

Measuring Dividend Quality



*“Do you know the only thing that gives me pleasure?
It’s to see my dividends coming in.”*

– JOHN D. ROCKEFELLAR

So, how can investors judge a “sustainable” yield?

Measuring a company’s core financial health makes it possible to evaluate whether it may increase (or need to decrease) its future dividends.

Rockefeller’s sentiment above remains true for many investors. For decades, dividend income has been a crucial component of a stock investor’s total return, often trumping capital appreciation in volatile markets. In this recent environment of falling yields on bonds with interest rates at or near zero, dividends are especially valued. That is when income-seeking investors start to include dividends in their search for yield to meet their financial goals.

Blindly focusing on yield, however, could be dangerous to an investment portfolio’s health. A seemingly generous dividend yield may actually signify a weak share price tied to negative news not yet revealed in the quarterly dividend. Yields for a current year are often estimated using the previous year’s dividend yield or by taking the latest quarterly yield, multiplying by four and dividing by the current share price. This explains why investors in dividend stocks must be confident the dividend being paid is sustainable. In other words, make sure the payout is well covered and the company can grow it over time.

FLAWED DIVIDEND STRATEGIES MAY CLOUD INVESTOR JUDGEMENT

Over the years, investors have applied various strategies to avoid overpaying for dividend yield. First, if a company has paid dividends over a long time period (often referred to as longevity), investors trust it will likely continue paying a dividend in the future.* The alternative, focusing on a dividend’s growth over time, views a reduction in the current distribution as a red flag that the dividend may be pared back further in the future

* Dividends represent past performance, and there is no guarantee they will continue to be paid.

Dividend yield is a financial ratio that indicates how much a company pays out in dividends each year relative to its share price. Dividend yield is represented as a percentage and can be calculated by dividing the dollar value of dividends paid in a given year per share of stock held by the dollar value of one share of stock.

Payout ratio is the dividend per share divided by earning per share.

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 beta for an ETF measures the expected change in return of the ETF relative to the return of a designated index. By definition, the beta of the Standard & Poor's (S&P) 500 Index is 1.00. Accordingly, a fund with a 1.10 beta is expected to perform 10% better than the S&P 500 Index in rising markets and 10% worse in falling markets.

There are flaws in both strategies:

- Reacting to a reduced dividend after it occurs results in holding the dividend-paying security until the next rebalance, potentially after the stock price has absorbed the negative dividend news;
- In order to evaluate a company, a long history of dividend payouts (often a decade or more) may be required, which means newer dividend payers are excluded from consideration; and
- Recent changes in the macro environment that could affect the company's ability to maintain or grow its dividend may be downplayed.

A third strategy is using the payout ratio – the dividend per share divided by earnings per share – to evaluate a dividend payer's financial health. While correct directionally, the payout ratio strategy also possesses several drawbacks. It looks only at the dividend in reference to "the bottom line," so it may not tell the full story. For instance, it gives no guidance about a company's flexibility in managing its income nor does it consider any competitive advantages to protect the firm during periods of market distress. More importantly, it evaluates the distribution in terms of accounting income and not actual cash flow. Further, a singular focus on payout ratios may eliminate companies in mature industries that return most of their income to shareholders but are financially stable and well-positioned to maintain that dividend rate.

A BETTER APPROACH – FOCUSING ON THE CORE FINANCIAL HEALTH OF THE DIVIDEND-PAYING COMPANY

So, how can investors judge a "sustainable" yield? Measuring a company's core financial health makes it possible to evaluate whether it may increase (or need to decrease) its future dividends. With this approach, the reliance on publicly available financial data means new dividend payers can be evaluated similarly to stocks that have paid dividends for decades. By using several lenses to evaluate financial health, an investor can gain a strong sense of how well-positioned a dividend-paying company is for success, and how protected future dividends are under current market and economic environments.

FlexShares' multi-faceted Dividend Quality Score (DQS) examines companies using three lenses in its Dividend Quality Index methodology:

		
Management Efficiency	Profitability	Cash Flow
<p>Management Efficiency is a quantitative evaluation of a firm's deployment of capital as well as its financing decisions. Firms that aggressively pursue capital expenditures and additional financing generally lose flexibility in both advantageous and challenging portions of the market cycle.</p>	<p>Profitability scores a firm's relative competitive advantage across several different metrics. Firms with wider margins may be better positioned to grow compared to firms with slimmer margins.</p>	<p>Cash Flow assesses the liquidity levels of the company. A firm that cannot meet its debt obligations and day-to-day liquidity needs will be poorly positioned to take advantage of future opportunities or enjoy a financial cushion during periods of distress.</p>

QUALITY DIVIDEND INDEX PROCESS



INTERNATIONAL QUALITY DIVIDEND INDEX PROCESS



MAXIMIZING QUALITY AND YIELD

FlexShares' DQS process is designed to maximize quality and yield while putting several diversification controls into effect. The strategy strives to harness dividend quality and yield through its selection and weighting process. Non-dividend payers are eliminated from the universe of large cap equities, as are the lowest 20 percent of companies in the DQS ranking.

