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Can Adaptive Factor Rotation Add Value?

Factor-based ETFs have flourished in recent years, supported by numerous academic studies showing that certain stock attributes—or factors—can be exploited in pursuit of better risk-adjusted returns than traditional equity benchmarks. Some of these funds track single factors, such as momentum, low volatility, quality, and value, while others combine multiple factors. While each of these approaches offers distinct benefits and drawbacks, we believe another intriguing strategy, which utilizes relative strength to rotate between multiple factors, including the "opposite" sides of traditional factors, is worth consideration.

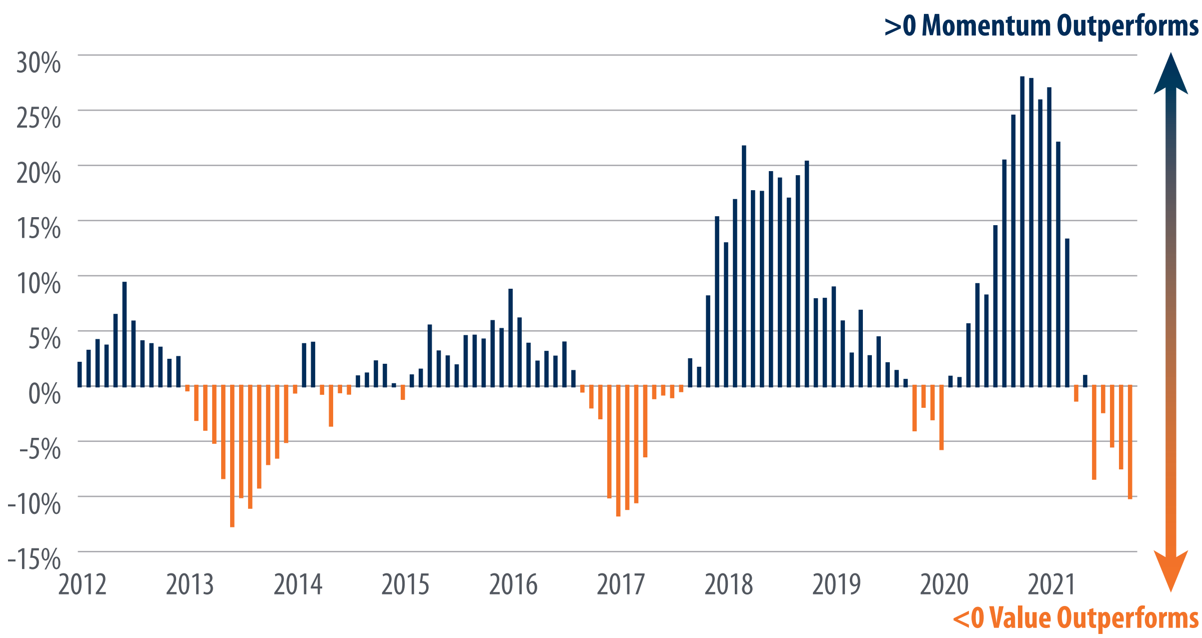
The Highs and Lows of Factors

While certain factors, such as value and momentum, have produced risk-adjusted excess returns over long periods of time, each has also periodically fallen out of favor, sometimes for multiple years. For example, during the five-year period ended on 9/30/2021, the S&P 500 Momentum Index outperformed the S&P 500 Index by a cumulative 20.7 percentage points, while the S&P 500 Value Index underperformed the S&P 500 Index by a cumulative 44.4 percentage points. On the other hand, during the early 2000's, the opposite occurred. For the five years ended on 12/31/2004, the S&P 500 Value Index outperformed the S&P 500 Index by 24.0 percentage points, while the S&P 500 Momentum Index underperformed the S&P 500 Index by 22.7 percentage points. Similarly, excess returns have come and gone for other well-known factors over various time periods. For this reason, patience and a reasonably long time horizon have often been required for investors to reap the benefits of factor-based strategies.

Factors Fall In and Out of Favor

S&P 500 Momentum Index minus S&P 500 Value Index

Rolling 1 Year Returns, 1/31/2012 - 9/30/2021



Source: Morningstar. **Past performance is not a guarantee of future results.** For illustrative purposes only and not indicative of any actual investment. Indexes do not charge 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.

An intriguing theory to explain the periodic underperformance of certain factors lays blame on their own popularity. If a factor becomes overly crowded, with too many investors chasing the same stocks and potentially bidding up their prices, expected future returns may be reduced. They become a victim of their own success. A corollary to this notion is that stocks that are least related to crowded factors may be neglected or even have investors betting against them by holding short positions, which could depress current valuations.

