# Two Paths for ETF Growth

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## Summary of Q2 2018 ETF Flows and Trends[1]

- Total US-listed ETF Assets reached $3.54 trillion at the end of Q2 2018, a 18.7% year-over-year increase. Estimated net asset flows in Q2 2018 totaled $57 billion, down slightly from Q1 2018.
- US Equity ETFs received the strongest estimated net inflows in Q2 2018, totaling $38 billion, rebounding from a lackluster Q1, in which estimated net inflows totaled just $1.3 billion. Sector Equity ETFs received an estimated $2.3 billion in net inflows for Q2 2018, down from $10.2 billion in Q1.
- Taxable Bond ETFs received the second highest estimated net inflows in Q2 2018 with $29 billion, nearly doubling the total from Q1. Municipal Bond ETFs received nearly $2 billion in estimated net inflows during Q2 2018, setting a new high-water mark for net inflows in a calendar quarter for the category.
- International Equity ETFs had the largest estimated net outflows during Q2 2018, totaling $12 billion, following a strong Q1, in which the category added $33 billion in estimated net inflows.
- Commodities ETFs and Alternatives ETFs both had estimated net outflows in Q2 2018, totaling $0.9 billion and $0.8 billion, respectively.

### Table 1

| | Total US-Listed ETF Assets | | Estimated Net Asset Flows | |
|---|---|---|---|---|
| US Category Group | As of 6/30/2018 | Year-over-year % change | Q2 2018 | Prior Quarter (Q1 2018) |
| US Equity | $1,638,746,463,588 | 22.0% | $37,610,346,736 | $1,299,610,319 |
| International Equity | $710,568,715,231 | 16.7% | ($11,661,053,022) | $33,281,644,560 |
| Taxable Bond | $577,584,741,657 | 16.1% | $28,630,478,983 | $14,764,074,563 |
| Sector Equity | $447,939,086,466 | 17.2% | $2,319,007,458 | $10,146,673,933 |
| Commodities | $68,210,962,931 | 6.6% | ($871,005,553) | $2,528,423,632 |
| Alternative | $48,358,749,397 | 7.2% | ($824,203,687) | $3,099,409,618 |
| Municipal Bond | $32,191,531,317 | 21.3% | $1,968,274,104 | $799,600,519 |
| Allocation | $12,478,087,053 | 10.3% | $194,252,811 | $39,949,117 |
| **Total** | **$3,536,078,337,640** | **18.7%** | **$57,366,097,830** | **$65,959,386,261** |

Source: Morningstar, as of 6/30/18. Includes all US-listed exchange-traded funds, exchange-traded notes and other exchange-traded products. All net inflow and outflow numbers are estimates based on information provided by Morningstar.

Over the past several decades, ETFs have become one of the most disruptive forces in the investment industry, with US-listed ETF assets reaching over $3.5 trillion, as of 6/30/18. While the lion's share of ETF assets are invested in funds tracking broad market-cap weighted indices, we believe many of the best opportunities for future ETF growth exist in funds designed to seek market outperformance, including thematic and industry ETFs, rules-based passive strategy ETFs (often referred to as "smart beta"), and actively-managed ETFs. Each of these groups has made strides in gathering assets recently and we believe each will continue to gain market share in the years ahead.

## Flows Favoring Thematic/Industry ETFs over Broad Sector ETFs in 2018

While a relatively small number of broad sector ETFs once dominated their category, ETFs offering narrower, more targeted exposure to an investment theme or industry have grown increasingly popular. In the first half of 2018, 30 of the 50 ETFs in Morningstar's "sector equity" category that gathered the most assets were funds providing exposure to narrow themes or industries, rather than broad sectors. These 30 ETFs received over $14 billion in net inflows during that time, while the other 20 asset-flow-leading "sector equity" ETFs tracking broad sectors received $9.1 billion.[1]

Investment advisors are using thematic and industry ETFs to more precisely target investment plays than would be possible using broadly diversified sector ETFs. For example, an advisor that wants to gain exposure to a trend, such as a shift in technology spending in favor of cloud computing services, can utilize a thematic ETF, such as the First Trust Cloud Computing ETF (SKYY), to invest in a diversified portfolio of stocks expected to benefit from this trend. Likewise, an advisor that is bullish on an industry such as the biotechnology industry, but perhaps wary of other health care sector stocks, such as large pharmaceutical stocks, can isolate exposure to the former using a biotechnology industry ETF, such as the First Trust NYSE Arca Biotechnology Index Fund (FBT).

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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.**

## More ETF Sponsors Join the "Smart Beta" Party

Semi-passive, rules-based investment strategies designed to seek better risk-adjusted returns than broad benchmarks have been assigned many different labels, such as smart beta, strategic beta, alternative beta, or enhanced index. Labels aside, the group of ETFs tracking these strategies has grown to more than 700 funds, offered by 76 different ETF sponsors, according to Morningstar's strategic beta classification.[1]

As noted in our ETF Newsletter from Q1 2018, we believe there is good reason for investment advisors to consider using strategic beta ETFs, as many have provided better risk-adjusted returns than their benchmarks over the past decade. However, we encourage advisors to familiarize themselves with the notable differences between these various ETFs. Among the most popular factor exposures provided by strategic beta ETFs are value, momentum, quality, dividend yield, low volatility, and size. Yet, even among funds aimed at providing exposure to the same factor or set of factors, there may be critical differences in methodology, which will impact relative ETF performance. For example, among funds that have existed for a minimum of 10 years, over the past decade, the spread between the best and worst performing "dividend" ETF was over 3.8% per year, which equated to a difference in cumulative return of 216% versus 123%.[1]

[1]Based on Morningstar data, as of 6/30/18.

