The simplicity, flexibility and liquidity of ETFs make currency hedging an easy-to-execute strategy for investors who need to offset exchange rate risk.

A MORE STRATEGIC, HOLISTIC APPROACH TO HEDGING AGAINST EXCHANGE RATE RISK

For those of us planning a trip overseas, the recent hyper-rise of the U.S. dollar is a welcome gift. But to strategic investors and the multinational companies they invest in, a strong dollar can mean a big dent in earnings. As much as 40% of earnings from S&P 500 companies come from overseas. For energy, technology and materials, the figure can be closer to 50% on average. When these companies convert foreign currency from purchases abroad into U.S. dollars, profits suffer. And in the longer term, as American goods and services become more expensive to foreign buyers, demand can suffer. The effect on stock prices can be devastating.

A significant dimension of our currency’s rise across the last couple of years is its speed – described as the fastest in 40 years. On top of a strong 2015, in 2016 the U.S. dollar’s value continued to increase against various currency indices. The situation left many treasury managers and investors little time to put preferred hedging vehicles into place that would effectively offset the negative impact.

Of course, it’s not just the U.S. dollar we’re talking about. Although investments overseas can generate substantial returns and help diversify portfolios, overseas investments can also bring exchange rate risk as currencies fluctuate with economic prosperity or decline. Europe and Japan are latecomers to quantitative easing policies; even many emerging markets are looking to boost growth via currency manipulation.

Whether or not to hedge in turbulent markets is an important question. Foreign companies remain affected by currency exposure even if their stock returns are hedged. The costs of putting hedges in place must be considered – especially when there is a significant interest rate differential between currency markets. And, because currencies typically revert to historical relationships, hedges must constantly be monitored and strategies adapted to new realities.
BUT WHY “TILT” AT ALL?
Experienced investors are familiar with the capital asset pricing model (CAPM), which describes the relationship between market risk (beta) and expected return of an individual security. Over the years some researchers demonstrated the model’s empirical flaws, such as findings by Sanjoy Basu that documented the positive significance of earnings to price multiples and Rolf W. Banz’s work that uncovered that small stocks as measured by market capitalization outperformed what CAPM would have expected. Nonetheless, CAPM remains one of the most influential and widely used pricing models in the securities world.

Recent U.S. equity market research showed small-cap stocks have historically outperformed large caps across long periods of time, even when controlling for beta. Research also demonstrated there is a value effect on performance. Stocks with favorable valuations – meaning low price-to-earnings ratios or high dividend yields – tended to outperform those with unfavorable ratios, again, even after controlling for beta which is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. Today we label these so-called CAPM anomalies the size and value risk premia, respectively. Later studies proved that the value and size factors may also explain differences in returns for equities in foreign markets.

Morningstar® is credited with popularizing this particular multifactor investing concept among retail investors in the United States with their Morningstar® Style Box™, which classifies equity mutual funds on the basis of market capitalization and value/growth orientation (value, blend, growth). Style classification quickly fueled demand for indexes to represent the various styles. So Morningstar® built three factor tilt indexes that skew the broad market portfolios of the United States, developed markets outside the United States and emerging markets toward small-cap and value stocks.

- The Morningstar® U.S. Market Factor Tilt Index
- The Morningstar® Developed Markets ex-U.S. Factor Tilt Index
- The Morningstar® Emerging Markets Factor Tilt Index

These three serve as the underlying indexes for the FlexShares suite of unhedged tilt ETFs.
THE MORNINGSTAR® TILT INDEX METHODOLOGY

As the underlying indexes for the FlexShares Tilt suite, it is important for investors to understand how Morningstar®’s indexes are built. First, Morningstar® defines the investable universe. Market candidates are reviewed each year and must pass several liquidity screens. Then, using Morningstar’s® standard breakpoints, stocks are assigned to large, mid- and small- capitalization boxes. The total market portfolio is designed to capture the largest portion of the international equity market while maintaining investability and liquidity.

Next, Morningstar® assigns a value orientation to securities in each index’s marketcap segments, using five metrics from their Style Box classifications:

- Price/book
- Price/earnings
- Price/cash flow
- Price/sales
- Dividend yield

Each stock is measured at the country level using local currency versions/applications/equivalents of those five metrics.

Morningstar’s® five-metric process has several benefits. Its methodology incorporates both forward-looking and historical metrics while combining metrics to mitigate “stale” factors. And, it lessens the “noise” from frequently oscillating or cyclical factors.

After setting the Style Box framework, Morningstar® runs a regression analysis of 25 possible factor portfolios to determine the optimum exposure to size and value. Finally, they apply a proprietary methodology to underweight large growth stocks and allocate additional weight to small and value stocks, based on the desired size and value exposure.

