Quality Low Volatility Strategies: Why Now?

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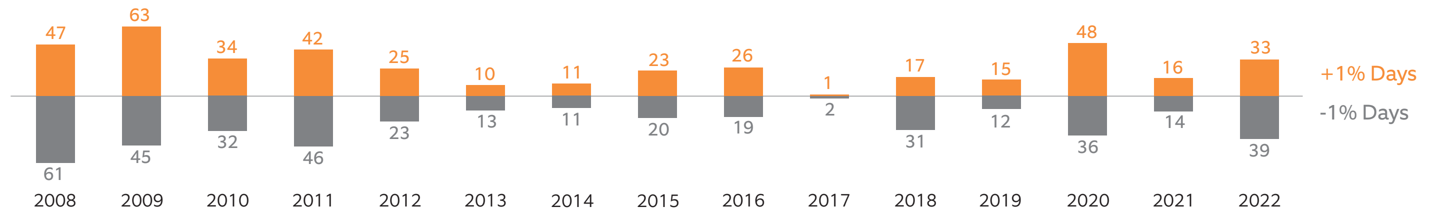
LOWER EXPECTED EQUITY RETURNS COUPLED WITH HIGHER VOLATILITY IS AN ENVIRONMENT WHERE LOW VOLATILITY SHINES.

We believe that the US economy in 2023 could have slower growth, increased inflation, rising interest rates and restrictive monetary policies are expected to lead to muted equity returns over the next five years. At the same time, equity market volatility is spiking to levels not seen since March 2020 during the height of the pandemic. This is a continuation of a trend observed since the Global Financial Crisis: larger and more frequent bouts of volatility spikes across all asset classes. Historically the low volatility factor has done well in periods of muted equity returns.

GLOBAL EQUITY VOLATILITY

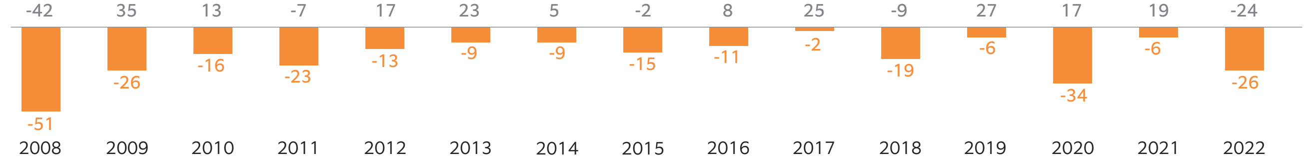
NUMBER OF 1% DAYS ON THE GLOBAL STOCK MARKET

Number of trading days with returns > 1%   Number of trading days with returns < -1%



GLOBAL EQUITY RETURNS AND MAX INTRA-YEAR DECLINES – %

Calendar year global equity return (%)   Calendar year max intra-year drawdown (%)



Source: Bloomberg. Correction data and max Intra-year declines based on the MSCI ACWI. Data through 9/30/2022. Past performance does not guarantee future results.

Our view is that the attractiveness of low volatility is further supported by the macroenvironment. Northern Trust Asset Management has previously examined how various factors behaved under different economic regimes. In periods of both economic slowdown and contraction, the low volatility factor produced its best performance. As global central banks look to curtail inflation by reining in growth, many investors expect a slowdown regime or a contraction environment to be the most likely scenarios.

FOR ASSET ALLOCATORS, LOWER VOLATILITY EQUITIES REPRESENT AN ATTRACTIVE ALTERNATIVE TO MOVING OUT OF EQUITIES IN FAVOR OF FIXED INCOME.

So why shouldn't investors simply shift to "risk off" and move out of equities in favor of fixed income? There are reasons why moving out of equities might not be the most advantageous approach.

First, this approach of moving between equity and fixed income is predicated on the historical diversification these asset classes have in deflationary environments. In periods of low inflation, bond prices and equity prices are negatively correlated with one another, meaning as equity prices decline bond prices will be rising and offer some counterbalance in turbulent equity markets. However in periods of high inflation, we find that equity and bond prices are positively correlated with one another; so as equity prices decline, so do bond prices. So in periods of increased inflation, bonds do not offer the same level of shelter as during low inflationary periods. This is consistent to what markets have experienced in 2022 where both global equities and global bond prices have both fallen with pronounced volatility it each.

