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Money Market Reform and the Opportunity for Enhanced Cash ETFs

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Summary of Q3 2016 Estimated ETF Flows and Trends

Table 1

US Category Group	Total US-Listed ETF Assets (9/30/16)	Estimated Net Asset Flows Q3 2016	Estimated Net Asset Flows Previous Quarter (Q2 2016)
Allocation	$9,012,445,901	$630,677,855	$345,313,522
Alternative	$46,119,558,522	$2,075,251,225	$739,232,664
Commodities	$74,628,093,075	$1,497,278,635	$6,886,284,801
International Equity	$451,888,983,169	$4,865,011,911	($3,794,719,754)
Municipal Bond	$23,486,175,634	$1,782,373,768	$1,536,454,947
Sector Equity	$325,172,782,795	$9,291,526,825	$3,349,163,295
Taxable Bond	$425,099,303,687	$27,288,757,436	$13,111,259,062
US Equity	$1,065,357,948,717	$45,623,733,095	$12,027,267,494
Total	$2,420,765,291,500	$93,054,610,750	$34,200,256,031

Source: Morningstar, as of 9/30/16. Includes all US-listed exchange-traded funds, exchange-traded notes and other exchange-traded products.

- Overall US listed ETF net inflows totaled $93.1 billion in Q3, accelerating significantly from $34.2 billion in net inflows in the previous quarter.
- The strongest category for net asset flows was US Equity ETFs, with $45.6 billion in net inflows in Q3, compared to $12 billion in net inflows in Q2.
- Flows into Taxable Bond ETFs also remained strong in Q3, accelerating to $27.3 billion in net inflows, compared to $13.1 billion in net inflows in Q2.
- Net asset flows into Sector Equity ETFs turned positive for 2016, as net inflows accelerated to $9.3 billion, compared to $3.3 billion in net inflows in Q2.
- After two straight quarters of net outflows, International Equity ETFs reversed course with net inflows totaling $4.9 billion in Q3.

All net inflow and outflow numbers are estimates based on information provided by Morningstar.

Money Market Reform and the Opportunity for Enhanced Cash ETFs

On October 14, 2016, the final provisions for money market fund (MMF) reform took effect, but these long-awaited regulatory changes have already begun to have significant effects on MMFs. Below, we present a summary of some of the key elements of MMF reform, along with an assessment of potential opportunities that have emerged for investors in non-money market ETFs that employ enhanced cash strategies, such as the First Trust Enhanced Short Maturity ETF (FTSM).

Money Market Reform in Context

The motivation for enacting MMF reform came principally from the contribution that regulators believe MMFs had to the bank liquidity crisis in the fall of 2008. Historically, one of the most important attributes of MMFs has been their use of special accounting conventions, which enable the funds to maintain a stable $1.00 per share net asset value (NAV) on a daily basis.[1] In September of 2008, a large MMF known as the Reserve Primary Fund, which held commercial paper issued by Lehman Brothers, was forced to reprice its NAV to $0.97 (known as "breaking the buck") following the bankruptcy of Lehman Brothers. This led to a run on "prime" MMFs, which invest in debt securities issued by non-government borrowers assessed to present minimal credit risk (as Lehman Brothers had been considered). During the month of September of 2008, prime MMFs faced $214 billion of net redemptions, while $273 billion of net creations flowed into government MMFs, which invest solely in debt securities issued by the US government.[2] For banks that were reliant on issuing commercial paper as a source of short-term funding, the resulting lack of demand from prime MMFs created a liquidity crunch.

On October 14, 2014, the SEC issued its "final rule" on money market fund reform, for which compliance was to be required in stages over the subsequent two years. A majority of these provisions, such as rules related to portfolio diversification, stress testing, and portfolio disclosure, took effect on April 14, 2016. But what may be the most significant rule changes for MMFs, in our opinion, took effect on October 14, 2016. These provisions affect how MMFs are allowed to calculate fund NAVs and provide daily liquidity, based on how an MMF is categorized. (See Table 2 on the following page). Under the new rules, while "stable NAV" pricing will still be allowed for government and retail MMFs—enabling both to maintain a daily $1.00 NAV—institutional MMFs are now required to calculate a floating NAV, based on underlying market prices. As for MMF liquidity constraints, retail and institutional MMFs are now allowed to impose fees or suspend redemptions (i.e., "gates") if weekly liquid assets fall below 30% of total assets. If liquid assets fall below 10% of total assets, these funds are required to impose a 1 percent "liquidity fee".[3] On the other hand, government MMFs are not required to impose liquidity fees or gates.