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Here are a few examples spanning the past 10 calendar years (2011-2020):

Quality – Outperformed the S&P 500 Index six times, but its opposite (low quality) also outperformed six times, and there were no years in which neither outperformed.

Low Volatility – Outperformed the S&P 500 Index five times, but its opposite (high volatility) also outperformed five times, with just two years in which neither outperformed.

Momentum – Outperformed the S&P 500 Index seven times, while its opposite (low momentum) outperformed just four times, with two years in which neither outperformed.

Value – Outperformed the S&P 500 Index just three times, while its opposite (expensive) outperformed eight times, with one year in which neither outperformed.

Despite the surprising performance of opposite-side factors, there are few ETFs designed to gain exposure to them.

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
11.01%	28.45%	54.44%	23.45%	8.62%	30.00%	24.11%	3.01%	38.50%	56.36%
10.49%	27.54%	47.73%	22.97%	5.96%	25.16%	22.84%	1.64%	37.46%	47.17%
2.11%	20.68%	39.06%	18.81%	5.20%	18.51%	22.71%	1.37%	35.68%	39.98%
1.91%	18.03%	33.25%	17.91%	1.65%	15.87%	21.83%	-4.38%	33.83%	30.39%
1.70%	16.00%	32.96%	16.87%	1.38%	14.73%	18.43%	-11.39%	33.18%	19.07%
-2.18%	15.61%	32.39%	15.36%	-4.58%	11.96%	16.61%	-11.85%	31.49%	18.79%
-6.44%	14.34%	31.07%	14.10%	-8.03%	5.88%	15.84%	-13.49%	31.12%	18.40%
-11.27%	13.04%	28.60%	13.69%	-9.35%	-0.49%	9.89%	-14.91%	30.29%	-0.34%
-16.24%	2.86%	17.08%	9.43%	-25.58%	-5.98%	8.84%	-16.68%	20.50%	-2.55%

Momentum | Momentum Laggards | **Quality** | Quality Laggards | Value | Value Laggards | **Volatility** | Volatility Laggards | **S&P 500 Index**

Source: Nasdaq. **Past performance is not a guarantee of future results.** For illustrative purposes only and not indicative of any actual investment. Indexes do not charge 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. The factors are based on eight Nasdaq factor sub-indexes which are each comprised of 50 securities from the Nasdaq US 500 Large Cap Index that represent the high and low side of each of the four factors.

An Adaptive Factor Rotation Strategy

One way that investment professionals have sought to smooth out periods of single factor underperformance has been to combine multiple factors. As in the example of value and momentum, excess returns from various factors have often come at different times. While most multi-factor strategies maintain consistent exposure to traditional factors, we believe a more active strategy that adapts to periods of single factor underperformance by incorporating "opposite side" factors may provide another compelling option for financial professionals.

In 2018, First Trust launched the First Trust Lunt U.S. Factor Rotation ETF (FCTR). This ETF tracks an adaptive factor rotation strategy that provides exposure to either the conventional or opposite side of four different factors, including momentum, value, quality, and low volatility.

The underlying index for FCTR selects stocks from the Nasdaq US 500 Large Cap Index. This universe of stocks is ranked by factor attributes for momentum, value, quality, and low volatility. The 50 highest scoring stocks for each factor are selected as constituents for conventional factor sub-indices, while the 50 lowest scoring stocks are selected as constituents for the opposite-side (or non-conventional) factor sub-indices. On a monthly basis, these eight sub-indices are evaluated for risk-adjusted relative strength to select either the conventional or opposite-side for each factor. For the month of November, the conventional factor sub-indices for momentum, quality, and low volatility were selected, along with the opposite-side factor sub-index for value.

This dynamic approach to factor investing has resulted in high active share (76.7% as of 10/31/21)^ and meaningful sector tilts, compared to the S&P 500 Index[1]. For example, as of 10/31/21, FCTR was overweight the industrials and energy sectors by 4.8 and 3.4 percentage points, respectively, and underweight the information technology and financials sectors by 5.5 and 4.8 percentage points, respectively. However, at various points over the past 12 months, FCTR has been overweight and underweight every sector of the S&P 500 Index.

^Source: Morningstar.

[1] "Active share" is a measurement of how similar a fund's holdings are to its benchmark, with scores ranging from 0% (identical holdings and weights) to 100% (no common holdings).