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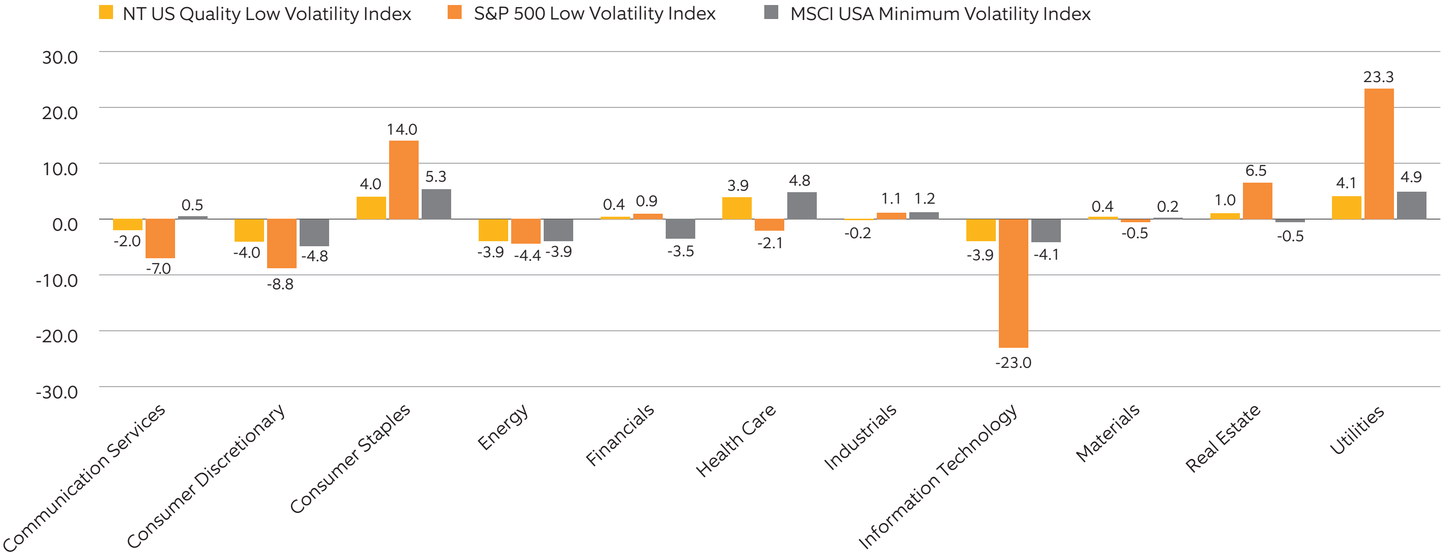
Another way to help reduce risk in your overall portfolio allocation is by reducing the volatility associated with equity markets. Instead of moving out of equities, shifting the weight within equities to a lower volatility approach can effectively lower portfolio risk while still maintaining an exposure to risk assets. This approach can offer some downside protection, but still participate in the upside when markets move higher. This asymmetric exposure of offering downside protection while still experiencing upside capture can benefit an overall asset allocation as markets move higher.

One important aspect to consider when deploying low volatility strategies to help reduce portfolio risk is to make sure that you are not increasing your non-compensated risks, effectively limiting the impact in risk reduction you receive from the low volatility approach. This is particularly important with low volatility strategies as some may incorporate large sector bets to sectors such as utilities in order to achieve a low volatility outcome.