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

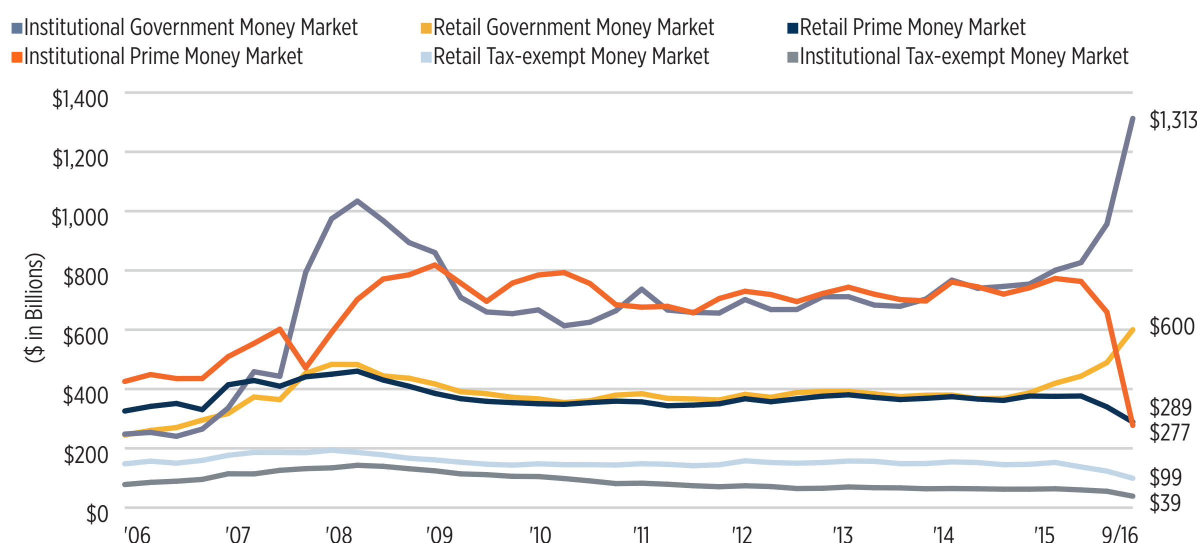
Table 2

Money Market Fund Category	NAV Pricing	Fund Liquidity Constraints?
Government	Stable NAV	No Liquidity Fees/Gates
Retail (prime and tax-exempt)	Stable NAV	Liquidity Fees and Gates
Institutional (prime and tax-exempt)	Floating NAV	Liquidity Fees and Gates

Investor Behavior in Light of Money Market Fund Reform

As the deadline for new regulations involving NAV pricing and fund liquidity approached this year, a massive shift began from prime MMFs into government MMFs, for both institutional and retail investors. According to Morningstar, during the second and third quarters, assets in institutional prime MMFs and retail prime MMFs declined by $486 billion (-64%) and $88 billion (-23%), respectively, while assets in institutional government MMFs and retail government MMFs increased by $486 billion (+59%) and $157 billion (+35%), respectively. (See Chart 1 below). Unlike the panic-induced shift out of prime MMFs that took place in September of 2008, which subsided in the following months, we believe the shift that's taken place this year may be more permanent. While the prior shift occurred as investors sought to reduce credit risk in favor of government guarantees, the latter has corresponded with permanent rule changes that have not only eliminated stable NAV pricing for institutional MMFs, but also pose the risk that retail and institutional MMFs may limit investors' ability to redeem shares during periods in which they may have the greatest need or desire for cash.

Chart 1: Money Market Fund Assets (12/31/06 - 9/30/16)



Source: Morningstar.

Enhanced Cash Strategies May Provide a Compelling Alternative to Money Market Funds*

Money market funds may fall short in meeting the income and liquidity needs of many investors, especially in the midst of today's ultra-low interest rate environment. When considering MMFs, investors must choose between accepting the very low yields produced by government MMFs, or seeking slightly higher yields offered by non-government MMFs (prime and tax-exempt), accompanied by the potential for liquidity fees and gates. For such investors, who are willing to take on more risks, we believe that ETFs employing enhanced cash strategies, such as the First Trust Enhanced Short Maturity ETF (FTSM), may provide a compelling alternative to money market funds.

FTSM is an actively managed ETF that utilizes a low duration strategy (0.28 year effective duration[4]), focused on preserving capital and providing intraday liquidity, while seeking to provide a higher level of income than MMFs. As an ETF, the fund's NAV is calculated to reflect the market value of its underlying portfolio on a daily basis, just as institutional prime and tax-exempt MMFs are now required to do. However, unlike both retail and institutional (prime and tax-exempt) MMFs, FTSM is not required to impose liquidity fees and gates, which we believe to be a key advantage.

In our opinion, one of the most important benefits of enhanced cash strategies like FTSM is the ability for such funds to invest in securities that money market funds are restricted from owning. This provides certain opportunities to seek higher returns and enhanced diversification that are not available to MMFs (but with different risks than MMFs). One recent example of this is related to the indirect effect that money market reform has had on 3-month LIBOR[5]. As the shift out of prime MMFs accelerated during the third quarter, there was a related decrease in the demand for the short-term instruments in which they invested. Not surprisingly, this corresponded with an increase in 3-month LIBOR, which rose by 20 basis points during the third quarter. FTSM was able to take advantage of this rate increase by investing in floating-rate corporate notes, which pay more income as LIBOR rises, while MMFs were unable to do so.

