Fund Focus

FlexShares US Quality Large Cap Index Fund

3 FACTOR COMBINATION

For investors seeking to maximize US large cap exposure to the quality, value and momentum factors

Large-cap stocks often make up the core of an investor's equity portfolio. And with most large-cap funds holding a broad mix of large-cap stocks, their performance may generally follow that of the broader equity market. However, our research has found that applying investing factors when building a large-cap stock portfolio may deliver superior risk-adjusted returns[1] compared to the broad large-cap market.

In this paper, we discuss how screening large-cap stocks for quality as well as value and momentum may improve performance and help manage risk. We then explain how the FlexShares US Quality Large Cap Index Fund (QLC) tracks an index with a multi-factor screening methodology.

THE BENEFITS OF MOVING BEYOND THE BROAD MARKET

For many investors, large-cap stocks comprise the core of their portfolio's equity allocation. And while large-cap stocks have historically been consistent drivers of performance, the returns of many large-cap equity funds may track closely to the performance of the broader large-cap market.

Factors may offer a solution for investors looking to enhance the risk-adjusted performance of their large-cap stock allocations. We believe that applying factors to equity holdings may lead to long-term outperformance of the broader market. Indeed, it is our opinion that factors such as value, quality and momentum are designed to target specific drivers of return:

Value Factor

The value factor prioritizes companies with attractive valuations relative to its market value based on metrics such as price to earnings (P/E) and price to book.[2] Our opinion is that historically, value stocks have outperformed the broad market over long periods.

Quality Factor

The quality factor is based on the desire to invest in companies with a financial underpinning that is solid enough to maintain or grow over time.

Momentum Factor

The momentum factor reflects our belief that stocks with strong recent performance continue to maintain that performance for some time in the future. Momentum focuses on technical metrics such a rising share price over a particular length of time or an increase in trading volume to measure market sentiment for a particular company.

While past performance does not guarantee future results, each of these factors offers the potential for a long-term return potential, we believe large-cap investors may benefit most from employing a multi-factor strategy which may also improve diversification. Meanwhile, low correlation between various factors may help maintain overall performance during periods when one factor is out of favor. However, it's important to find the right combination of factors to meet the goal of achieving risk-adjusted return premiums.

THE FLEXSHARES SOLUTION: A MULTI-FACTOR APPROACH

The FlexShares US Quality Large Cap Index Fund (QLC) is designed to offer the potential benefits of exposure to the quality, value and momentum factors, while targeting the same general risk profile of the overall large-cap space. The Fund tracks the Northern Trust Quality Large Cap Index,[3] and Northern Trust Investments (NTI) is the investment adviser for FlexShares ETFs.

Starting with the Northern Trust 1250 Index,[4] NTI includes only securities that at the time of annual reconstitution are considered to be a top 600 corporation as measured by their largest float adjusted market capitalization. They then apply a screen to give each company a composite score on each of the three factors (quality, value and momentum). A key differentiator to NTI's approach is the use of multiple data points within each factor to establish that composite score:

Value Score

The value score is measured on several valuation metrics, including price-to-earnings ratio, and forward P/E. NTI also measures valuation over several different time periods, including current, historical average, and forward-looking.

Quality Score

The quality score is evaluated through the three lenses of management efficiency, profitability and cash flow.

Momentum Score

The momentum score evaluates both long-term price momentum and short-term reversal signals.[5]

Based on this analysis, each company's stock receives a composite score ranking and is assigned to quintiles, with quintile 1 representing the highest scores. The index eliminates stocks ranked in the lowest quintile.

Next, NTI adds a layer of optimization in an effort to avoid additional uncompensated risk[6] from its factor exposure. For instance, if a particular sector is strongly outperforming the market, those stocks may exhibit higher momentum scores. An un-optimized index may significantly increase exposure to that sector as a result. However, our opinion is that investors engaging in heavy sector overweights or underweights often aren't adequately compensated for the additional risks these sector exposures can introduce to their portfolio.

