Equity | Fixed Income | Real Assets

FEDM | FEHY
FEUS | FEIG

Are your ESG strategies assessing future risks?

Why sustainable investing strategies should be both historically aware and forward-looking

Sustainable investing offers another way to manage risk in portfolios. So naturally, investors may expect that funds using environmental, social and governance (ESG) criteria will help avoid companies with sustainability challenges and instead focus on companies with a greater chance of delivering long-term growth. One challenge to meeting this goal is that we believe most ESG scoring is primarily based on historical information.

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Data on issues such as greenhouse gas emissions, labor practices and board composition may help identify today's ESG leaders and laggards — but those rankings don't necessarily reveal how companies might respond to sustainability challenges and opportunities in the future. That critical assessment should be informed by historical performance but must be complemented by a forward-looking approach to ESG analysis.

Following is an example of why it's important to look at both a company's ESG track record and indicators of its ability to handle future sustainability issues. We also explain three ways FlexShares has built forward-looking insights into several of our sustainable investing strategies.

COMPANIES WITH SIMILAR ESG ISSUES BUT DIFFERENT TRAJECTORIES

Imagine two companies operating in the same sector, both with similar past employee health & safety problems. Based on this information, these companies have the same risks and so may have been given similar scores through frameworks that are looking just through this lens.

But if we look more closely, we can see Company A, is continuing to operate business as usual, while Company B has developed a new series of training programs and safety protocols in its facilities. It has also established board-level oversight of these issues, with annual auditing to assess compliance.

In this case, Company B is taking proactive steps to safeguard its business from future liability and work stoppages, and potentially helped to improve employee morale in the process. We believe that the long-term outlook from a sustainability perspective for Company B is quite different from that of Company A — an important consideration for us when building an ESG-focused fund.

THREE WAYS TO ASSESS POTENTIAL FUTURE SUSTAINABILITY

While there is no way to predict the future, we believe these three methods can help gauge how companies are positioned relative to sustainability issues over the long term:

1. Analyzing future carbon risk

Climate change is forcing the world to transition to a low-carbon economy. How this transition might hurt or help a company's performance depends on its exposure to climate- and carbon-related risks.

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FlexShares' ESG & Climate strategies start with historical analysis of a company's carbon intensity by measuring:

- Exposure to fossil-fuel assets like oil, gas and thermal coal that may become "stranded" in the future.
- Carbon footprint, as measured by greenhouse gas emissions.

This current exposure is complemented by a forward-looking assessment of exposure to future carbon-related risks. For example, utilities that are proactively shifting away from fossil fuels and toward renewable energy would exhibit a lower carbon-risk score.

This approach may help an index to avoid companies that may hurt long-term portfolio performance, while tilting toward companies that could be better positioned to handle the transition to a low-carbon economy.

Strong corporate governance is critical for financial management.

2. Emphasizing corporate governance

Strong corporate governance is critical for financial management. It can also signal how effectively a company is managing sustainability issues. We look closely at governance indicators, such as:

- Management's identification of sustainability issues that represent material risks or opportunities.
- A clear oversight framework for managing those issues, and disclosure of key metrics.
- Adherence to best practices in financial reporting, board independence and shareholder rights.

Governance issues are critical to balancing short-term corporate performance with long-term shareholder interests. That's why we give governance metrics a meaningful weight in the proprietary Northern Trust ESG Vector Score that drives portfolio construction in several FlexShares ESG strategies.

The recommendations from the Task Force on Climate Related Financial Disclosures (TCFD) established a series of best practices for companies to manage and mitigate their climate-related risks.

3. Using a consistent, forward-looking risk assessment framework for all ESG issues

The recommendations from the Task Force on Climate Related Financial Disclosures (TCFD) established a series of best practices for companies to manage and mitigate their climate-related risks. The core elements of this framework examine:

- A company's governance and oversight of climate risk
- Acknowledging the climate-related risks and opportunities the company has identified, and describing the company's strategy for resiliency
- How a company is identifying and managing risks related to their business
- And disclosure of metrics and targets to manage these risk

We believe this approach represents best practices for managing all material sustainability risks a company faces, whether related to health and safety, raw material sourcing or business ethics. That's why we adapted the framework to apply to all issues, not simply climate, as part of the Northern Trust ESG Vector Score. We believe that having an approach that combines an historical assessment with forward-looking insights provides a consistent way to measure the potential direction of a company's ESG risks and opportunities relative to its peers on long-term sustainability risks and opportunities.

As ESG reporting continues to evolve, we can incorporate new data that may further clarify a company's sustainability today, and in the future.

Our thinking is that using a standardized framework has other forward-looking benefits: As ESG reporting continues to evolve, we can incorporate new data that may further clarify a company's sustainability today, and in the future. We believe these insights will provide advisors and their clients additional ways to thoughtfully manage long-term investment risks and opportunities.

For more on sustainable investing, see our blog post:

- ESG Investing Takes Center Stage in Portfolios

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

- FlexShares ESG & Climate US Large Cap Core Index Fund (FEUS)
- FlexShares ESG & Climate Developed Markets ex-US Core Index Fund (FEDM)
- FlexShares ESG & Climate High Yield Corporate Core Index Fund (FEHY)
- FlexShares ESG & Climate Investment Grade Corporate Core Index Fund (FEIG)

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.

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. 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. An ESG investment methodology that includes and excludes issuers and assigns weights to issuers by applying non-financial factors, such as ESG factors, such ESG investment methodology may underperform the broader equity market or other investment products that do or do not use ESG investment criteria.

FlexShares ESG & Climate Developed Markets ex-US Core Index Fund (FEDM), FlexShares ESG & Climate Emerging Markets Core Index Fund (FEEM), FlexShares ESG & Climate High Yield Corporate Core Index Fund (FEHY), FlexShares ESG & Climate Investment Grade Corporate Core Index Fund (FEIG) and the FlexShares ESG & Climate US Large Cap Core Index Fund (FEUS) are passively managed and use a representative sampling strategy to track their underlying index respectively. Use of a representative sampling strategy creates tracking risk where the Fund's performance could vary substantially from the performance of the underlying index. Fund returns may not match the return of the respective indexes. The Funds are subject to the following principal risks: ESG Investing; corporate bond; concentration; Income; currency; derivatives; LIBOR; emerging markets; equity securities; fluctuation of yield; foreign securities; geographic; industry concentration; interest rate / maturity risk; issuer; large cap; management; market; market trading; new funds; non-diversification; passive investment; privatization; small cap stock; tracking error; turnover; Authorized Participant concentration; liquidity; high yield and volatility risk. A full description of risks is in the prospectus.

Environment, Social and Governance (ESG) investing is defined as utilizing environmental, social, and governance (ESG) criteria as a set of standards for a company's operations that socially conscious investors use to screen potential investments. An ESG investment methodology will influence exposure to certain companies and sectors. Currently, there is a lack of common industry standards relating to the development and application of ESG criteria, which may make it difficult to compare an ESG investment methodology with the investment strategies of other investment products or funds that integrate certain ESG criteria. The subjective value that investors may assign to certain types of ESG characteristics may differ substantially from that of an ESG investment methodology or a data provider.