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# Getting Broader and Smaller in 2024

After an unusually good year for US equities in 2023, concerns about high valuations and concentration risk for U.S. equity indices, such as the S&P 500® Index, have led some financial professionals to seek potentially better opportunities among small- and mid-capitalization ("SMid-cap") stocks. However, fears that an economic recession could be on the horizon have led some to shy away from tilting portfolio allocations towards smaller companies. Below, we discuss these issues, highlighting why we believe that SMid-cap stocks may offer an attractive opportunity, but also why selectivity may be critical for navigating the current market environment. We then discuss why we believe those seeking to increase allocations to SMid-cap stocks should consider the First Trust SMID Cap Rising Dividend Achievers ETF (SDVY).

## The Case for Tilting Smaller

In our view, one of most compelling arguments for tilting portfolio allocations towards SMid-cap stocks is that valuations have become more attractive than large caps. As of 1/31/24, the forward price-to-earnings ("P/E") ratio for the S&P 500® Index was 19.8, compared to 14.4 for the S&P MidCap 400® Index and 13.5 for the S&P SmallCap 600® Index (see Chart 1). Over the past 20 years, the valuation gap between these indices has usually been much narrower, often with richer valuations favoring small- and mid-caps (see Chart 2). While the forward P/E ratio of the S&P 500® Index is currently 12% higher than its 20-year average, the forward P/E ratios of both the S&P MidCap 400® Index (12% cheaper) and S&P SmallCap 600® Index (21% cheaper) are lower than their 20-year averages, as of 1/31/24.

**Chart 1: Forward Price to Earnings Ratios (Next Twelve Months)**

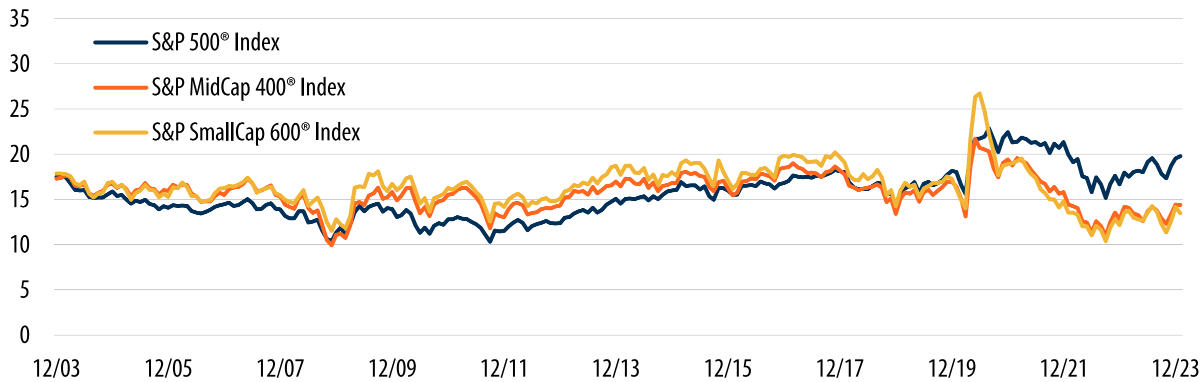
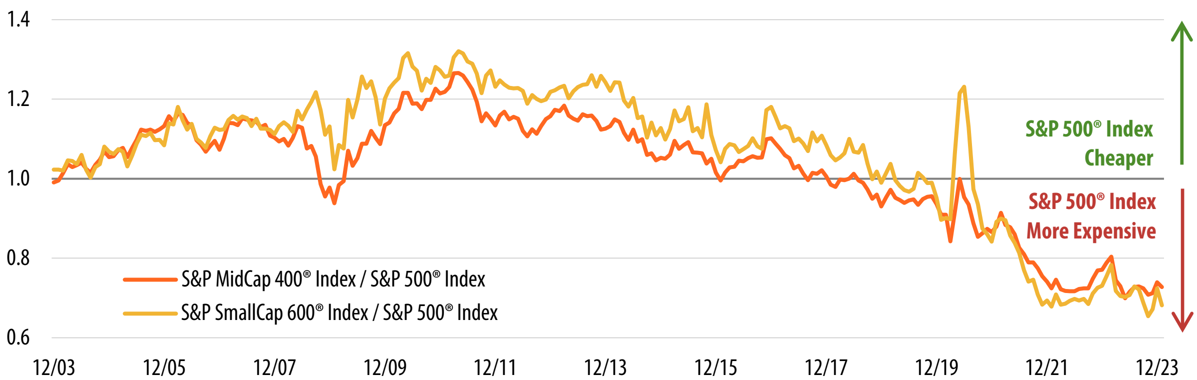