The index's optimization rules include maintaining maximum overweights and underweights for any single stock, industry or sector, as well as for beta[7] and style factor. The index also is rebalanced on a quarterly basis, with rules limiting portfolio turnover to 20% during each rebalancing.

ADVANTAGE OF A DEFINED MULTI-FACTOR PROCESS

We believe employing a multi-factor approach to a large-cap equity portfolio may deliver higher risk-adjusted returns to investors. While factors work well in isolation, the combination of the factors—and how they are combined—is also important.

NTI selected the quality, momentum and value factors based on their historical long-term return premiums. NTI researchers also determined the process for combining them quite deliberately, drawing on proprietary testing around the metrics in each category that offer the greatest efficacy. While quality is a powerful factor on its own, we believe combining it with value and momentum factors makes each one stronger. Historically, value and momentum have negative correlation to one another. Our research suggests that combining factors with low or negative correlation can help smooth the cycle for each factor, dampening the swings each would experience in isolation.

The Northern Trust Quality Large Cap Index aims to harness each factor through its selection and weighting process. This simple but powerful investment process is designed to deliver the potential benefits of factor exposure while attempting to limit uncompensated risk.

CONCLUSION

Large-cap stocks often are the workhorses of an investor's equity portfolio. Employing a multi-factor approach to this popular segment of the equity market may help large-cap portfolios deliver greater potential risk-adjusted returns. However, we believe the process of combining factors such as quality, value and momentum must be done carefully to capture the true benefits of this multi-factor approach.

FlexShares US Quality Large Cap Index Fund (QLC) aims to strengthen investors' core large-cap holdings with a multi-factor approach focused on quality, value and momentum. The fund's underlying index relies on a deliberate process to construct and combine these factors in an effort to take full advantage of the individual and collective benefits of each factor. We believe this rules-based methodology offers distinct advantages to investors who want the potentially stabilizing benefits of large-cap stocks while also including the potential for enhanced performance due to the focus on these three factors.

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

2 Price to earnings ratio indicates the dollar amount an investor can expect to invest in a company in order to receive one dollar of that company's earnings. The price to book ratio is calculated by dividing a company's stock price by its book value per share, which is defined as its total assets minus any liabilities.

3 Northern Trust Quality Large Cap Index is designed to measure the performance of a universe of large capitalization securities which demonstrate characteristics of what we believe are better quality, attractive valuation and positive momentum.

4 The Northern Trust 1250 Index is designed to provide broad-based exposure to the U.S. equity markets, with a bias toward large and mid-capitalization companies. In an effort to include a greater number of dividend-paying companies, a constituent limit of 1250 is used at the time of each annual reconstitution.

5 Short-term reversal signals is the phenomenon that stocks with relatively low returns over the past month or week earn positive abnormal returns in the following month or week, and stocks with high returns earn negative abnormal returns.

6 Uncompensated risk is the level of additional risk for which no additional returns are generated.

7 Beta is a statistical measure of the volatility, or sensitivity, of rates of return on a portfolio or security compared to a market index. In this instance, the beta for an individual security measures the expected change in return of that security relative to the return of a designated index. By definition, the beta of the Standard & Poor's (S&P) 500 Index is 1.00. Accordingly, a fund with a 1.10 beta is expected to perform 10% better than the S&P 500 Index in rising markets and 10% worse in falling markets.

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.

Past performance is no guarantee of future results.

FlexShares US Quality Large Cap Index Fund (QLC) 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. Additionally, the Fund is at increased dividend risk, as the issuers of the underlying stock might not declare a dividend, or the dividend rate may not remain at current levels. The Fund is also is at increased risk of industry concentration, where it may be more than 25% invested in the assets of a single industry. Finally, the Fund may also be subject to increased volatility risk, where volatility may not equal the target of the underlying index.