Inside First Trust ETFs

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Seeking Alpha with Thematic ETFs

Over the past few years, thematic ETFs have grown in popularity among financial professionals seeking exposure to a variety of investment trends, many of which are related to innovative, high-growth industries. While there is no industry-standard definition for what makes an ETF "thematic," we generally consider those that seek to capture specific trends—often outside of broad sector constraints—as thematic investments. Many of these ETFs focus on secular growth opportunities in digital technologies such as cybersecurity, cloud computing, and blockchain, while some target trends in other industries such as water, agriculture, and green energy. For investment professionals seeking to incorporate thematic ETFs in client portfolios, we offer a few considerations and suggestions below.

Clarify Investment Thesis and Time Horizon

In our view, one of the most important aspects of implementing thematic ETFs is to clearly determine an investment thesis and time horizon. Establishing appropriate entry and exit points up front may help manage clients' return expectations and avoid making emotionally-charged behavioral mistakes. For example, an investor with a long-term time horizon may view a pullback in a high conviction thematic ETF as an opportunity to buy additional shares at a lower price instead of a signal to sell out of their position.

Looking back at the asset flows and performance of one of First Trust's most popular thematic ETFs in 2020 illustrates the potential value of staying committed to a long-term investment theme – despite poor short-term performance. From 2017-2019, the First Trust Cloud Computing ETF (SKYY) had $946 million in net inflows, as investors became increasingly optimistic about the long-term growth of cloud computing. As the Covid-19 pandemic began impacting the US, SKYY declined 32.8% from 2/19/2020 through 3/16/2020 on a total return basis, down just a bit more than the S&P 500 Index, which declined by 29.4%. However, investors in SKYY generally remained steadfast, with the ETF experiencing just 4 days of net redemptions and a total of $14 million in net inflows during the period. As it became clear that the pandemic would accelerate cloud-enabled trends like remote work and online learning, SKYY rebounded 106.4%, based on net asset value (NAV), from 3/16/2020 through the end of the year, rewarding those investors that stayed the course. For comparative purposes, the S&P 500 Index posted a total return of 59.6% over the same period.

Clearly, not all thematic ETFs will rebound from future sell-offs as sharply as SKYY did last year. But for investors with high conviction in long-term themes like cloud computing, sticking with their stated time horizon and investment thesis may help them ride out periods of volatility or underperformance.

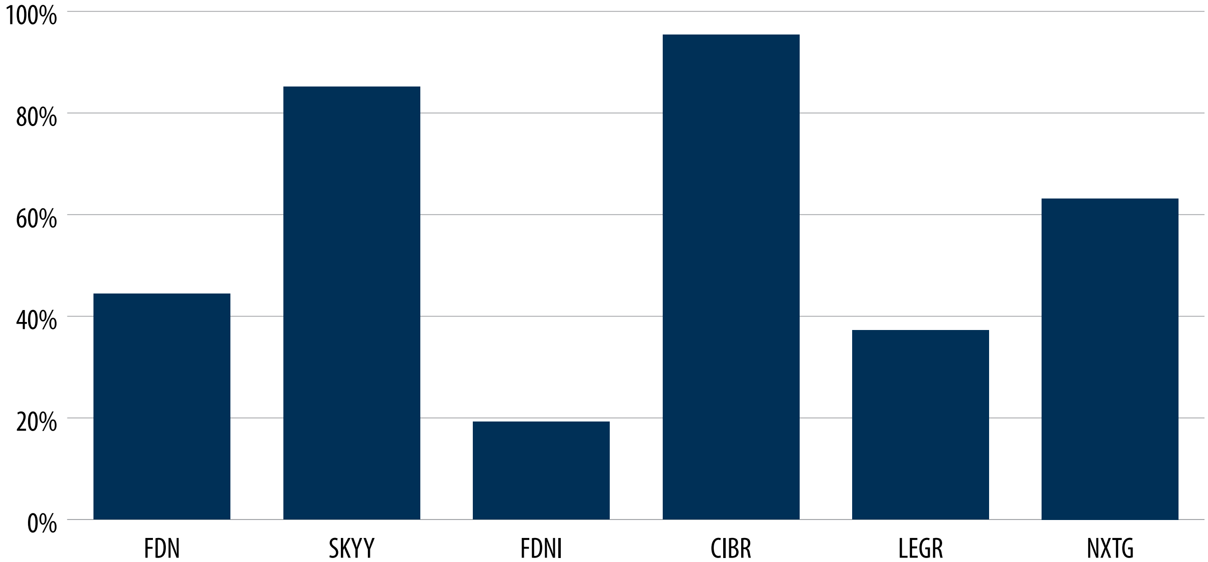
Analyze Sector Biases and Other Tilts

Many ETFs have more nuanced methodologies and exposures than one might initially expect. In our opinion, it's important for investment professionals to do their homework when considering a thematic ETF to understand its industry, sector, and geographical exposures. These exposures should then be analyzed in the context of an investor's overall portfolio allocation.