As the implications of money market reform continue to set in, we believe that more investment advisors will recognize the need to seek alternatives for managing their core cash allocation. Even before these new regulations took effect, income produced by MMFs was falling far short of the rate of inflation. But there are many compelling options for enhanced cash strategies to generate income that are simply unavailable to MMFs. We believe that an experienced, active manager, consistently performing careful credit research, can add tremendous value by uncovering these opportunities.

*It is important to note that there are differences between FTSM's investment objective and risks of fixed-income securities in which FTSM invests versus money market securities discussed herein. Prices of fixed-income securities change in response to many factors and are subject to higher volatility than money market securities. Please see the Risk Considerations for more information.

[1]Source: Investment Company Institute. Money market funds provide a stable $1.00 NAV by using "amortized cost" accounting to value securities.

[2]Source: Morningstar.

[3]The SEC has provided an exception to this requirement if a fund's board determines that such a fee is not in the best interests of the fund.

[4]As of 9/30/16. Duration is a measure of a security's sensitivity to interest rate changes that reflects the change in a security's price given a change in yield.

[5]3-Month LIBOR is a short-term funding rate estimated by banks in London that they would be charged if borrowing from other banks assuming a three month maturity.

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

The fund lists and principally trades its 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. 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

The market price and net asset value of the fund's shares and the fund's yield will change daily. There may be instances when the fund will experience large in-flows and out-flows, which will significantly alter the fund's size. At times, these fluctuations may negatively impact the fund's yield, result in increased transaction costs for the fund and contribute to the overall volatility of the fund. The risk will be more prevalent when the fund is smaller in size, such as during the fund's invest-up period. An investor may lose money by investing in this fund because this fund is not a money market fund and may experience significant fluctuations in its net asset value.

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

Certain of the fixed-income securities in the fund may not have the benefit of covenants which could reduce the ability of the issuer to meet its payment obligations and might result in increased credit risk.

The fund is subject to credit risk, call risk, income risk, interest rate risk and prepayment 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 that the value of a security may decline as a result. Credit risk is heightened for the floating-rate loans in which the fund invests because companies that issue such loans tend to be highly leveraged and thus are more susceptible to the risks of interest deferral, default and/or bankruptcy. Call risk is the risk that if an issuer calls higher-yielding debt instruments held by the fund, performance could be adversely impacted. Income risk is the risk that income from the fund's fixed-income investments could decline during periods of falling interest rates. Interest rate risk is the risk that the value of the fixed-income securities in the fund will decline because of rising market interest rates. Prepayment risk is the risk that during periods of falling interest rates, an issuer may exercise its right to pay principal on an obligation earlier than expected. This may result in a decline in the fund's income.

The risk of investing in mortgage-related and other asset-backed securities include interest rate risk, extension risk and prepayment risk. Generally, rising interest rates tend to extend the duration of fixed rate mortgage-related securities, making them more sensitive to changes in interest rates. Extension risk is prevalent when in a period of rising interest rates, the fund holds mortgage-related securities and such securities exhibit additional volatility. Prepayments can reduce the returns of the fund because the fund may have to reinvest that money at the lower prevailing interest rates. The fund's investments in asset-backed securities are subject to risks similar to those associated with mortgage-related securities, as well as additional risks associated with the nature of the assets and the servicing of those assets.

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. Credit risk may be heightened for senior loans because companies that issue loans tend to be highly leveraged and thus are more susceptible to the risks of interest deferral, default and/or bankruptcy.

High-yield securities, or "junk" bonds, are subject to greater market fluctuations and risk of loss than securities with higher ratings, and therefore, may be highly speculative.

Investments in debt securities issued by foreign governments ("Sovereign Debt") involve special risks because the governmental authority that controls the repayment of the debt may be unwilling or unable to repay the principal and/or interest when due.

The fund may invest in the shares of other investment companies, and therefore, the fund's investment performance and risks may be related to the investment performance and risks of the underlying funds.

Some of the securities held by the fund may be illiquid. Lower-quality debt tends to be less liquid than higher-quality debt.

The fund currently has fewer assets than larger funds, and like other relatively new funds, large inflows and outflows may impact the fund's market exposure for limited periods of time.

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

The fund currently intends to effect a portion of creations and redemptions for cash, rather than in-kind securities. As a result, the fund may be less tax-efficient.

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

The fund is subject to management risk because it is an actively managed portfolio. In managing the fund's investment portfolio, the advisor will apply investment techniques and risk analyses that may not have the desired result.

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.

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