Fund Focus

FlexShares High Yield Value-Scored Bond Index Fund

VALUE OF YIELD

For investors seeking income diversification while focusing on value and quality issuers

High yield bonds have advanced from a specialty fixed income investment to a strategic, mainstream asset held across most diversified portfolio allocations. Once viewed as being the “penalty box” for wayward public debt issuers, over the years the sector has transformed into a dynamic, competitive marketplace for capital raising and refinancing. A multitude of forces were needed to bring high yield out of the shadows and into the spotlight. Now the sector is ready for a further evolution that combines earlier high yield principles with new techniques to again deliver truly high income strategies for today’s investors.

In this paper, we discuss some of the changes that are affecting the high yield bond market. We then describe how the FlexShares High Yield Value-Scored Bond Index Fund (HYGV) uses a multi-factor approach to select and weight securities, which we believe offers the potential for improved diversification and income generation.

FOCUSING ON YIELD

The evolution of high yield has been supported by low market interest rates, tight credit spreads, shifting norms in corporate financial management, regulation, changing investor risk tolerances and new portfolio construction models. High yield investing has grown, matured and transformed over the decades into a familiar but distinctly different asset class.

For an investor, a fixed income high yield strategy focused on yield may seem oxymoronic. After all, historically fixed income plays two important roles in a portfolio – diversification and income generation. Additionally, income generation, by definition, is a function of yield.

Our research indicates that, historically, the coupon/ yield on a fixed income portfolio contributed more significantly to overall returns. Our research confirms prior findings, including a study by Gauthier and Goodman[1] that showed 95.3% of expected fixed income returns came from the cumulative effect of duration[2] positioning and credit risk. Analysis of historical return components shows that, in order to maximize the value of high yield as an investment, investors should consider focusing on maximizing exposure to yield in constructing and managing their high yield portfolio.

In our view, focusing on yield call for a more innovative approach to building a high-yield portfolio—particularly in the areas of identifying issuer quality and targeting the potential for enhanced risk-adjusted returns. We believe that high yield fixed-income factors such as value and quality—which our research suggests may provide the potential for long-term return premiums—may help improve high-yield bond portfolio construction.

A MULTI-FACTOR APPROACH TO INDEX CONSTRUCTION

The FlexShares High Yield Value-Scored Bond Index Fund (HYGV) seeks to provide investors the potential benefits of income diversification while focusing on value and quality issuers by tracking the Northern Trust High Yield Value-Scored US Corporate Bond Index (the Underlying Index)[3], a custom index with what we believe is a unique multi-factor methodology. Northern Trust Investments Inc. (NTI) is the investment adviser for FlexShares ETFs.

Starting with the Northern Trust High Yield US Corporate Bond Index[4], NTI first categorizes eligible credit issuers securities. Then, each issuer in those sectors receives a composite score based on the investment factors value, quality and liquidity. NTI's value screen is a multi-metric assessment of value that incorporates both relative value and market-based valuation of default.

The quality screen examines three critical elements NTI believes offers a forward-looking assessment of creditworthiness and an issuer's ability to pay debt obligations:

MANAGEMENT EFFICIENCY

A quantitative evaluation of a firm's deployment of capital and its financing decisions. Firms that aggressively pursue capital expenditures and additional financing generally lose the flexibility to respond to both advantageous and challenging portions of the market cycle.

PROFITABILITY

A way to measure a firm's relative competitive advantage. Firms with wider profit margins may be better positioned to grow compared with firms that have slimmer margins.

SOLVENCY

An assessment of a company's ability to meet its debt obligations and day-to-day liquidity needs. This provides insight into how we believe the organization will be positioned to take advantage of future opportunities and whether it has enough financial cushion to withstand periods of distress.

NTI's liquidity screen is a multi-metric assessment of liquidity that incorporates such characteristics as time to maturity (e.g. time until the security reaches its maturity date as measured in years), total issuer debt outstanding (e.g. the sum of all debt outstanding for a single corporate issuer), and time since original issuance (e.g. the time that has elapsed since the security was originally issued as measured in years).

We believe optimization is further enhanced through the use of several constraints, including:

- A maximum issuer index weight of 5%
- A maximum sector over-weight/underweight to the overall universe of +/- 8%
- Proprietary Credit-Score constraint in order to remove bonds ranking in the lowest decile of the proprietary score
- Proprietary Liquidity Score constraint to restrict new issuances that fall in the bottom 5% of liquidity within each sector, per the proprietary score, at each reconstitution

During this optimization process, the primary objective is to maximize exposure to the value-score factor relative to the eligible universe.

CREATIVE, EFFICIENT EXPOSURE TO THE HIGH YIELD CREDIT MARKET

We believe that the index's composite value, quality and liquidity score ranking creates the potential for greater diversification and income generation, and may enhance risk-adjusted returns. Initially, high-yield ETFs were panned by legacy high-yield active managers. They predicted dire market behaviors and atypical performance outcomes due to the ETFs' all-day trading liquidity and full price transparency. Our research suggests that those predictions have not held up with the passage of time.

Our multi-factor approach represents the kind of innovation that, in our view, is needed to help investors pursue higher levels of potential income in our current low market interest rate environment.

CONCLUSION

High yield bonds remain an important component of many investors' fixed-income holdings, offering the potential for diversification and income generation. Low bond yields and the evolving high-yield fixed income market place have made pursuing these potential benefits more difficult. The FlexShares High Yield Value-Scored Bond Index Fund (HYGV) is designed to address the needs of these investors and the conditions of today's fixed-income markets by employing multi-factor selection criteria and diversification controls that we believe may enhance the portfolio's risk-adjusted returns.

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) or visit **www.FlexShares.com.**

FOOTNOTES

1 Risk/Return Trade-Offs on Fixed Income Asset Classes, 2003, Gauthier, Laurent, Goodman, Laurie, Fixed Income Portfolio Management – Volume 4 by Frank J. Fibozzi.

2 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.

3 Northern Trust High Yield Value-Scored US Corporate Bond Index is designed to measure the performance of a diversified universe of high yield, US-dollar denominated bonds of companies exhibiting favorable fundamental qualities, market valuations and liquidity, as defined by Northern Trust Investments, Inc.'s proprietary scoring models.

4 Northern Trust High Yield US Corporate Bond Index is designed to measure the performance of a diversified universe of high yield, US dollar denominated corporate bonds issued by companies who are members of the G12 or G10 Currencies.

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 High Yield Value-Scored Bond Index Fund (HYGV) invests in high yield securities, which are considered highly speculative, and is subject to greater credit risk, price volatility and risk of loss than if it invested primarily in investment grade securities. There is a higher risk that an issuer will be unable to meet principal and interest rate payments on an obligation and may also be subject to more substantial price volatility due to such factors as interest rate sensitivity, market perception of credit worthiness of and general market liquidity than if the fund invested in investment grade securities. The fund may invest in distressed securities, which generally exposes the fund to risks in addition to investing in non-investment grade securities. These risks can adversely impact the Fund's return and net asset value. When interest rates rise, the value of corporate debt can be expected to decline. The value of the securities in the Fund's portfolio may fluctuate, sometimes rapidly and unpredictably at a greater level than the overall market. The Fund may invest in derivative instruments. Changes in the value of the derivative may not correlate with the underlying asset, rate or index and the Fund could lose more than the principal amount invested. The Fund will concentrate its investments (i.e., hold 25% or more of its total assets) in a particular industry or group of industries to approximately the same extent that the Underlying Index is concentrated. The fund is also subject to the risk that the Fund's investment in companies whose securities are believed to be undervalued will not appreciate in value as anticipated.