

SHINING A LIGHT ON..... FIRST TRUST US LARGE CAP CORE ALPHADDEX ETF

At a glance

The US market is notoriously difficult for active managers to outperform; the argument is that it is highly efficient and therefore investors would be better to hold a fund that tracks the index rather than paying for active management.

We were recently introduced to First Trust US Large Cap Core AlphaDEX ETF which is best described as a half-way house between the outperformance of an active fund with the structure of an ETF. At this stage it is very difficult to test the performance of the fund as it was only introduced in the UK in 2013.

However what is interesting about the fund is that it aims to provide performance above a tracker fund through active allocation. In a recent fund review we reviewed the Baillie Gifford American Fund and explained that it had struggled to outperform the index. The ETF was launched in April 2013 and over 12 months returned 12.87% by comparison the index returned 8.07% and Baillie Gifford 7.49%.

We wanted to understand why investors might select this over an active fund or a pure tracker fund.

Fund highlights?

For investors looking at investing in the US market there is an argument that active managers consistently underperform the index, in fact only around 20% outperform. The problem with index funds is that they have around 20% of their holdings in the 10 biggest companies in the index.

Going back over a twenty year period, history shows that the largest companies on the S&P index tend to underperform the smallest companies. Index funds tend to have the lowest weighting to the smallest companies where the performance comes and the highest weighting to the largest companies where the performance is weaker.

This ETF is size agnostic and simply rates all 500 stocks on the index. The stocks are split between growth and value stocks. Growth considers price momentum, sales growth and price / sales and value considers price / book, price / cash flow and returns on asset.

As an example IBM is the 5th largest company in the US. On a price to book it ranks at 482 which means it is overpriced compared to the market. Because the fund eliminates the lowest scoring 25% of stocks it can in theory avoid the sell-off if it comes. In 2013 IBM was down -0.75%. Whereas a company like Xerox had a rating of 20 and returned 81.38%.

The fund is equally weighted in chunks. So the top 75 stocks have a weighting of 33.3% (0.44% each stock), the next 75 stocks have 26.7% weighting, then 20%, 13.3% and finally 6.7%.

Each quarter the whole portfolio is re-rated and re-balanced. There is no emotional bias and it is a pure asset allocation play.

In summary this is a pure play on the S&P 500 which aims to deliver above average returns compared to other index funds but not concentrating the portfolio to one group of companies. For

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investors looking to invest in the US market but not sure whether to choose active or passive this is a good half-way house. However, although they have experience in this field dating back to 2006 it is relatively new in the UK and the track record is not there.

The strategy tends to perform well in an up market and not so well when the markets are falling. The cost of the fund is more expensive than a pure passive fund and slightly cheaper than an active fund at around 0.65%.

First Trust

First Trust is not well known in the UK. They manage over \$95 billion in the US of which \$24 billion is in ETFs. The ETF business started in 2005 and came to the UK 18 months. The manager of the strategy is Eric Anderson who joined the business in 2005. The use of these types of funds is more popular in the US but is beginning to gain traction in the UK because investors have access to holdings on a daily price and the cost is transparent and clear.

Fund performance

The table below shows performance over the last five years and going into 2014:

	2013	2014	Since Launch (24 April 2013)
First Trust US Large Cap Core AlphaDEX ETF	11.32%	0.16%	11.50%
Baillie Gifford American Fund	6.47%	0.97%	7.49%
iShares MSCI North America	7.26%	-0.05%	7.21%

You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation, but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced.

The source of information in this note has been provided by First Trust and is correct as at February 2014. These are notes from meeting the fund manager or representative and should not be seen as a recommendation to purchase any fund mentioned. Any reference to shares is not a recommendation to buy or sell. Should you wish to make a decision based on these notes we cannot take responsibility for this and you should carry out your own research before making a decision. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well rise.