The DQS score evaluates dividend-paying equities across all these lenses and ranks companies on a sector basis. (For international dividend payers, the DQS score evaluates firms on both a regional and sector basis.) This not only helps ensure an "apples-to-apples" comparison – profiling similar firms against each other – it also identifies quality companies in every sector (and country for international markets), supporting diversification even in the initial construction process.

The International Quality Dividend Index Fund follows the same process for international (both developed and emerging market) large cap securities, including additional constraints on country and regional basis. Some investors prefer a beta target less than or greater than the parent index, so FlexShares offers "defensive" (beta less than the parent) and "dynamic" (beta greater than the parent) index options. The FlexShares Quality Dividend Suite is comprised of the Northern Trust family of quality dividend indexes, including three domestic funds and three international funds, for a total of six funds.

MORE INFORMATION = BETTER DECISIONS

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.

ETF TICKERS	FUNDS
TARGETS A BETA CLOSE TO THE MARKET UNIVERSE'S BETA	
QDF	FlexShares Quality Dividend Index Fund
IQDF	FlexShares International Quality Dividend Index Fund
TARGETS A BETA LESS THAN THE MARKET UNIVERSE'S BETA	
QDEF	FlexShares Quality Dividend Defensive Index Fund
IQDE	FlexShares International Quality Dividend Defensive Index Fund
TARGETS A BETA GREATER THAN THE MARKET UNIVERSE'S BETA	
QDYN	FlexShares Quality Dividend Dynamic Index Fund
IQDY	FlexShares International Quality Dividend Dynamic Index Fund

INVESTOR-CENTRIC FOCUS. DISCIPLINED APPROACH. DISTINCTIVE ETF SOLUTIONS

At FlexShares, our focus is on understanding and responding to investor needs. We design funds that seek to meet specific investment objectives and we continually work to help investors become well-educated consumers of Exchange Traded Funds. We freely share our knowledge and expertise to help investors make informed decisions on how ETFs can best help them achieve their long-term goals.

Capital Appreciation:

Investment strategies seeking to replicate the performance outcomes of investing in growth-seeking assets

Target Outcome:

Seek Growth with Purpose

Income Generations:

Investment strategies seeking to replicate the performance outcomes of investing in income-generating assets

Target Outcome:

Seek Income for Expected Needs



Risk Management:

Investment strategies seeking to manage specific factor-related risks and mitigate portfolio risks

Target Outcome:

Seek to Manage Risk

Liquidity Management:

Investment strategies featuring cash-plus and fixed income solutions with flexible guidelines

Target Outcome:

Seek Liquidity and Flexibility

EQUITY

TILT	FlexShares Morningstar® U.S. Market Factor Tilt Index Fund	ESG	FlexShares STOXX® US ESG Impact Index Fund	QDYN	FlexShares Quality Dividend Dynamic Index Fund
TLTD	FlexShares Morningstar® Developed Markets ex-U.S. Market Factor Tilt Index Fund	ESGG	FlexShares STOXX® Global ESG Impact Index Fund	IQDF	FlexShares International Quality Dividend Index Fund
TLDH	FlexShares Currency Hedged Morningstar® DM ex-U.S. Factor Tilt Index Fund	QLC	FlexShares U.S. Quality Large Cap Index Fund	IQDE	FlexShares International Quality Dividend Defensive Index Fund
TLTE	FlexShares Morningstar® Emerging Markets Factor Tilt Index Fund	QDF	FlexShares Quality Dividend Index Fund	IQDY	FlexShares International Quality Dividend Dynamic Index Fund
TLEH	FlexShares Currency Hedged Morningstar® EM Factor Tilt Index Fund	QDEF	FlexShares Quality Dividend Defensive Index Fund		

FIXED INCOME

TDTT	FlexShares iBoxx® 3-Year Target Duration TIPS Index Fund	SKOR	FlexShares Credit-Scored U.S. Corporate Bond Index Fund	BNDC	FlexShares Core Select Bond Fund
TDTF	FlexShares iBoxx® 5-Year Target Duration TIPS Index Fund	LKOR	FlexShares Credit-Scored U.S. Long Corporate Bond Index Fund	MBSD	FlexShares Disciplined Duration MBS Index Fund
RAVI	FlexShares Ready Access Variable Fund				

REAL ASSETS

GUNR	FlexShares Morningstar® Global Upstream Natural Resources Index Fund	GQRE	FlexShares Global Quality Real Estate Index Fund	NFRA	FlexShares STOXX® Global Broad Infrastructure Index Fund
ASET	FlexShares Real Assets Allocation Index Fund				

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. 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.

An investment in the FlexShares Quality Dividend funds suite (QDF, QDEF, QDYN, IQDE, IQDF, IQDY) is subject to numerous risks including loss of principal. Highlighted risks: dividend (issuers of underlying stock might not declare a dividend, or dividend rate may not remain at current levels); concentration (more than 25% of assets in a single industry); currency (foreign currencies may fluctuate in value relative to the US dollar, adversely affecting IQDE, IQDF & IQDY investments); emerging markets (countries potentially less liquid and subject to greater volatility); foreign securities (IQDE, IQDF & IQDY typically invest at least 80% of assets in ADRs and GDRs); and volatility (volatility may not equal target of Underlying Index). See prospectus for full description of risks. Beta is a statistical measure of the volatility, or sensitivity, of rates of return on a portfolio or security compared to a market index.

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