Fund Focus

FlexShares Disciplined Duration MBS Index Fund

POOL RULES

For investors seeking the income diversification of mortgaged-back securities with targeted duration

Many investors look to mortgage-backed securities (MBS) as an option to help diversify their fixed-income holdings and pursue higher potential yields than are available from U.S. Treasuries. However, investing in MBS comes with special considerations around duration[1]—a key measurement of a fixed-income security's sensitivity to interest rate movements. We believe that historically duration has been a major driver of MBS risk and returns, and that investors must continually monitor the effective duration of an MBS portfolio due to the impact of mortgage prepayments.

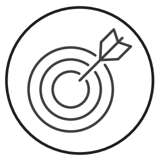
In this paper, we examine the role of prepayments on MBS duration volatility. Then, we describe how the FlexShares Disciplined Duration MBS Index Fund (MBSD) tracks an index with a rules-based approach to manage MBS portfolio duration more consistently.

THE IMPORTANCE OF DURATION POSITIONING IN MBS PORTFOLIOS

For many years, investors have been attracted to the diversification and income-generating potential of MBS. Historically, these securities have offered a mix of attractive yields and strong credit quality, as they are backed by the government agencies the Government National Mortgage Association (GNMA or "Ginnie Mae"), the Federal Home Mortgage Association (FNMA or "Fannie Mae"), or the Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac").

However, MBS investing comes with special considerations around duration—a key measure of a fixed-income investment's sensitivity to changes in interest rates. Duration is often expressed as a number of years. Higher numbers represent greater volatility in the face of interest rate changes. In MBS, however, duration is also affected by mortgage prepayments. For example, if interest rates fall and mortgage holders find it attractive to refinance their loans, that activity may reduce the duration on MBS—which in turn may affect the targeted duration positioning of an investor's MBS portfolio.

Our opinion is that duration positioning combined with interest rate movements can be responsible for large percentage of MBS returns. As a result, we believe investors need innovative ways to manage duration and interest rate risk in an MBS portfolio in an effort to pursue stable returns.



THE FLEXSHARES SOLUTION: DISCIPLINED REBALANCING TO MAINTAIN A DURATION TARGET

The FlexShares Disciplined Duration MBS Index Fund (MBSD) is designed to provide market-like exposure to the MBS segment, while controlling for potential duration drift. The Fund tracks the ICE BofAML Constrained Duration US Mortgage Backed Securities Index,[2] which follows a rules-based approach in an effort to maintain the portfolio's duration within a target range.

The index is composed of securities selected from the universe of 10-year, 15-year, and 30-year MBS. The index seeks to maintain a monthly effective duration within a one-year band of 3.25 years to 4.25 years—with a midpoint target of 3.75 years. This range was chosen in an effort to help avoid greater turnover than potentially necessary to help maintain the target duration. The index also factors such as current Federal Reserve policy, the outlook for U.S. interest rates and potential reforms of agency mortgage programs.

The index is rebalanced on a monthly basis to maintain its target effective duration. For example, if the index's duration falls below the 3.25-year low point, ICE BofAML will trim positions in the index's shortest-duration instruments and reallocate those funds into longer-duration MBS within the target range.

This trimming and rebalancing will continue until the index's effective duration falls within the 3.5-year to 4.0-year range—rather than simply rebalancing back to the lowest or highest end of the target duration range. This policy is intended to help potentially reduce additional turnover that may be caused by further movements in duration in subsequent months.

TAKING OVER THE ROLE OF DURATION MONITORING

By tracking an index that seeks duration within a disciplined band, we believe the FlexShares Disciplined Duration MBS Index Fund (MBSD) offers investors exposure to the potential benefits of MBS securities while also helping to control for one of the biggest challenges within this asset class.

In our view, it's important that investors who seek exposure to the MBS segment for its diversification and return potential also understand the potential risks associated with duration fluctuation. By maintaining an MBS portfolio with a more consistent duration, we believe our fund may remove much of the uncertainty around duration positioning and seeks to offer an improved MBS investing experience.

CONCLUSION

An allocation to the MBS segment may help investors diversify their fixed-income holdings with bonds that offer strong credit quality and attractive yields. However, managing duration positioning in an MBS portfolio can be challenging, as changes in interest rates also can lead to changes in mortgage prepayment levels that may move MBS duration more dramatically than expected.

The FlexShares Disciplined Duration MBS Index Fund (MBSD) seeks to provide exposure to the potential benefits of MBS investing while helping address the challenge of duration management. The underlying index's rules-based approach for managing effective duration within a one-year band around a target midpoint of 3.75 years may lead to less volatility in duration than investors would experience in a traditional market-weighted MBS index—helping investors position MBS exposure more efficiently and effectively within their overall portfolios.

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 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.

2 ICE BofA ML Constrained Duration US Mortgage Backed Securities Index tracks the performance of US dollar denominated 30-year, 20-year and 15-year fixed rate residential mortgage pass-through securities publicly issued by US agencies in the US domestic market.

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 Disciplined Duration MBS Index Fund (MBSD) is passively managed and uses a representative sampling strategy to track its underlying index. Use of a representative sampling strategy creates tracking risk where the Fund's performance could vary substantially from the performance of the underlying index along with the risk of high portfolio turnover. It is subject to credit risk, which is the risk that the inability or unwillingness of an issuer or guarantor of a fixed-income security, or a counterparty to a TBA, repurchase or other transaction, to meet its payment or other financial obligations will adversely affect the value of the Fund's investments and its returns. Changes in the credit rating of a debt security held by the Fund could have a similar effect. Debt extension risk is the risk that an issuer will exercise its right to pay principal on an obligation held by the Fund (such as a mortgage-backed security) later than expected. This may happen during a period of rising interest rates. Under these circumstances, the value of the obligation will decrease and the Fund will suffer from the inability to invest in higher yielding securities. Mortgage-backed pass-through securities risk is the risk of investing in mortgage-backed securities issued by a U.S. Agency. These securities may not be backed by the full faith and credit of the U.S. government. As interest rates rise, bond prices fall, reducing the value of fixed income investments.