The process seeks to deliver a diversified, low-turnover, core portfolio that captures the small and value premiums that would be missed by a legacy market-cap-weighted approach.
Evolving investment strategies call for innovative product strategies

As investors become increasingly aware of the potential negative impact of currency exposure on equity returns, they are beginning to move past tactical single-currency “bets” to more strategic, holistic hedging solutions. Today, investors are looking for tools that allow seamless selection between hedged and unhedged versions of a particular investment strategy. That’s why we designed the FlexShares Currency Hedged Morningstar® Factor Tilt Index Funds – two new funds using a fund-of-fund structure.

The FlexShares Currency Hedged Morningstar® DM ex-US Factor Tilt Index Fund (TLDH) delivers exposure to developed market equities outside of the United States. First, it seeks to replicate the Morningstar® Developed Markets ex-U.S. Factor Tilt Index Fund (TLTD) index by purchasing the TLTD unhedged fund. That tilts the portfolio toward the long-term growth potential of the smaller-cap and value segments. Then it applies a series of one-month currency forwards contracts that are long in U.S. dollars and short a notional amount of each foreign currency. That reduces exposure to potential volatility in currencies compared to the U.S. dollar.

The FlexShares Currency Hedged Morningstar® EM Factor Tilt Index Fund (TLEH) applies the same approach to emerging market equities, purchasing Morningstar® Emerging Markets Factor Tilt Index Fund (TLTE) and adding a similar series of one-month currency forwards contracts.

Why “tilt” with FlexShares?

It is no longer the exception for investors to place a significant percentage of their portfolios in markets outside the United States – whether in developed or emerging economies. Overlay that with the heightened divergence in monetary policy among countries around the globe, and international equity investors face a very real and growing impact of currency exposures on total return.

The FlexShares Currency Hedged Morningstar® Factor Tilt Index Fund suite presents a unique and cost efficient way to use currency hedging in portfolios tilted toward small cap and value stock exposure. Both the developed and emerging market ETFs in the suite target the same risk exposure as Morningstar’s® tilt index by investing in their respective unhedged twin FlexShares ETFs. This innovative fund of fund structure offers seamless unhedged/hedged total market exposure while providing incremental exposure to size and value risk premiums through a modified weighting scheme.

Sophisticated investors have utilized hedging instruments for years, deploying currency futures, forwards and options to mitigate risk. But for many, the complexity of these vehicles has often translated into avoidance. Now, the simplicity, flexibility and liquidity of ETFs make currency hedging an easy-to-execute strategy for investors who need to offset exchange rate risk. FlexShares is proud to offer the innovative Currency Hedged Factor Tilt Index Fund suite.

The amount hedged in TDLH and TLEH is based on country exposure weighting for the foreign currencies in each of the respective benchmark indexes. All currency hedges are rebalanced monthly.
The fund of fund structure gives investors access to all foreign markets and helps to limit tracking error. Since it is more efficient to own a single U.S. security than 2,000-plus securities trading on more than 20 different international exchanges, the structure also allows for lower share price and creation unit size and creation unit fees, so the product is actually easier and cheaper for market makers to access. Further, the structure means the hedged funds do not cannibalize the unhedged products and the scale each has achieved.

We feel that adding the currency hedged products to the total FlexShares Morningstar® Tilt suite provides more opportunities for investors who want to stick with a long-term size/value exposure strategy and take full advantage of risk premiums, while also addressing currency fluctuations concerns.

Despite these important benefits, hedging of any kind always comes with a cost. Investors in currency hedged funds of all types will find increased management fees as well as some increased transaction costs incurred by entering into the currency forward contracts. Rolling the hedge contracts creates a realized gain/loss, so investors may experience less tax efficiency in the form of monthly realized capital gains. Finally, interest rate differentials between the U.S. and foreign markets can result in gains or losses. Compared to investing in most hedged mutual funds, or putting single currency hedges in place in several foreign markets, however, these costs are likely to be minimal by comparison due to the overall efficiency of exchange traded funds.

FOR MORE INFORMATION
We believe our strategic beta ETF strategies here at FlexShares are among the most innovative in the industry. FlexShares Exchange Traded Funds offer focused ETF strategies that seek to help investors achieve real-world goals, by providing solutions that empower advisors to construct, allocate and manage outcome-oriented portfolios. We would be happy to share our insights on how investors and their advisors can help preserve, protect and grow investment portfolios. Please visit flexshares.com.

END NOTES


IMPORTANT INFORMATION

Before investing, carefully consider the FlexShares investment objectives, risks, charges and expenses. This and other information is in the prospectus, a copy 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. The Funds are subject to the following principal risks: asset class; commodity; concentration; counterparty; currency; derivatives; dividend; emerging markets; equity securities; fluctuation of yield; foreign securities; geographic; income; industry concentration; inflation-protected securities; infrastructure-related companies; interest rate/maturity; issuer; management; market; market trading; mid cap stock; MLP; natural resources; new funds; non-diversification; passive investment; privatization; small cap stock; tracking error; value investing; and volatility risk. A full description of risks is in the prospectus.