As an example, the First Trust Dow Jones Internet Index Fund (FDN) is often considered a technology ETF. However, as of 12/31/2020, just 44.5% of the portfolio was allocated to the information technology sector, while communication services (33%), consumer discretionary (18.3%), and health care (4.2%) made up the balance of FDN's sector allocation. Unlike many traditional technology ETFs, FDN selects 40 of the largest and most liquid US stocks that generate most of their revenue from the internet – regardless of sector. While stocks such as PayPal, Cisco, and Zoom Video are among its information technology holdings, consumer discretionary stocks such as Amazon, eBay, and Expedia, and communication services stocks like Facebook, Netflix, and Alphabet are also prominent in the portfolio. This unique methodology – without traditional sector constraints – has resulted in FDN becoming the best performing US-listed ETF since its inception in June of 2006.[1] Over that period, FDN has produced a 17.7% annualized total return, based on NAV.[2]

The First Trust Indxx NextG ETF (NXTG), which provides exposure to stocks expected to benefit from the build out of 5G mobile networks and related technology, is another thematic ETF with meaningful portfolio tilts. Not only does NXTG have exposure to multiple sectors (including information technology, communication services, and real estate), it also invests in stocks from 29 different countries as of 12/31/20 including the US (40%), Japan (10%), India (8%), China (7%), South Korea (6%), and others. We believe investment professionals should analyze how these geographical exposures may impact their overall asset allocation.

Information Technology Sector Exposure of First Trust "Thematic Tech ETFs" as of 12/31/2020



FDN – First Trust Dow Jones Internet Index Fund
SKYY – First Trust Cloud Computing ETF
FDNI – First Trust Dow Jones International Internet ETF
CIBR – First Trust Nasdaq Cybersecurity ETF
LEGR – First Trust Indxx Innovative Transaction & Process ETF
NXTG – First Trust Indxx NextG ETF

Source: Bloomberg

Balance Risk and Return

Many investment professionals utilize thematic ETFs as satellite positions for seeking alpha within more diversified equity portfolios. For such strategies, we believe it's important to seek a balance between striving for excess returns and taking on too much risk. One popular strategy to maintain an acceptable level of risk is to incorporate less risky, lower beta strategies among core equity holdings, which may help to offset allocations to riskier, higher beta thematic ETFs. In the same vein, it's important to understand that if allocations to thematic ETFs are too small, the potential excess returns that thematic ETFs may generate could fail to "move the needle" from a performance standpoint, and have little impact on a portfolio's overall return.

Diversify Excess Returns

Finally, while thematic ETFs related to disruptive technologies have become popular in recent years, we believe investors may benefit from having exposure to multiple investment themes that are expected to perform well in different market environments.

Take for example, the First Trust Water ETF (FIW) and the First Trust Cloud Computing ETF (SKYY). While we believe both themes are well-positioned to potentially achieve above average growth in the coming years, the underlying factors that may help drive returns for each are much different. While FIW may benefit from water-specific trends, such as the need to boost capital spending on aging water infrastructure, SKYY may benefit from cloud-specific trends, such as increases in remote work and online learning.

Over the past five years, both ETFs outperformed, but did so at different times. FIW had a 20.0% average annual NAV return, and SKYY had a 26.5% average annual NAV return, compared to 15.2% for the S&P 500 Index. But during that stretch, monthly excess returns for FIW and SKYY were negatively correlated (-0.22) indicating that each tended to work well at different points along the way. By incorporating various themes that may outperform in different environments, we believe investment professionals may be able to smooth out periods of underperformance.

In the end, we believe thematic ETFs are a practical tool for financial professionals to utilize in client portfolios. By providing exposure to some of today's most exciting and rapidly growing industries, thematic ETFs may generate excess returns that have a meaningful impact on a broader investment portfolio. In our opinion, an approach to thematic investing that establishes a thesis and time horizon, analyzes portfolio biases and tilts, maintains appropriate levels of risk, and diversifies sources of potential alpha may set a solid foundation for success and help clients as they seek to achieve their long-term investment goals.

[1]Excluding leveraged ETFs.

[2]According to Morningstar. Universe includes all non-leveraged or inverse ETFs, based on monthly returns from 6/30/2006-12/31/2020 out of 243 funds.

References to specific securities should not be construed as a recommendation to buy or sell and should not be assumed profitable.

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

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. 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. The COVID-19 pandemic may last for an extended period of time and will continue to impact the economy for the foreseeable future.

