Fund Focus

FlexShares Core Select Bond Fund

INFORMED INCOME

For investors seeking a managed portfolio made up of passively managed fixed income ETFs

Bonds historically have served as a key part of a diversified portfolio. The income and relative stability they provide over the short term may help investors buffer volatility in the equity markets. However, bond investors today face new considerations: Conventional bond indexes are market- weighted, which may leave them vulnerable to overconcentration in large sectors that can hurt their performance. Actively managed bond funds are designed to potentially avoid these pitfalls, but their improved performance may come with the cost of less transparency.

In this paper, we examine why conventional, index-based core bond funds can experience changes in allocation that may negatively affect their risk-reward properties. We then explain the methodology that FlexShares Core Select Bond Fund (BNDC) uses to construct an actively managed bond fund out of what we believe are cost effective and efficient exchange-traded funds (ETFs).

THE SHORTCOMINGS OF CONVENTIONAL CORE BOND FUNDS

Bond portfolios play an important role in most investors' strategies. They may provide important diversification benefits and potentially offer a measure of protection against equity market volatility.

We believe that most of the low-cost opportunities for core bond holdings rely on conventional bond indices, such as the Bloomberg Barclays US Aggregate Bond Index.[1] However, our opinion is that these indices are typically market-weighted, which means the amount of debt they hold in a given segment of the credit market directly reflects the amount of outstanding debt in that category. As a result, the composition of the index can change in ways that could increase or decrease the risk-return profile[2] of a portfolio that follows the index.

For example, the increase in U.S. Treasuries issued following the 2008 financial crisis raised that sector from approximately 15% of total fixed income outstanding in 2007 to over 30% in 2012.[3] Similarly, a market-weighted index may end up holding a disproportionate amount of debt from very large corporate issuers, without regard to any relative differences in risk/returns among those issuers. Market weighting also means an index's duration[4] can fluctuate with the duration of debt being issued, leading to potential fluctuations in its interest-rate sensitivity.

What's not included in a bond market index may also increase an investors' risk. For example, the Bloomberg Barclays US Aggregate Bond Index does not hold any positions in Treasury Inflation-Protected Securities (TIPS).

In addition to potential risks, the make-up of market-weighted indexes may also reduce investors' potential returns. Treasuries are considered by many as among the safest investments in the fixed-income universe and consequently have historically had some of the lowest overall interest rates, which means their increased presence in an index could decrease its overall yield.

We believe that in order to provide investors with better fixed-income exposure, a well-diversified core bond holding should aim to include:

- A consistent risk profile, designed to provide stable sector exposures and duration
- Tactical adjustments to manage risk and capture potential opportunities, implemented by experienced professional investors
- Exposure to TIPS in an effort to help mitigate inflation risk
- Competitive fees and tax efficiency

THE FLEXSHARES SOLUTION: AN ACTIVELY MANAGED CORE BOND ETF OF ETFS

The FlexShares Core Select Bond Fund (BNDC) is an ETF that seeks to provide a diversified, core fixed-income portfolio that balances total return and income, while offering price stability and diversification away from equities.

The ETF is actively managed by institutional fixed-income managers at Northern Trust, the adviser of the FlexShares funds. These managers aim to build a diversified bond portfolio through existing ETFs, using both the FlexShares ETF family and ETFs from other providers, to provide exposure across sectors of the fixed income markets.

For example, the Fund captures exposure to the major fixed-income asset classes such as Treasuries, corporate bonds, and mortgage-backed securities (MBS), while also choosing ETFs that offer potentially more refined, value-added exposures to a variety of products such as TIPS.

Northern Trust's fixed-income team positions the fund strategically and tactically based on:

The interest rate outlook and may extend duration if the team expects rates to fall and shorten duration if the team expects rates to rise.	Risk exposure across bond market sectors by adjusting weightings toward Treasuries, MBS and corporate bonds in an effort to optimize risk-adjusted yields.[5]

MORE CONSISTENT RISK EXPOSURE IN AN EFFICIENT VEHICLE

The fund-of-funds model employed by the FlexShares Core Select Bond Fund (BNDC) gives investors access to Northern Trust's institutional fixed-income expertise. The Fund's portfolio managers have the ability to change the fund's duration and risk allocation in response to changes in interest rates or risk levels in various sectors. This ability to make tactical adjustments allows the Fund's managers to express their current views on the evolution of the fixed-income market, which may help investors capture opportunities while managing risk.