Investment in TILT, TLTD and TLTE is subject to numerous risks including loss of principal. Highlighted risks: concentration (may invest 25% or more of assets in a single industry/sector); currency (foreign currencies may fluctuate in value relative to the U.S. dollar, adversely affecting the Fund’s investments); emerging markets (countries potentially less liquid and subject to greater volatility); foreign securities (TLTD & TLTE typically invest at least 80% of assets in ADRs and GDRs); small cap stock (smaller-company stock may be subject to more abrupt/erratic market movement than larger companies); value investing (possibility that an investment in companies whose securities are believed to be undervalued may not appreciate in value as anticipated).

Investment in TLDH and TLEH is subject to commodity exposure risk, the risk of investing in economies that are susceptible to fluctuations in certain commodity markets. The Funds enter into foreign currency forward contracts designed to offset the Funds’ currency exposure of non-U.S. dollar denominated securities included in the Underlying Indices against the U.S. dollar, which may not be successful. Investments in foreign and emerging market securities involve certain risks such as currency volatility, political and social instability and reduced market liquidity. The Funds’ investments are concentrated in the securities of issuers in a particular market, industry, sector or asset class. The Funds 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 Funds 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 Funds could lose more than the principal amount invested. See prospectus for full description of risks.

The Morningstar® U.S. Market Factor Tilt Index, Morningstar® Developed Markets ex-US Factor Tilt Index, Morningstar® Emerging Markets Factor Tilt Index, Morningstar® Developed Markets ex-US Factor Tilt Hedged Index and Morningstar® Emerging Markets Factor Tilt Hedged Index are the intellectual property (including registered trademarks) of Morningstar® and/or its licensors (“Licensors”), which is used under license. The securities based on the Index are in no way sponsored, endorsed, sold or promoted by Morningstar® and its Licensors and neither of the Licensors shall have any liability with respect thereto.
DEFINITIONS

**Currency futures** are a transferable futures contract that specifies the price at which a currency can be bought (long) or sold (short) at a future date. Currency future contracts are intended to allow investors to hedge against foreign exchange risk. An investor is said to be **long** when they have bought a contract and **short** when they have sold a contract.

A **currency forward** is intended to be a hedging tool that does not involve any upfront payment and is considered a binding contract in the foreign exchange market that locks in the exchange rate for the purchase or sale of a currency on a future date.

A **currency option** is a contract that grants the buyer the right, but not the obligation, to buy or sell a given currency at a specified exchange rate during a specified period of time.

The **dividend yield** is the dividend per share, divided by the price per share.

The **price-to-book ratio** is a financial ratio used to compare a company’s current market price to its book value.

The **price-to-cash-flow ratio** is the ratio of a stock’s price to its cash flow per share.

The **price-to-earnings ratio** is the current market price of a company share divided by the earnings per share of the company.

The **price–sales ratio** is calculated by dividing the company’s market cap by the revenue in the most recent year.

**Beta** is a statistical measure of the volatility, or sensitivity, of rates of return on a portfolio or security compared to a market index.

The Morningstar® U.S. Market Factor Tilt IndexSM measures the performance of U.S. equity markets with increased exposure toward small-capitalization and value stocks. Stocks that are deemed to be small-capitalization or value will have an overweighting compared to their weight in a corresponding market capitalization-weighted index. Likewise, stocks designated as “large” or “growth” stocks will have an underweighting compared to a standard market-capitalization weighting. The Morningstar index methodology defines “U.S. market” as those stocks that form the top 99.5% of the market capitalization of the stocks eligible to be included in Morningstar’s investable universe. All stocks are then designated as “core,” “growth” or “value” based on factors such as price-to-book ratios and price-to-earnings ratios, and are modified free float market-capitalization weighted. Stocks of companies with, for example, relatively low valuations based on price-to-book ratios, price-to-earnings ratios and other factors are designated as “value” securities. Similarly, stocks of companies with relatively high valuations based on price-to-book ratios, price-to-earnings ratios and other factors would be designated as “growth” securities. Stocks that are not designated as “growth” or “value” securities are designated as “core” securities.

The Morningstar® Developed Markets ex-US Factor Tilt IndexSM measures the performance of stocks located in developed countries across the world (as defined by Morningstar, excluding the United States) with increased exposure to small-capitalization and value stocks. Stocks that are deemed to be small capitalization or small value have an overweighting in the index compared to their weight in a corresponding market-capitalization-weighted index. Likewise, stocks designated as “large” or “growth” stocks have underweighting compared to a standard market-capitalization weighting.
The Morningstar® Emerging Markets Factor Tilt Index℠ measures the performance of stocks located in emerging countries across the world (as defined by Morningstar) with increased exposure to small-capitalization and value stocks. Stocks that are deemed to be small capitalization or small value have an overweighting in the index compared to their weight in a corresponding market-capitalization-weighted index. Likewise, stocks designated as “large” or “growth” stocks have underweighting compared to a standard market-capitalization weighting.

One cannot invest directly in an index.

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