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.

A fund may invest in a concentrated portfolio which involves additional risks including limited diversification.

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

A fund containing securities of non-U.S. issuers is subject to additional risks as non-U.S. issuers are subject to higher volatility than securities of U.S. issuers. Risks may be heightened for securities of companies located in, or with significant operations in, emerging market countries. Non-U.S. dollar denominated securities may lose money if the local currency depreciates against the U.S. dollar.

Certain funds are classified as "non-diversified" and may invest a relatively high percentage of their assets in a limited number of issuers. As a result, the funds 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.

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

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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.

Performance Summary (%)

As of 12/31/20	Inception Date	Gross Expense Ratio^	Net Exposure Ratio	1 Year	5 Year	10 Year	Since Fund Inception
CIBR Performance*	7/6/2015	N/A	0.60%				
NAV				50.46	20.86	N/A	16.40
Market Price				50.41	20.87	N/A	16.43
Nasdaq CTA Cybersecurity Index℠				51.88	21.71	N/A	17.25
S&P Composite 1500 Information Technology Index				43.23	27.39	N/A	25.56
S&P 500 Index**				18.40	15.22	N/A	13.74
FDN Performance*	6/19/2006	0.52%	0.52%				
NAV				52.65	23.26	20.02	17.69
Market Price				52.68	23.26	20.00	17.68
Dow Jones Internet Composite Index℠				53.51	23.95	20.69	18.33
S&P Composite 1500 Information Technology Index				43.23	27.39	20.22	16.04
S&P 500 Index**				18.40	15.22	13.88	10.20
FDNI Performance*	11/5/2018	N/A	0.65%				
NAV				85.86	N/A	N/A	49.75
Market Price				85.35	N/A	N/A	49.87
Dow Jones International Internet Index				87.43	N/A	N/A	50.99
MSCI ACWI ex USA Index				10.65	N/A	N/A	11.96
MSCI ACWI ex USA Information Technology Index				45.35	N/A	N/A	35.96
FIW Performance*	5/8/2007	0.55%	0.55%				
NAV				21.20	19.99	13.44	10.72
Market Price				21.21	20.01	13.42	10.72
ISE Clean Edge Water Index				22.17	20.63	14.13	11.41
Russell 3000® Index				20.89	15.43	13.79	9.28
LEGR Performance*	1/24/2018	N/A	0.65%				
NAV				18.45	N/A	N/A	9.59
Market Price				18.60	N/A	N/A	9.58
Indxx Blockchain Index				19.65	N/A	N/A	10.61
S&P 500 Index				18.40	N/A	N/A	12.19
NXTG Performance*	2/17/2011	N/A	0.70%				
NAV				27.36	15.09	N/A	10.04
Market Price				27.25	15.25	N/A	10.05
Indxx 5G & NextG Thematic Index				28.74	N/A	N/A	N/A
MSCI ACWI Information Technology Index				45.61	26.23	N/A	17.67
MSCI ACWI Index				16.25	12.26	N/A	8.71
MSCI World Index				15.90	12.19	N/A	9.32
SKYY Performance*	7/5/2011	N/A	0.60%				
NAV				57.84	26.56	N/A	18.13
Market Price				57.81	26.61	N/A	18.13
ISE CTA Cloud Computing™ Index				58.80	27.17	N/A	18.78
S&P Composite 1500 Information Technology Index				43.23	27.39	N/A	20.87
S&P 500 Index				18.40	15.22	N/A	13.82

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.

^ FDN expenses are capped contractually at 0.60% per year, at least until April 30, 2021. FIW expenses are capped contractually at 0.60% per year, at least until April 30, 2021.

***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. The fund's performance reflects fee waivers and expense reimbursements, absent which performance would have been lower.

Performance information for the indexes 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. The **S&P Composite 1500 Information Technology Index is a capitalization weighted index of companies classified by GICS as information technology within the S&P Composite 1500 Index. The **S&P 500 Index** is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. The **MSCI ACWI Information Technology Index** is a free float-adjusted market capitalization weighted index that is designed to measure the information technology sector performance of developed and emerging markets. The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the equity market performance of 23 developed markets around the world. The **MSCI ACWI Index** is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The **Russell 3000® Index** is comprised of the 3000 largest and most liquid stocks based and traded in the U.S. The **MSCI ACWI ex USA Information Technology Index** includes large and mid cap securities in the Information Technology sector across 22 of 23 Developed Markets (DM) countries (excluding the US) and 24 Emerging Markets (EM) countries. The **MSCI ACWI ex USA Index** captures large and mid and cap representation across 22 of 23 Developed Markets countries, excluding the United States, and 24 Emerging Markets countries.