For 2023, diversification is back in the spotlight

Market conditions have changed. Are your portfolios prepared?

Inflation and high interest rates are now realities. Here are tips to help you build a well-diversified portfolio in these market conditions.

Last year's market performance was a wake-up call for investors. The era of low interest rates and nearly non-existent inflation is over, and as a result, portfolios that may have generated strong returns for more than a decade are revealing their risks.

With the sudden shift in market conditions and the U.S. Federal Reserve's monetary policy, investors are facing an environment we haven't seen since the 1970s and '80s. With this change, it's critical to reexamine some fundamental principles of diversification to help build resilient portfolios. Here are three important areas to consider when reviewing your investment strategies for 2023.

DIVERSIFYING EQUITY ALLOCATIONS WITH FACTOR EXPOSURE

After an extended market rally that routinely delivered double-digit equity returns, 2022 marked a turning point. Going forward, we believe investors should be prepared for a period of more muted equity returns on a nominal basis. With higher inflation, this means inflation-adjusted returns will be even lower.

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In such an environment, investors typically need equity portfolios that can capture more than just market returns — which is why diversifying with factor exposure may be important. Factors to consider include:

Value: Low inflation and low interest rates benefitted growth-oriented companies whose earnings were projected farther into the future. But higher interest rates cause the value of those future earnings to decline. Value stocks, which tend to have higher current cash flow and earnings, may perform better when interest rates are high. We saw this effect in 2022, when the Russell 1000 Value Index returned -7.54%, compared to the -29.14% for the Russell 1000 Growth Index.

Low Volatility: The surge in market volatility during 2022 highlighted the importance of diversifying among stocks that are less tied to the market's broader movements. An allocation to low volatility stocks historically has helped cushion equity portfolios on the downside, while still capturing some of the market's upside.

Quality: High interest rates and increased costs for goods and labor will put pressure on companies that lack financial strength. The quality factor can help differentiate among stocks within the same sector by identifying companies with stronger balance sheets, higher current cash flows, and conservative capital expenditure strategies.

FOCUSING ON COMPENSATED RISK IN FIXED-INCOME ALLOCATIONS

Advisors should help their clients assess whether they are more comfortable with interest rate risk or credit risk in their fixed-income portfolios. FlexShares believes that investors should be compensated for the risks they're taking, and in the current environment we don't see investment-grade corporate bonds offering investors much in the way of compensation over U.S. Treasuries.

Instead, investors may want to diversify fixed-income holdings with exposure to high-yield bonds. The yield advantage of high-yield bonds offers potential compensation for the additional credit risk that investors are taking.

What's more, the increase in interest rates during 2022 has created a potential opportunity for investors should yields begin falling in 2023.

Real Assets Include:

- Natural Resources
- Infrastructure
- Real Estate

In the current market environment, we believe that natural resource and infrastructure stocks, in particular, may warrant a closer look.

ADDING EXPOSURE TO REAL ASSETS

Real assets — which include natural resources, infrastructure and real estate — have historically offered investors diversification benefits through their inflation-hedging potential and low correlation with fixed-income and other equity classes. In the current market environment, we believe that natural resource and infrastructure stocks, in particular, may warrant a closer look.

We anticipate supply and demand imbalances may provide investors with opportunities in the energy sector, which often are classified under natural resources. However, avoiding concentration in any one sector is critical to managing risk in a natural resources strategy. That's why we encourage investors, in consultation with their advisors, to consider diversified natural resources strategies that include exposure to additional categories beyond energy, such as agriculture, timber, metals and mining and water.

Infrastructure investing strategies also tend to be concentrated in utilities, which carry a higher degree of interest rate risk than other stocks. Utilities stocks may prove to be a challenging sector if interest rates remain elevated in 2023. To help reduce interest rate risk, investors may want to examine diversified infrastructure strategies that include exposure to categories such as such as pipelines, communications equipment and government outsourcing.

For more on diversifying portfolios for high interest rate and high inflation environments see our articles:

- How to Prepare Portfolios for Rising Rates
- Inflation Protection in Portfolio Allocation

For more on FlexShares' investing strategies, see our fund pages:

- FlexShares US Quality Low Volatility Index Fund (QLV)
- FlexShares US Quality Large Cap Index Fund (QLC)
- FlexShares High Yield Value-Scored Bond Index Fund (HYGV)
- FlexShares Morningstar® Global Upstream Natural Resources Index Fund (GUNR)
- FlexShares Stoxx Global Broad Infrastructure Index Fund (NFRA)

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).

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.

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Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

The FlexShares US Quality Low Volatility Index Fund (QLV) 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 higher portfolio turnover. Although the fund seeks lower volatility than the broader U.S. equity market, there is no guarantee it will be successful as securities or other assets in the Fund's portfolio may be subject to greater price volatility than the market as a whole The Fund may also 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 is also is at increased risk of Industry Concentration, where it may be more than 25% invested in the assets of a single industry.

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.

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.

FlexShares Morningstar® Global Upstream Natural Resources Index Fund (GUNR) 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 the global natural resource industry. As the demand for or prices of natural resources increase, the Fund's equity investment generally would be expected to also increase. Conversely, declines in demand for or prices of natural resources generally would be expected to cause declines in value of such equity securities. Such declines may occur quickly and without warning and may negatively impact your investment in the Fund. Investments in foreign market securities involve certain risks such as currency volatility, political and social instability and reduced market liquidity. To the extent that the Fund invests in Emerging markets, those investments may be subject to increased price volatility and may be more susceptible to adverse economic, market, political or regulatory occurrences affecting that country, market, industry, sector or asset class.

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FlexShares STOXX® Global Broad Infrastructure Index Fund (NFRA) 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 infrastructure-related companies risk and MLP risk. Risks associated with infrastructure-related companies include: realized revenue volume may be significantly lower than projected and/or there will be costs overruns; infrastructure project sponsors will alter their terms making a project no longer economical; macroeconomic factors such as low gross domestic product ("GDP") growth or high nominal interest rates will raise the average cost of infrastructure funding; government regulation may affect rates charged to infrastructure customers; government budgetary constraints will impact infrastructure projects; and special tariffs will be imposed. Investments in foreign market securities involve certain risks such as currency volatility, political and social instability and reduced market liquidity. To the extent that the Fund invests in Emerging markets, those investments may be subject to increased price volatility and may be more susceptible to adverse economic, market, political or regulatory occurrences affecting that country, market, industry, sector or asset class.

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