**Chart 2: Relative Valuations Based on Forward P/E Ratios (Next Twelve Months)**




Source for charts: Bloomberg. Data from December 2003 to December 2023. **Past performance is no guarantee of future results.**

One key reason that the S&P 500® Index has grown more expensive since the end of 2022 is that the index has grown more "top heavy" as valuations of its largest stocks have also increased. Over 13 months, the weight of the S&P 500® Index's top five holdings went from 18.8% to 24.9%, and the average P/E ratio of its top five holdings went from 20.6 to 35.0 (12/31/22-1/31/24).[1] Hence, another potential benefit of tilting portfolio allocations toward SMid-cap stocks is to reduce the level of idiosyncratic, stock-specific risk found in market-cap weighted large-cap indices, like the S&P 500® Index.

Finally, those that believe interest rate increases peaked in 2023 may have another reason for tilting portfolio allocations towards SMid-cap stocks. While lower interest rates may benefit companies of all sizes, smaller companies are often perceived to be more negatively impacted by rising interest rates. Thus, after the Federal Reserve held interest rates steady at its November 1st meeting—and Jerome Powell made comments interpreted by some as hinting at the end of interest rate increases[2] —the S&P MidCap 400® Index and S&P SmallCap 600® Index both rallied, significantly outpacing the S&P 500® Index through the end of the 2023.

[1] As of 12/31/22, the five largest stocks in the S&P 500® Index were AAPL, MSFT, AMZN, BRK.B, and GOOG/GOOGL (figures combine 2 share classes of Alphabet Inc.). As of 1/31/24, the five largest stocks in the S&P 500® Index were MSFT, AAPL, GOOG/GOOGL, NVDA, and AMZN. References to specific securities should not be construed as a recommendation to buy or sell and should not be assumed profitable.

[2] Bloomberg. November 2023.

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## SMid-Caps and Economic Recessions

One apprehension about tilting portfolio allocations to SMid-cap stocks often comes from those concerned about a looming recession. Conventional wisdom suggests that larger stocks may be better equipped to weather an economic storm than smaller stocks. While this has sometimes been true, the evidence has been mixed (at best) in recent years. In fact, large-cap stocks underperformed both small- and mid-cap stocks during two of the past three U.S. recessions:

- **2001 recession** (March 2001-November 2001): S&P 500® Index (-0.9%); S&P MidCap 400® Index (+5.9%); S&P SmallCap 600® Index (+6.8%).
- **2008-2009 recession** (December 2007-June 2009): S&P 500® Index (-35.0%); S&P MidCap 400® Index (-30.8%); S&P SmallCap 600® Index (-30.6%).
- **2020 "COVID" recession** (February 2020-April 2020): S&P 500® Index (-1.1%); S&P MidCap 400® Index (-8.9%); S&P SmallCap 600® Index (-12.5%).[3]

Moreover, although the S&P 500® Index did outperform during the 2020 "COVID" recession, one of the (many) unique aspects of this recession was its brevity, lasting just two months. Twelve months after the recession began, the S&P MidCap 400® Index (+39.8%) and the S&P SmallCap 600® Index (+46.6%) had both significantly outperformed the S&P 500® Index (+31.3%).

While concerns related to the size of SMid-cap stocks during recessions seem misplaced, in our view, we are more leery about the high percentage of unprofitable stocks found in many small- and mid-cap indices. For example, unprofitable stocks account for 41.0% of the Russell 2000® Index, 18.1% of the S&P SmallCap 600® Index, and 9.2% of the S&P MidCap 400® Index.[4] One potential risk for unprofitable stocks, in our opinion, is that they may be more negatively impacted if interest rates remain elevated, especially if they are forced to refinance debt at higher costs. Consequently, we believe selectivity may be warranted when investing in SMid-cap stocks.