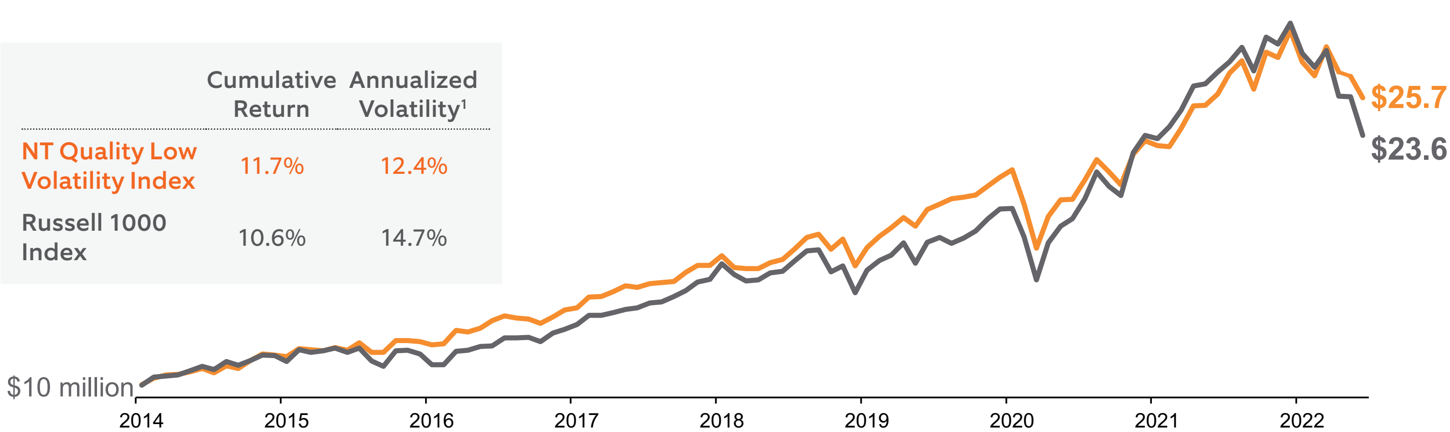
ACTIVE SECTOR WEIGHTS VS RUSSELL 1000 INDEX (AS OF 9/30/2022)



This can be especially troublesome in a rising rate environment as utility companies often exhibit a sensitivity to interest rate increases, leading to underperformance when rates move higher. Ignoring these sector biases can lead to unintended consequences in asset allocation decisions. Luckily, a well-designed approach to capturing low volatility can be designed to help mitigate sector biases while still delivering a similar level of volatility reduction.

HYPOTHETICAL GROWTH OF $10 MILLION

	Cumulative Return	Annualized Volatility[1]
NT Quality Low Volatility Index	11.7%	12.4%
Russell 1000 Index	10.6%	14.7%



Source: Bloomberg. Past performance is no guarantee of future results. Periods greater than one year are annualized except where indicated. Returns reflect the reinvestment of dividends and other earnings and are shown before the deduction of investment management fees, unless indicated otherwise. Returns of the indexes also do not typically reflect the deduction of investment management fees, trading costs or other expenses. It is not possible to invest directly in an index. Indexes are the property of their respective owners, all rights reserved.

THE CURRENT MACRO ENVIRONMENT TENDS TO FAVOR COMPANIES ACROSS ALL SECTORS THAT ARE ABLE TO DEMONSTRATE SUPERIOR FINANCIAL STRENGTH RELATIVE TO THEIR PEERS.

In addition to slower growth, increased inflationary pressures and tighter monetary conditions, we believe another key theme for 2023 centers around regional rebuilding blocs and making economic systems and supply chains more resilient. In our opinion, this would lead to a level of deglobalization, which will have an impact on both the cost of raw materials as well as the cost of labor. Combined with slowing global growth, the increase in raw material costs, labor costs and financing costs can lead to disparate performance between companies that are able to manage these changes better than others.

In conclusion, we believe that evaluating the financial strength of a company through a quality factor can help evaluate those companies best positioned to navigate this changing landscape best. Through a series of metrics the Northern Trust Quality score looks to evaluate:

1. Aggressiveness of a company's capital expenditures and external financing decisions

2. Relative profitability compared to peers

3. Ability to meet its debt obligations and daily cash liquidity needs

Each of these lenses help build a mosaic of a company's quality and can help us evaluate a company's ability to adjust to increasing costs in today's environment.

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 the ETF discussed in this report in greater depth or find out more about the index methodology behind it please don't hesitate to call us at 1-855-FlexETF (1-855-353-9383).

DEFINITIONS

Minimum variance strategy is an investing method that helps you maximize returns and minimize risk. It involves diversifying a portfolio's holdings to reduce volatility, or such that investments that may be risky on their own balance each other out when held together.

MSCI USA Minimum Volatility Index aims to reflect the performance characteristics of a minimum variance strategy applied to the large and mid cap USA equity universe.

Northern Trust Quality Low Volatility Index tracks a portfolio of is designed to reflect the performance of a selection of companies that, in aggregate, possess lower overall absolute volatility characteristics relative to the Northern Trust 1250 Index.

Russell 1000 Index is an index of approximately 1,000 of the largest companies in the U.S. equity market.

FOOTNOTE

1 Annualized volatility if represented by standard deviation which is a measure of risk based on how widely an asset's price fluctuates over a given period of time.

IMPORTANT INFORMATION