A Guide to Exchange-Traded Funds

First Trust

Exchange-Traded Funds

Exchange-Traded Funds (ETFs) provide an efficient and simple way to invest in worldwide markets. ETFs offer investors the opportunity to buy and sell an entire basket of securities with a single transaction throughout the trading day. ETFs combine the characteristics of a mutual fund with the convenience and trading flexibility of stocks. ETFs offer investors the potential advantages of low operating costs and improved tax efficiency over traditional, actively-managed mutual funds.

Since the first ETF was introduced in 1993, the industry has grown significantly and has moved beyond simply tracking broad market indexes like the S&P 500. Today, ETFs invest in a wide variety of assets and strategies and, although the majority of ETFs are still designed to track a specific index, ETFs which are actively managed are also available.

ETFs can be an effective tool for implementing many different investment strategies for investors. They allow individual investors to obtain the economies of scale that large fund managers enjoy, which the average person would not be able to produce with a small amount of capital.

How do ETFs Compare?	ETFs	Stocks	Index Funds
Tax Efficient	☐	☐	☐
Low Expenses	☐	☐	☐
Low Investment Minimums	☐	☐	☐
Intraday Liquidity	☐	☐	
Diversification	☐		☐
Fully Invested	☐	☐	Possible
Portfolio Transparency	☐	☐	Possible
Ease of Ownership	☐		☐
Able to Sell Short[1]	☐	☐	
Able to Buy on Margin[1]	☐	☐	
Able to Use Limit and Stop Orders[1]	☐	☐	
Listed Options Available[1]	☐	☐	
Sales Charges, fees, and/or expenses[2]	☐	☐	☐
Risks[3]	☐	☐	☐
Ease of Dollar Cost Averaging			☐

[1]Substantial risks and higher costs may result from borrowing and short selling ETFs. These strategies may not be suitable for all investors. Investors should consider their own situation and risk tolerance before employing these strategies.
[2]There are costs associated with an investment in each type of security. Consult your brokerage firm and/or the security's prospectus (if applicable) for complete details.
[3]Investing involves risk, including possible loss of principal. The different types of investments shown here may offer different characteristics in terms of income, tax treatment, capital appreciation and risk. Please read the risks specific to exchange-traded funds at the end of this brochure as well as each security's prospectus (if applicable).

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.

See the back of this brochure for risks and important information.

Not FDIC Insured • Not Bank Guaranteed • May Lose Value

The ETF Structure Provides Many Potential Benefits:

- Diversification — Owning an ETF allows investors to have exposure to a basket of securities through a single investment. Diversification primarily helps reduce volatility and also has the potential to enhance your returns. It is important to note that diversification does not guarantee a profit or protect against loss.
- Low Expenses — ETFs are less likely to carry high management fees and usually have lower annual expense ratios than other managed investment vehicles.
- Tax Efficiency — The typical ETF's structure allows it to substantially lessen and/or possibly avoid capital gains distributions through an in-kind redemption process. The creation and redemption process allows all share activity to be facilitated through the in-kind distribution transfers with institutional investors, preventing the fund from incurring capital gains as a result of shareholder trades. However, the ETF structure does not necessarily eliminate all capital gain distributions. Additionally, some ETFs effect creations and redemptions for cash rather than in-kind securities.
- Flexible — Any ETF can be bought and/or sold with the same flexibility as an individual stock. This allows investors to place stop-limit orders, buy on margin, or sell short. Any of these transactions would make them subject to the same terms that would apply to individual common stocks.
- Transparency — Investors will know exactly what they purchase. The holdings of ETFs are listed on a daily basis, whereas mutual funds generally release their holdings quarterly. The transparency of the ETF's portfolio allows investors to easily obtain or hedge exposure to a specific group of securities.
- Tradability — ETFs can be purchased or sold during any part of the trading day. They are listed on an exchange, so it's easy for investors to buy or sell shares throughout the day. Because ETFs are listed, investors can obtain up-to-the-minute share prices from their broker or financial advisor and trade the ETF just like a single stock.

Investment Strategies Using ETFs

In today's financial marketplace investors are focusing on the fundamentals of sound investing and are realizing that a well-constructed portfolio is vital to investment success. Sound portfolio construction begins with aligning investment goals to appropriate investment strategies such as asset allocation, diversification, cost control and risk management and applying periodic portfolio rebalancing.

