short position agrees to sell the asset when the contract expires and stands to profit as long as the underlying asset price goes down.

[10]A fixed-to-floating rate security has a coupon rate that is fixed for a certain period of time (typically five, ten or thirty years from the time of issuance), after which the coupon resets at a floating rate based on a spread over the security's benchmark (typically 3-month LIBOR).

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

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 underlying index. Securities held by an index fund will generally not be bought or sold in response to market fluctuations.

The funds may not be fully invested at times. 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.

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.

The funds may invest in securities issued by companies concentrated in a particular sector, industry or country 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.

An investment in a fund containing securities of foreign issuers is subject to additional risks, including currency fluctuations, political risks, withholding, the lack of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be heightened for securities of companies located in, or with significant operations in, emerging market countries. Additionally, the funds may invest in depositary receipts. Depositary receipts may be less liquid than the underlying shares in their primary trading market.

Preferred securities, high-yield securities, municipal bonds and senior loans are subject to credit risk, interest rate risk and income risk. Credit risk is the risk that an issuer of a security will be unable or unwilling to make dividend, interest and/or principal payments when due and the related risk that the value of a security may decline because of concerns about the issuer's ability to make such payments. Credit risk may be heightened if a fund invests in "high-yield" or "junk" debt. Interest rate risk is the risk that if interest rates rise, the prices of the fixed-rate instruments held by a fund may fall. Income risk is the risk that if interest rates fall, the income from a fund's portfolio will decline as a fund may hold floating rate debt that will adjust lower with falling interest rates. High-yield securities are also subject to prepayment risk. Prepayment risk is the risk that an issuer of a loan may exercise its right to pay principal on an obligation earlier than expected. This may result in a fund reinvesting proceeds at lower interest rates, resulting in a decline in a fund's income.

Risk Considerations Cont'd

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.

Lower-quality debt tends to be less liquid than higher-quality debt.

FTSL, HYLS, FMB and FTGC 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. Short selling creates special risks which could result in increased volatility of returns and may result in greater gains or greater losses.

Income from FMB may be subject to the federal alternative minimum tax. FMB may invest in zero coupon bonds which may be highly volatile as interest rates rise or fall. Income from municipal bonds held by FMB could be declared taxable because of, among other things, unfavorable changes in tax laws, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. Participation interests in municipal leases pose special risks.

The trading prices of commodities futures, fixed income securities and other instruments fluctuate in response to a variety of factors. The value of commodities and commodity-linked instruments typically is based upon the price movements of a physical commodity or an economic variable linked to such price movements. The prices of commodities and commodities-linked instruments may fluctuate quickly and dramatically and may not correlate to price movements in other asset classes.

FTGC does not invest directly in futures instruments. Rather, it invests in a wholly-owned subsidiary, which has the same investment objective as the fund, but unlike the fund, it may invest without limitation in futures instruments. FTGC, through the subsidiary, will engage in trading on commodity markets outside the United States. Trading on such markets is not regulated by any United States government agency and may involve certain risks not applicable to trading on United States exchanges. Commodity futures contracts traded on non-U.S. exchanges or with non-U.S. counterparties present risks because they may not be subject to the same degree of regulation as their U.S. counterparts.

FTGC's strategy may frequently involve buying and selling portfolio securities to rebalance the fund's exposure to various market sectors which may result in the fund paying higher levels of transaction costs and generating greater tax liabilities for shareholders.

FTGC may be subject to the forces of the "whipsaw" markets (as opposed to choppy or stable markets), in which significant price movements develop but then repeatedly reverse, which could cause substantial losses to the fund.

With the exception of HYLS, the funds are 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, these funds may be more susceptible to the risks associated with these particular companies, or to a single economic, political or regulatory occurrence affecting these companies.

EMLP, FTSL, HYLS, FPE, FMB and FTGC are subject to management risk because they are actively managed portfolios. In managing a fund's investment portfolio, the advisor or sub-advisor will apply investment techniques and risk analyses that may not have the desired result. There can be no guarantee that a fund will meet its investment objective.

First Trust Advisors L.P., the investment adviser of FTGC, is registered as a commodity pool operator and commodity trading advisor and is also a member of the National Futures Association.

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.

This material is not intended to be relied upon as investment advice or recommendations.