**Alpha** is an indication of how much an investment outperforms or underperforms on a risk-adjusted basis relative to its benchmark. **Beta** is a measure of price variability relative to the market.

## Actively Managed ETFs Are Gaining Market Share

The notion of an actively managed ETF was once considered an oxymoron, akin to "jumbo shrimp," but over the past few years, actively managed ETFs have gained momentum, as well as market share. The goal of most actively managed ETFs is to outperform their respective benchmark indices, rather than to simply track them. As of 6/30/18, there were 250 actively managed ETFs, offered by 60 ETF sponsors, with assets totaling nearly $58 billion. While this total represents just over 1.6% of overall ETF assets, actively managed ETF assets were just 0.9% of overall ETF assets three years ago. Year to date, actively managed ETFs have gathered over 10% of total ETF inflows.[1]

The most successful category for actively managed ETFs has been the taxable bond category, which accounts for 70% of total actively managed ETF assets, although over the past three years, flows have begun to accelerate in other categories as well, including sector equity ETFs, commodities ETFs, and international equity ETFs (See Table 2 below).[1]

**Table 2: Actively Managed ETF Growth**

| Category | Total Assets 6/30/2018 | % of Actively Managed ETFs | 3-Year Growth Rate |
|---|---|---|---|
| Taxable Bond | $40,302,340,676 | 70% | 45% |
| Sector Equity | $5,380,280,539 | 9% | 63% |
| Commodities | $3,193,369,544 | 6% | 74% |
| International Equity | $2,340,448,064 | 4% | 148% |
| US Equity | $2,329,766,720 | 4% | 16% |
| Alternative | $1,468,717,063 | 3% | 3% |
| Allocation | $1,757,262,948 | 3% | 16% |
| Municipal Bond | $975,277,846 | 2% | 40% |
| **Total** | **$57,747,463,400** | | **44%** |

Source: Morningstar. Data from 4/1/15 - 6/30/18. Includes all US-listed actively managed exchange-traded funds.

## ETFs as the Building Blocks for Seeking Alpha

Over the years, some industry pundits have equated the success of ETFs with investors abandoning the hope of outperforming the market. Yet, from early in the history of ETFs, investment advisors and portfolio managers have used these "passive" tools to manage "active" client portfolios that diverged from benchmark weights. At first, ETFs were used in this regard to simply over- or underweight broad equity sectors, or to employ sector rotation strategies. As the ETF industry has expanded, the toolbox that investment advisors can utilize to construct client portfolios has become much better equipped. Today, in addition to potentially adding value for investors by making asset allocation decisions using passive broad market or sector ETFs, advisors are increasingly turning to thematic/industry ETFs, smart beta ETFs, and actively managed ETFs in seeking to generate alpha. As the makeup of the ETF industry evolves in the years ahead, we believe newer, more innovative ETFs will continue to gain market share.

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

Investors buying or selling fund shares on the secondary market may incur customary brokerage commissions. 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.

## 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. There can be no assurance that a fund's investment objective will be achieved.

A fund may invest in small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies.

Biotechnology and pharmaceutical companies are subject to changing government regulation which could have a negative effect on the price, profitability and availability of their products and services. Biotechnology and pharmaceutical companies face increasing competition from generic drugs, termination of their patent protection and technological advances which render their products or services obsolete. The research and development costs required to bring a drug to market are substantial and may include a lengthy review by the government, with no guarantee that the product will ever be brought to market or show a profit. Many of these companies may not offer certain drugs or products for several years, and as a result, may have significant losses of revenue and earnings.

An investment in a fund containing securities of non-U.S. issuers is 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.

A fund may invest in depositary receipts which may be less liquid than the underlying shares in their primary trading market.

Information technology companies are subject to certain risks, including rapidly changing technologies, short product life cycles, fierce competition, aggressive pricing and reduced profit margins, loss of patent, copyright and trademark protections, cyclical market patterns, evolving industry standards and frequent new product introductions. Certain companies may be smaller and less experienced companies, with limited product lines, markets or financial resources. Information technology company stocks, especially those which are Internet related, have experienced extreme price and volume fluctuations that are often unrelated to their operating performance.

The risks related to investing in cloud computing companies include interruptions or delays in service, security breaches involving sensitive, proprietary and confidential information, privacy concerns and laws, and other regulations that may limit or otherwise affect the operations of such companies.

Changes in currency exchange rates and the relative value of non-US currencies may affect the value of a fund's investments and the value of a fund's shares.

Actively managed funds are subject to management risk because the advisor or sub-advisor will apply investment techniques and risk analyses that may not have the desired result.

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