## High-Quality, Profitable SMid-Cap Stocks

In our opinion, SDVY may be an effective strategy for gaining exposure to high-quality, profitable SMid-cap stocks. The index SDVY seeks to track consists of 100 small- and mid-cap stocks screened for:

- Earnings growth (over the trailing 3 years)
- Dividend growth (over the trailing 3 and 5 years)
- High cash reserves relative to debt (cash to debt ratio greater than 25%)
- Earnings reinvestment (trailing 12-month dividend payout ratio no greater than 65%)

In our opinion, there are compelling reasons to consider tilting portfolio allocations in favor of SMid-cap stocks. Large-cap indices have become exceptionally top heavy, in our view, and valuations have expanded significantly over the past year, creating more potential downside risk if earnings growth expectations prove to be too optimistic. Conversely, earnings multiples for small- and mid-cap stocks have remained below longer-term averages. Cognizant of the risks that the economy could weaken this year or that interest rates could remain elevated, we believe that SDVY may be an effective way to increase allocations to high-quality, profitable SMid-cap stocks.



[3]National Bureau of Economic Research (NBER). NBER defines a period of recession as a significant decline in economic activity that is spread across the economy and lasts more than a few months.

[4]Capital IQ. As of 12/29/23.

**Performance Summary (%) as of 12/29/23**

| SDVY Performance* | 3 Month | YTD | 1 Year | 3 Year | 5 Year | Since Fund Inception |
|---|---|---|---|---|---|---|
| Net Asset Value (NAV) | 16.85 | 28.69 | 28.69 | 13.55 | 15.22 | 10.35 |
| Market Price | 16.92 | 28.77 | 28.77 | 13.55 | 15.25 | 10.36 |
| **Index Performance**** | | | | | | |
| Nasdaq US Small Mid Cap Rising Dividend Achievers™ Index | 17.09 | 29.65 | 29.65 | 14.28 | 15.95 | 11.04 |
| S&P 1000® Index | 12.72 | 16.35 | 16.35 | 7.85 | 12.14 | 8.52 |

***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: 11/1/17. Expense ratio: 0.60%. The Investment Advisor has implemented fee breakpoints, which reduce the fund's investment management fee at certain asset levels. Please see the fund's Statement of Additional Information for full details.

*__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, except those for periods of less than one year, which are cumulative.

**Performance information for each listed 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.

### Risk Considerations

**You could lose money by investing in a fund. An investment in a fund is not a deposit of a bank and is not insured or guaranteed. There can be no assurance that a fund's objective(s) will be achieved. Investors buying or selling shares on the secondary market may incur customary brokerage commissions. Please refer to each fund's prospectus and Statement of Additional Information for additional details on a fund's risks. The order of the below risk factors does not indicate the significance of any particular risk factor.**

Unlike mutual funds, shares of the fund 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 premium or discount to a fund's net asset value and possibly face delisting and the bid/ask spread may widen.

The success of consumer discretionary companies is tied closely to the performance of the overall U.S. and international economies, interest rates, competition, consumer confidence, disposable household income and consumer spending. Changes in demographics and consumer tastes can also affect the demand for consumer discretionary products.

Current market conditions risk is the risk that a particular investment, or shares of the fund in general, may fall in value due to current market conditions. As a means to fight inflation, the Federal Reserve and certain foreign central banks have raised interest rates and expect to continue to do so, and the Federal Reserve has announced that it intends to reverse previously implemented quantitative easing. Recent and potential future bank failures could result in disruption to the broader banking industry or markets generally and reduce confidence in financial institutions and the economy as a whole, which may also heighten market volatility and reduce liquidity. Ongoing armed conflicts between Russia and Ukraine in Europe and among Israel, Hamas and other militant groups in the Middle East, have caused and could continue to cause significant market disruptions and volatility within the markets in Russia, Europe, the Middle East and the United States. The hostilities and sanctions resulting from those hostilities have and could continue to have a significant impact on certain fund investments as well as fund performance and liquidity. The COVID-19 global pandemic, or any future public health crisis, and the ensuing policies enacted by governments and central banks have caused and may continue to cause significant volatility and uncertainty in global financial markets, negatively impacting global growth prospects.