Our belief is that building a portfolio of ETFs also allows managers to make adjustments to the Fund's composition more efficiently. They can potentially fine-tune the Fund's duration or sector exposure through a small number of ETF transactions, rather than through dozens of transactions involving individual securities. We believe this efficiency helps keep the Fund's turnover and fees low.

CONCLUSION

Our opinion is that conventional core bond funds or index-based ETFs may have drawbacks for investors because of their potential reliance on market weighting. Trends in bond issuance may change the weighting of an index in ways that can negatively affect investors' risk exposure and return potential. What's more, some investments, like TIPS, aren't included in some of the broader indices at all.

The FlexShares Core Select Bond Fund (BNDC) combines Northern Trust's fixed-income expertise with the transparency and potential cost effectiveness often associated with ETFs. As a result, we believe the Fund provides investors an opportunity to participate in the potential upside of an actively managed bond portfolio while enjoying the benefits of an ETF.

FIND OUT MORE

The FlexShares approach to investing is, first and foremost, investor-centric and goal oriented. We pride ourselves on our commitment to developing products that are designed to meet real-world objectives for both institutional and individual investors. If you would like to discuss the attributes of any of the ETFs discussed in this report in greater depth or find out more about the index methodology behind them please don't hesitate to call us at 1-855-FlexETF (1-855-353-9383).

FOOTNOTES

1 Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. This includes Treasuries, government-related and corporate securities, mortgage-backed securities, asset-backed securities and collateralized mortgage-backed securities.

2 The risk-return profile is an overview of how much the investment risk within the fund or strategy has the chance that the actual value of, or return from, an investment may be less than its expected value or return.

3 SIFMA, https://www.sifma.org/resources/research/fixed-income-chart/. At the end of each year, SIFMA calculates the total outstanding debt within the fixed income market from these categories Corporate Bonds, Mortgage-Backed Securities, Asset-Backed Securities, Federal Agency Securities, Treasury Securities & Municipal Securities beginning of 1996 to end of 2019. Each category is then assigned a percentage within the larger total of the combined categories.

4 Duration is how sensitive your investment or a portfolio is to a change in interest rates. You will often see it expressed as a number of years – the higher the number the more volatile will be the expected change. Historically, rising interest rates have often meant falling bond prices, while declining interest rates have meant rising bond prices.

5 Risk-adjusted yields defines an investment's yield by measuring how much risk is involved in producing that yield, which is generally expressed as a number or rating

IMPORTANT INFORMATION

Before investing, carefully consider the FlexShares investment objectives, risks, charges and expenses. This and other information is in the prospectus and a summary prospectus, copies of which may be obtained by visiting www.flexshares.com. Read the prospectus carefully before you invest.

Foreside Fund Services, LLC, distributor.

An investment in FlexShares is subject to numerous risks, including possible loss of principal. Fund returns may not match the return of the respective indexes. A full description of risks is in the prospectus.

FlexShares Core Select Bond Fund (BNDC) is actively managed and does not seek to replicate a specified index. The Fund is subject to increased credit and default risk, where there is an inability or unwillingness by the issuer of a fixed income security to meet its financial obligations, debt extension risk, where an issuer may exercise its right to pay principal on an obligation later than expected, as well as interest rate/maturity risk, where the value of the Fund's fixed income assets will decline because of rising interest rates. The Fund is subject to increased underlying fund risk, where the Fund's investment performance and its ability to achieve its investment objective may be directly related to the performance of the Underlying Funds in which it invests. The Fund may also be subject to increased concentration risk as it may invest more than 25% of its assets into the securities of a single developed market. Additionally, the Fund may invest without limitation in mortgage or asset-backed securities, which puts it at increased risk for interest rate/maturity risk, debt extension risk, and prepayment (or call) risk.