Since its inception on 7/25/18, FCTR has effectively navigated an unusual market environment, producing a 19.8% average annual return, compared to 18.0% for the S&P 500 Index, as of 10/29/21. Over the past three years, the fund has outperformed 96% of its peer ETFs in Morningstar's Large Blend category, based on annualized returns.^^

Investment professionals seeking to potentially capitalize on factor premiums have numerous tools at their disposal. Over the long-term, many of these strategies have developed admirable track records, despite facing periods of underperformance. In our view, the adaptive factor rotation strategy employed by FCTR may be a unique and compelling complement to traditional factor-based ETFs.

^^Source: Morningstar. As of 9/30/21. FCTR Percentile Rank: 16%/1 Year/156 ETFs, 4%/3 Year/112 ETFs, 3%/Since Fund Inception/107 ETFs based on NAV.

Performance Summary (%) as of 9/30/21	1 Year	3 Year	Since Fund Inception
FCTR Performance*			
Net Asset Value (NAV)	34.75	18.99	18.74
Market Price	34.65	18.97	18.74
Index Performance**			
Lunt Capital Large Cap Factor Rotation Index	35.75	19.91	19.65
Nasdaq US 500 Large Cap Index	29.16	16.63	16.62
S&P 500 Index	30.00	15.99	16.00
Morningstar Large Blend Category	29.67	14.47	14.74

Performance data quoted represents past performance. Past performance is not a guarantee of future results and current performance may be higher or lower than performance quoted. Investment returns and principal value will fluctuate and shares when sold or redeemed, may be worth more or less than their original cost. You can obtain performance information which is current through the most recent month-end by visiting www.ftportfolios.com.

Inception Date: 7/25/2018. Expense Ratio: 0.65%

***NAV** returns are based on the fund's net asset value which represents the fund's net assets (assets less liabilities) divided by the fund's outstanding shares. **Market Price** returns are determined by using the midpoint of the national best bid offer price ("NBBO") as of the time that the fund's NAV is calculated. Returns are average annualized total returns.

****Performance information for the Lunt Capital Large Cap Factor Rotation Index is for illustrative purposes only and does not represent actual fund performance.** Indexes do not charge 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.

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.

Risk Considerations

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.

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 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 a fund's 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. The outbreak of the respiratory disease designated as COVID-19 in December 2019 has caused significant volatility and declines in global financial markets, which have caused losses for investors. While the development of vaccines has slowed the spread of the virus and allowed for the resumption of "reasonably" normal business activity in the United States, many countries continue to impose lockdown measures in an attempt to slow the spread. Additionally, there is no guarantee that vaccines will be effective against emerging variants of the disease.

As the use of Internet technology has become more prevalent in the course of business, funds have become more susceptible to potential operational risks through breaches in cyber security.

A fund may be a constituent of one or more indices or models which could greatly affect a fund's trading activity, size and volatility.

There is no assurance that the index provider or its agents will compile or maintain the index accurately.

A portfolio comprised of low volatility stocks may not produce investment exposure that has lower variability to changes in such stocks' price levels. Low volatility stocks are likely to underperform the broader market during periods of rapidly rising stock prices.

A fund that employs a "momentum" style of investing emphasizes selecting stocks that have had higher recent price performance compared to other stocks. Momentum can turn quickly and cause significant variation from other types of investments.

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

A fund and a fund's advisor may seek to reduce various operational risks through controls and procedures, but it is not possible to completely protect against such risks.

High portfolio turnover may result in higher levels of transaction costs and may generate greater tax liabilities for shareholders.

A fund may not correctly identify companies with strong fundamentals and selected companies may not maintain strong fundamentals. In addition, returns on quality securities may be less than returns on other styles of investing or the overall stock market.

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

Trading on the exchange may be halted due to market conditions or other reasons. There can be no assurance that the requirements to maintain the listing of a fund on the exchange will continue to be met or be unchanged.

Value stocks are subject to the risk that valuations never improve or that the returns on value stocks are less than returns on other styles of investing or the overall stock market.

The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, First Trust is not undertaking to give advice in any fiduciary capacity within the meaning of ERISA, the Internal Revenue Code or any other regulatory framework. Financial professionals are responsible for evaluating investment risks independently and for exercising independent judgment in determining whether investments are appropriate for their clients.

First Trust Advisors L.P. (FTA) is the adviser to the fund. FTA is an affiliate of First Trust Portfolios L.P., the fund's distributor.

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