A fund is susceptible to operational risks through breaches in cyber security. Such events could cause a fund to incur regulatory penalties, reputational damage, additional compliance costs associated with corrective measures and/or financial loss.

Companies that issue dividend-paying securities are not required to continue to pay dividends on such securities. Therefore, there is a possibility that such companies could reduce or eliminate the payment of dividends in the future.

Equity securities may decline significantly in price over short or extended periods of time, and such declines may occur in the equity market as a whole, or they may occur in only a particular country, company, industry or sector of the market.

Financial services companies are subject to the adverse effects of economic recession, currency exchange rates, government regulation, decreases in the availability of capital, volatile interest rates, portfolio concentration in geographic markets, industries or products, and competition from new entrants in their fields of business.

An index fund will be concentrated in an industry or a group of industries to the extent that the index is so concentrated. A fund with significant exposure to a single asset class, or the securities of issuers within the same country, state, region, industry, or sector may have its value more affected by an adverse economic, business or political development than a broadly diversified fund.

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. Losses or costs associated with any index provider errors generally will be borne by a fund and its shareholders.

Industrials and producer durables companies are subject to certain risks, including the general state of the economy, intense competition, consolidation, domestic and international politics, excess capacity and consumer demand and spending trends. They may also be significantly affected by overall capital spending levels, economic cycles, technical obsolescence, delays in modernization, labor relations, and government regulations.

As inflation increases, the present value of a fund's assets and distributions may decline.

Market risk is the risk that a particular security, or shares of a fund in general may fall in value. Securities are subject to market fluctuations caused by such factors as general economic conditions, political events, regulatory or market developments, changes in interest rates and perceived trends in securities prices. Shares of a fund could decline in value or underperform other investments as a result. In addition, local, regional or global events such as war, acts of terrorism, spread of infectious disease or other public health issues, recessions, natural disasters or other events could have significant negative impact on a fund.

There can be no assurance that the securities held by a fund will stay within a fund's intended market capitalization range.

A fund faces numerous market trading risks, including the potential lack of an active market for fund shares due to a limited number of market makers. Decisions by market makers or authorized participants to reduce their role or step away in times of market stress could inhibit the effectiveness of the arbitrage process in maintaining the relationship between the underlying values of a fund's portfolio securities and a fund's market price.

An index fund's return may not match the return of the index for a number of reasons including operating expenses, costs of buying and selling securities to reflect changes in the index, and the fact that a fund's portfolio holdings may not exactly replicate the index.

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. The fund also relies on third parties for a range of services, including custody, and any delay or failure related to those services may affect the fund's ability to meet its objective.

A fund that invests in securities included in or representative of an index will hold those securities regardless of investment merit and the fund generally will not take defensive positions in declining markets.

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

The market price of a fund's shares will generally fluctuate in accordance with changes in the fund's net asset value ("NAV") as well as the relative supply of and demand for shares on the exchange, and a fund's investment advisor cannot predict whether shares will trade below, at or above their NAV.

Securities of small- and mid-capitalization companies may experience greater price volatility and be less liquid than larger, more established companies.

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

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

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.



### Index Definitions:

**S&P 500® Index** - An unmanaged index of 500 companies used to measure large-cap U.S. stock market performance.

**S&P 1000® Index** -Combines the S&P MidCap 400® Index and the S&P SmallCap 600® Index to form an investable benchmark for the mid- to small-cap segment of the U.S. equity market.

**S&P MidCap 400® Index** - A capitalization-weighted index that tracks the mid-range sector of the U.S. stock market.

**S&P SmallCap 600® Index** - A capitalization-weighted index that tracks U.S. stocks with a small market capitalization.

**Russell 2000® Index** - Comprised of the smallest 2000 companies in the Russell 3000® Index, representing approximately 8% of the Russell 3000® Index total market capitalization.

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

**Not FDIC Insured • Not Bank Guaranteed • May Lose Value**