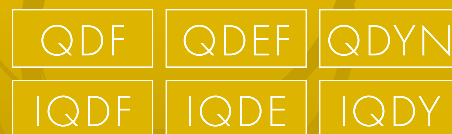
FlexShares® THE CASE FOR DIVIDEND QUALITY

# A Multi-Faceted Approach




INCOME GENERATION

**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.*[1]

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

— JOHN D. ROCKEFELLER

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.[2] 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.

---

*1 Source: Investopedia http://www.investopedia.com/terms/d/dividendyield.asp*
*2 Dividends represent past performance, and there is no guarantee they will continue to be paid.*

Managed by Northern Trust

**Payout ratio** *is the dividend per share divided by earnings per share.*

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.

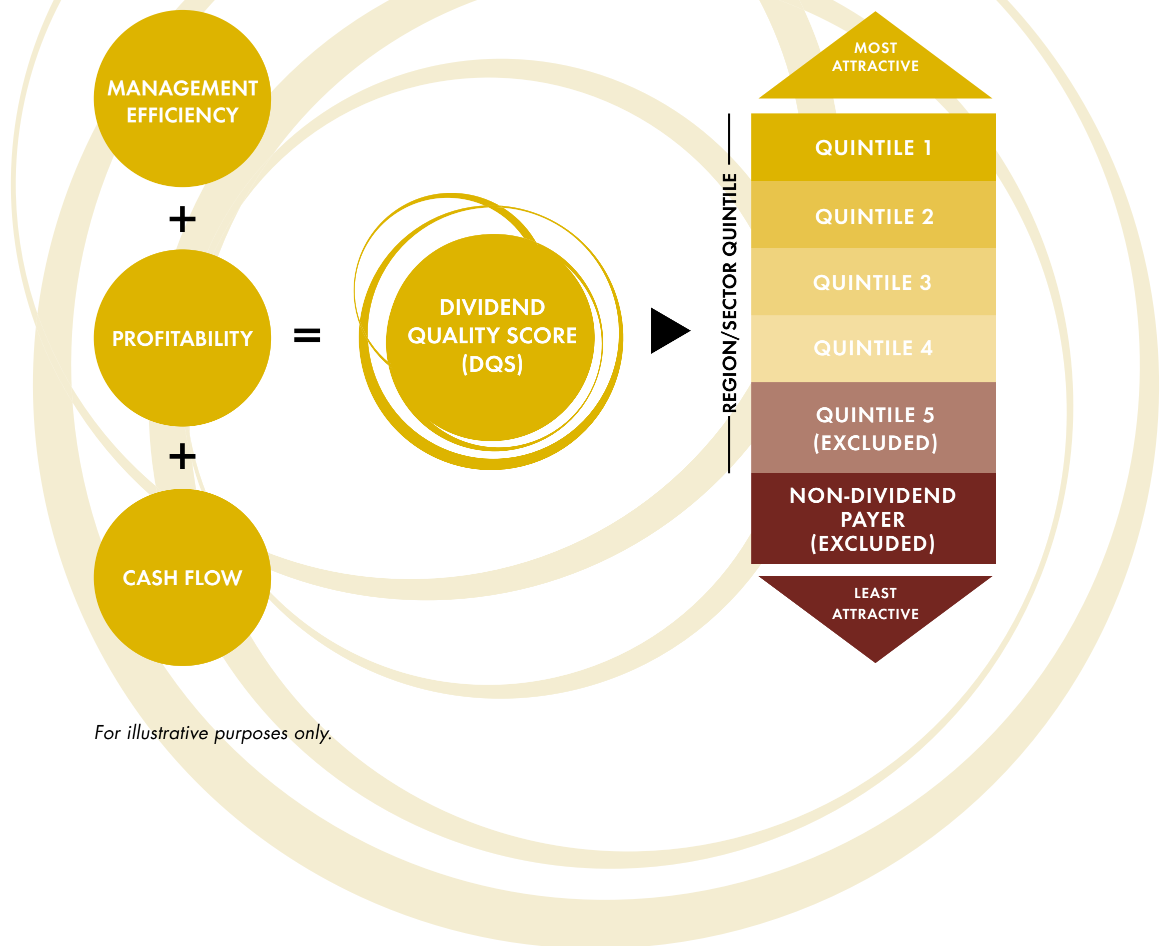
## A BETTER APPROACH – FOCUSING ON THE CORE FINANCIAL HEALTH OF THE DIVIDEND-PAYING COMPANY

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 (see Figure 1):

- **Management efficiency** is a quantitative evaluation of a firm's deployment of capital as well as its financing decisions. Research finds firms that aggressively pursue capital expenditures and additional financing lose flexibility in both advantageous and challenging portions of the market cycle.
- **Profitability** scores a firm's relative competitive advantage across several different metrics. Firms with wider margins are better positioned to grow and maintain their dividends than firms with slimmer margins.
- **Cash flow** assesses the liquidity levels of the company. A firm that cannot meet its debt obligations and day-to-day liquidity needs will struggle to maintain its dividend level.

FIGURE 1
DIVIDEND QUALITY INDEX METHODOLOGY




*For illustrative purposes only.*

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.

## 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 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.

| 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 |

## MORE INFORMATION = BETTER DECISIONS

The more informed the investor, the more successful and satisfying the investment. When the subject is equities, the necessary information is not always readily available to the individual investor. At FlexShares, we believe our approach to "intelligent construction" is invaluable in guiding individuals to high-quality decisions in their investment choices.

Ask a financial advisor for more information on how FlexShares ETFs can play an important role in reaching the goals of your investment portfolio. Contact us at 1-855-FlexETF (1-855-353-9383) or visit us at flexshares.com.

## 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.**

*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.*

Managed by
Northern Trust



Q55910 (9/15)