The flexibility provided by ETFs makes these instruments one of the most useful investment tools available for both individual and institutional investors. ETFs offer a simple way for investors to assemble a low-cost, broadly diversified portfolio of securities from major global market segments. ETFs can be adapted to suit a multitude of objectives. The potential benefits of investing in ETFs can be enhanced when using them strategically.

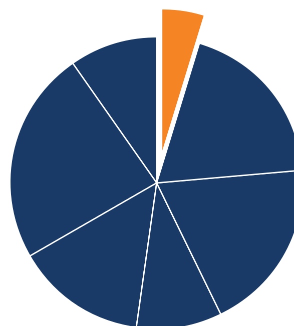
Asset Allocation

There are many significant considerations when constructing an investment portfolio — your current financial situation, future needs for capital and your risk tolerance to name just a few. Investors have long recognized the importance of balancing risk and creating diversification by dividing assets among major asset classes such as cash, bonds, stocks, and real estate. ETFs provide a sophisticated means to efficiently gain exposure to market segments encompassing a wide range of asset classes, market capitalizations, styles and sectors. ETFs have made it possible for all investors to build tailored investment portfolios consistent with their financial needs, risk tolerance and investment horizon. Selecting an appropriate asset allocation strategy and conducting periodic reviews may help to achieve your long-term investment goals and provide the potential for above average returns while reducing risk.

Portfolio Completion

An investor can use ETFs to fill a missing asset class in their allocation. Many portfolios might not have adequate exposure to certain sectors or market capitalization ranges. If, for example, your portfolio was underweighted in small-cap companies, you could purchase an ETF to gain the proper degree of exposure which is dictated by your asset allocation plan.

Small-Cap & Micro-Cap ETFs



Tax Loss Harvesting

ETFs provide an effective way for investors to realize a tax loss while maintaining wanted exposure to a market segment. Tax-loss harvesting is a common year-end strategy of selling a stock which is at a loss and buying an ETF that closely correlates to its sector, thereby keeping portfolio allocations intact. The many choices of ETFs that are available today have given investors options that may offer similar objectives, but are not substantially identical to the investments they sold to harvest losses. As always, please consult your tax advisor for specific information about tax loss harvesting and the wash sale rule.

Core & Satellite Portfolio Structure

The core and satellite investing strategy has been part of investor's asset allocation plans for decades. This strategy considers an investor's tolerance for risk and allows them to actively tailor the investments based on their specific asset allocation plan. In this strategy, broad based ETFs are used as the core of an allocation and are complemented by sector, style or other specialty ETFs that are used for the satellite assets. The core investments form the foundation and consist of traditional broad based assets that provide market matching returns. The core component typically makes up the majority of the portfolio and it is not unusual for investors to allocate from 70% to 90% of assets to these core holdings. Satellite holdings typically invest in more strategic asset classes which often do not react to market conditions the same way as the core holdings. These holdings are added in order to seek excess returns or to manage risk.

With the wide variety of ETFs available today, investors can use ETFs effectively as both core and satellite components. And because ETFs can be bought and sold throughout the trading day, investors are able to make changes easily which has a direct impact on risk management.

Risk Management — Diversification

Diversification is a risk-management practice that combines a variety of investments within a portfolio in an effort to reduce the overall volatility of the portfolio. Because ETFs provide broad exposure to an entire asset class, they can be used to efficiently mitigate the risk of being over exposed to any one company or area of the market. Of course, diversification does not guarantee an investor will not suffer a loss.

Risk Management — Hedging

ETFs have opened up risk management strategies for individual investors that were once available only to large institutions. They can be purchased on margin and sold short, even on a downtick, providing maximum trading flexibility. Listed options are available on some ETFs and offer opportunities for additional hedging or to increase income. It is important to note that substantial risks and higher costs may result from borrowing and short-selling ETFs. These strategies may not be suitable for all investors.

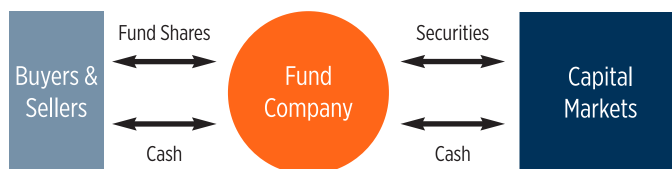
Tax Efficiency

Unlike traditional open-end mutual funds, ETF investors are not generally impacted by purchases and redemptions by other shareholders. The creation and redemption process allows all share activity to be facilitated through in-kind distribution transfers with institutional investors, preventing the fund from incurring capital gains as a result of shareholder trades. However, the ETF structure does not necessarily eliminate all capital gain distributions. Additionally, some ETFs effect creations and redemptions for cash rather than in-kind securities.

