The Curse of Inflation

"Reasoning in the abstract, the mind cannot stop short of an extreme...But everything takes a different shape when we pass from abstractions to reality."
- Carl von Clausewitz

THE NATURE OF THE BEAST

It is often said that inflation is the result of too many dollars chasing too few goods. If the same concept is reworded to say that inflation is too few goods being chased by too many dollars, the math is the same, but the perspective changes.

In the late Roman Empire, the government started shaving 5-10% of the precious metals from coins to make new coins. This increased the money supply without finding new sources of gold and silver, which was inflationary. In more recent times, central banks have monetized government debt through large-scale purchases – in some countries leading to hyperinflation of over 1,000% per year. This has led many to say that inflation is always a monetary phenomenon.

On the other side of the ledger, inflation can be the result of a scarcity of natural resources or housing, or insufficient infrastructure to move materials efficiently. Famously, prior to the collapse of the Soviet Union, Russians would pay American tourists $200-300 for a pair of blue jeans that retailed for $25 in the US – a case where there was demand for an existing product that was unavailable in that market.

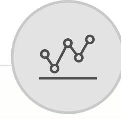
So, inflation is really an imbalance between supply and demand, with demand funded by additional units of currency. While inflation in the abstract is fine for central bankers to debate, consumers and investors are more interested in how it affects them. Consumers have to deal with inflation in real-time by reducing spending, securing wage increases, or tapping savings; and investors face the prospect of reduced long-term purchasing power for their portfolios.

NORTHERN TRUST

Because there are multiple potential sources of inflation, multiple investment vehicles should be employed to hedge against them.

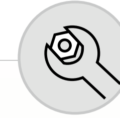
WHERE THE RUBBER HITS THE ROAD

Inflation is a significant long-term risk to investment portfolios, as it erodes the purchasing power of assets over long periods of time, and needs to be hedged against. Because there are multiple potential sources of inflation, multiple investment vehicles should be employed to hedge against them.



Treasury Inflation Protected Securities (TIPS) are fixed income securities that have their principal value adjusted semiannually based on changes in the Consumer Price Index (CPI). Consumer inflation is far down the supply chain and includes the effects of many variables. And although principal amounts are adjusted, the coupon rate remains the same, and rising interest rates can have a particularly negative effect on TIPS over shorter periods.

Natural resource production is at the upper end of the supply chain and is essential to the entire production process. Scarcity of raw materials is a precursor to inflation throughout the supply chain. An allocation to natural resources, particularly those furthest upstream, can hedge against inflation initiating at the source of production.



Infrastructure investments focus on the supply chain, which encompasses transportation of raw materials, as well as completed goods to points of sale or direct to consumers. It does little good if there are natural resources and/or finished goods in abundance if they cannot be transported for consumption. In addition to offering some hedging against inflation, infrastructure investments are also strategic.

Real estate has long been seen as an inflation hedge. While prices in the sector are less volatile than most stocks, real estate is subject to periodic bubbles, and heavily reliant on both the level of, and changes to, interest rates.

Each investment vehicle that can offer any inflation hedge has its own strengths and weaknesses.

SORRY LONE RANGER, THERE IS NO SILVER BULLET

There is no way to eliminate inflation risk in a portfolio, and with no single source of inflation, there is no single way to hedge against it. Each investment vehicle that can offer any inflation hedge has its own strengths and weaknesses. A prudent strategy is to consider incorporating any of those that are suitable.

FlexShares offers six ETFs that may help investors hedge their portfolios against the various sources of inflation, when the abstract becomes reality:

- FlexShares iBoxx 3-Year Target Duration TIPS Fund (TDTT) and FlexShares iBoxx 5-Year Target Duration TIPS Index Fund (TDTF) may help hedge against consumer inflation as tracked by the Consumer Price Index.
- FlexShares Morningstar® Global Upstream Natural Resources Index Fund (GUNR) provides access to natural resources that are considered upstream in the production process, which allows for a potential hedge against inflation. The strategy also includes allocations to water and timber assets, which are often overlooked by other ETFs.
- FlexShares STOXX® Global Broad Infrastructure Index Fund (NFRA) provides exposure to the supply chain itself, as well as the broader logistics of the movement of goods.
- FlexShares Global Quality Real Estate Index Fund (GQRE) provides exposure to real estate and its unique economic characteristics. Studies have shown that global diversification reduces the risk of a real estate portfolio.
- Real Assets Allocation Index (ASET) provides one-stop shopping for allocations in three of the ETFs mentioned above: GUNR, NFRA, and GQRE.

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.

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.

The FlexShares Real Assets Allocation Index Fund (ASET) is passively managed and primarily uses a replication strategy to track its underlying index. Use of a replication 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. The Fund is subject to commodity exposure risk, the risk of investing in economies that are susceptible to fluctuations in certain commodity markets. The Fund is subject to counterparty risk, which is the risk that counterparty to a financial instrument may default on its payment obligation to an Underlying Fund. Investments in foreign and emerging market securities involve certain risks such as currency volatility, political and social instability and reduced market liquidity. The Fund's investments are concentrated in the securities of issuers in a particular market, industry, sector or asset class. The Fund may be subject to increased price volatility and may be more susceptible to adverse economic, market, political or regulatory occurrences affecting that market, industry, sector or asset class. 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.

FlexShares Global Quality Real Estate Index Fund (GQRE) 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 real estate sector risk in addition to the general risk of the stock market. 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. Investing in securities of real estate companies will make the Fund more susceptible to risks associated with the ownership of real estate and with the real estate industry in general, as well as risks that relate specifically to the way in which real estate companies are organized and operated. Real estate companies may have lower trading volumes and may be subject to more abrupt or erratic price movements than the overall securities markets. The value of real estate securities may underperform other sectors of the economy or broader equity markets. To the extent that the Fund concentrates its investments in the real estate sector, it may be subject to greater risk of loss than if it were diversified across different industry sectors. The Fund is also subject to the risk that its investments will be affected by factors that impact REITs and the real estate sector generally. Investing in REITs involves certain unique risks in addition to those risks associated with investing in the real estate industry in general. REITs whose underlying properties are concentrated in a particular industry or geographic region are also subject to risks affecting such industries and regions. By investing in REITs through the Fund, a shareholder will bear proportionate expenses of the REITs in addition to expenses of the Fund.

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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FlexShares iBoxx 3-Year Target Duration TIPS Fund (TDTT) and the FlexShares iBoxx® 5-Year Target Duration TIPS Index Fund (TDTF) are passively managed and primarily use a replication strategy to track their underlying index. Use of a replication 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. They may invest in derivative instruments. Changes in the value of the derivative may not correlate with the underlying asset, rate or index and the Funds could lose more than the principal amount invested. The Funds are subject to fluctuation of yield risk, income risk, inflation protected security risk and interest rate/maturity risk. The Funds are non-diversified meaning the Funds' performance may depend on the performance of a small number of issuers because the Funds may invest a large percentage of its assets in securities issued by or representing a small number of issuers.

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