Creation & Redemption Process

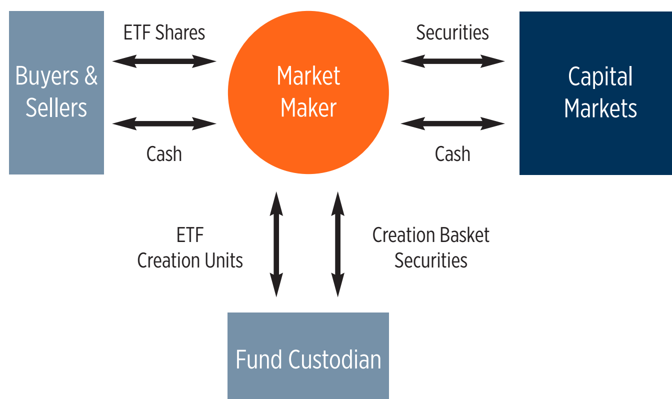
Before discussing the process that makes an ETF more tax efficient, it is important to understand how traditional mutual funds operate. Mutual fund shareholders, either directly or through a broker, purchase and redeem shares from the fund in exchange for cash. When investors send cash to purchase shares, the fund manager can either hold the cash or purchase additional securities for the fund. Conversely, when investors redeem their shares, the fund manager will often have to sell securities in order to raise the cash needed to meet the redemption. This may generate a capital gain which gets passed along to the remaining shareholders of the fund. In a year where the fund experiences negative performance, investors can be particularly disappointed when they receive unwanted taxable capital gains distributions.

Traditional Mutual Fund



Unlike traditional mutual funds, only Authorized Participants (APs) can create or redeem ETF shares directly with the fund in very large blocks of shares called creation units. APs consist of market makers, large investors, specialists or institutional broker/dealers. To create units, the AP purchases a basket of securities, which represents the ETF's holdings, through the capital markets and delivers them to the fund custodian. In return, the custodian delivers the appropriate number of ETF shares to the AP. For most ETFs, this transaction is done in-kind, meaning that securities are exchanged for ETF shares. Once the AP receives the ETF shares, the shares are then sold to investors on the open market just like shares of stock. Although the ETF structure does not guarantee that there will never be capital gains distributions, it is this in-kind transfer process that makes most ETFs more tax efficient than their open-end fund counterparts.

Typical Exchange-Traded Fund



Redemptions are simply the opposite of the creation process. Creation units are redeemed in exchange for the underlying securities through an in-kind transfer between an AP and the fund custodian.

Risks & Considerations

A fund's shares will change in value, and you could lose money by investing in a fund. There can be no guarantee that a fund will meet its investment objective. One of the principal risks of investing in a fund is market risk. Market risk is the risk that a particular security owned by a fund, fund shares or securities in general may fall in value.

An index fund's return may not match the return of the applicable index. A fund may not be fully invested at times. Securities held by an index fund will generally not be bought or sold in response to market fluctuations.

Actively managed funds are subject to management risk. In managing a fund's investment portfolio, the sub-advisor will apply investment techniques and risk analyses that may not have the desired result.

A fund may invest in securities issued by companies concentrated in a particular industry, sector or country 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, more established companies.

An investment in a fund containing equity securities of foreign issuers is subject to additional risks, including currency fluctuations, political risks, withholding, the lack of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be heightened for securities of companies located in, or with significant operations in, emerging market countries.

Investors buying or selling fund shares on the secondary market may incur 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, shares may only be redeemed directly from the 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.

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 and the Internal Revenue Code. First Trust has no knowledge of and has not been provided any information regarding any investor. Financial advisors must determine whether particular investments are appropriate for their clients. First Trust believes the financial advisor is a fiduciary, is capable of evaluating investment risks independently and is responsible for exercising independent judgment with respect to its retirement plan clients.

This summary is not intended to be tax or legal advice. This summary cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. This summary is being used to support the promotion or marketing of the transactions herein. The taxpayer should consult an independent tax advisor.

1-866-848-9727 • www.ftportfolios.com

First Trust Advisors L.P. is the adviser to the First Trust exchange-traded funds. First Trust Advisors L.P. is an affiliate of First Trust Portfolios L.P., the funds' distributor.

ETFIG0060117