WHY REAL ASSETS?
Disappointing global economic growth in the recent past has moved central banks to intervene with aggressive monetary policy, fueling the drive toward riskier asset classes. Inflation has been muted and traditional fixed income assets have not provided the yield necessary to meet short- and long-term income needs. In response, an increasing number of investors are looking to other asset classes to serve as sources of income and to maintain purchasing power.

Institutional investors have long incorporated real asset classes such as commodities, real estate, agricultural land or oil into their portfolios. The potential advantages to these types of exposure are many, and include dampening inflation risk, improving portfolio efficiency, accessing stable bond-like yields and participating in equity-like capital appreciation.

Financial advisors and individual investors are now following this wisdom and adding real assets to their portfolios, aided by two major factors. First, investment vehicles such as exchange traded funds (ETFs) join a growing menu of mutual funds that can make real assets more readily available. Second, the range of investment strategies is continually expanding, offering asset owners’ maximum flexibility in addressing all their real asset needs.

However, the sheer magnitude of available options may be acting as a headwind, hindering investors’ adoption of real assets. Potential users are often discouraged because they are not sure which real asset strategies are most appropriate to meet their investment objectives. At FlexShares, we believe this conundrum presents an opportunity – because there is a simpler way to take advantage of the benefits of real assets.

THE RISE OF REAL ASSET INVESTING
First, some background on real asset investing. Prior to the late 1980s, many investment professionals believed the best way to mitigate portfolio risk was to diversify holdings among different asset classes, focusing primarily on stocks, bonds and cash. This approach, popularized by institutional money managers, ultimately led to the model 60% equity/ 40% fixed income portfolio.
This traditional asset allocation continued to evolve as institutions sought investments that better matched their liabilities and also offered higher-growth alternatives. U.S. entities with pensions or other fixed long-term funding obligations started to expand their asset allocation to include hedge funds, private equity, foreign stocks and real assets. This approach was popularized by David Swensen, the chief investment officer of Yale University Endowment. Over time, a wide range of other institutional investors embraced more diverse asset allocations, and began to deploy a greater share of their investment capital toward real assets, as demonstrated in Exhibit 1.

In Swenson’s endowment approach, real assets account for approximately 30% of the total asset allocation and consist of “pure play” (or single-focused company) real asset investments and Treasury Inflation Protected Securities (TIPS), which are real-return financial instruments. Swenson’s asset mix excluded the commodity markets due to their volatile nature and lack of income opportunity. This allocation approach emphasizes long-term assets, stable inflation-adjusted income and current yield.

However, it also presents drawbacks for individual investors, who typically lack:

- Expertise to source and measure the relative performance of “pure play” real asset investments;
- Ability to handle the regulatory and operational hurdles associated with real asset industries;
- Patience to bear the potential illiquidity risk; and
- Knowledge to invest tactically and determine the optimal allocation of underlying real asset categories.

It’s no surprise, then, that many potential investors either avoided investing in real asset classes or invested in a sub-optimal, narrow manner.

One desirable solution may be a turnkey, equity-based real asset allocation product that addresses the identified drawbacks and, ideally, could be applied across the full range of client investment objectives.

**Real Assets and Income Generation**

Historically, the strong dividend payments of real asset securities have presented a good option for income sensitive investors. This is especially important in zero or near zero rate environments where traditional income producing assets such as fixed income, have compressed yields relative to...
The income component is largely driven by the generally steady and predictable cash flows produced by real estate. Due to contractual and regulatory agreements, cash flows generated by real estate and infrastructure asset classes are high-confidence cash flows. As commercial and retail rental rates are re-negotiated periodically, they can better adjust in rising-rate or inflationary environments. Furthermore, because the infrastructure industry tends to be highly regulated, these companies are contractually allowed to make periodic pricing adjustments, typically based on the Consumer Price Index (CPI). While economic conditions may help or hurt asset-level performance, the contractual nature of infrastructure-related revenue streams tends to make flows more secure. Consequently, infrastructure cash flows persist even when economic growth is subdued.

Real Assets and Capital Appreciation
In addition to income, the total return potential of real assets is another attractive feature, as highlighted in Exhibit 2. Due to their sensitivity to macroeconomic trends, real assets offer potential capital appreciation. When economies expand, the global demand for natural resources and commodities such as copper, iron ore, liquefied natural gas and grains all typically increase. This expansion ultimately affects related industries like home builders, infrastructure projects and fuel suppliers. The rapid growth in emerging economies, fueled by urbanization, raises demand for energy, industrial metals, infrastructure and housing. This increase in demand positively affects real asset growth and capital appreciation prospects.

EXHIBIT 2: COMPOUNDED ANNUALIZED RETURNS

<table>
<thead>
<tr>
<th>Natural Resources</th>
<th>Real Estate</th>
<th>Infrastructure</th>
<th>Equity</th>
<th>Fixed Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.33%</td>
<td>6.27%</td>
<td>5.81%</td>
<td>6.04%</td>
<td>3.93%</td>
</tr>
</tbody>
</table>

Real Assets and Long-Term Purchasing Power Protection
The current non-seasonally-adjusted CPI level is historically low. Many investors, however, have liabilities that span multiple inflationary cycles as well as other expenses that march higher than traditional inflation measures (e.g., health insurance premiums), and so require inflation-hedging tools to address these situations. Historically, real assets have responded favorably in rising inflationary or expanding economic cycles. As a result, real assets are strongly correlated to inflation, as highlighted in Exhibit 3.
EXHIBIT 3: CORRELATION OF ASSET CLASS RETURNS AND INFLATION

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Correlation with Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Natural Resources</td>
<td>54.47%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>37.03%</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>38.34%</td>
</tr>
<tr>
<td>Equity</td>
<td>40.86%</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>18.56%</td>
</tr>
</tbody>
</table>

Consequently, many investors seek real assets to diversify away inflation risk, while also complementing their return objectives. The attractive inflation sensitivity of real assets is a key reason why many institutional and retail investors desire real assets exposure.

**OPTIMALLY ALLOCATING TO REAL ASSET CLASSES WITH FLEXSHARES**

Many individual investors think about how to possibly replicate Swenson’s institutional approach to real assets. Our research demonstrates that an optimally combined real asset allocation may present an easier way to do this while also effectively building a better-diversified portfolio overall. A multi-asset, real asset portfolio such as FlexShares Real Asset Allocation Index Fund (ASET) seeks to capture the key benefits of real asset classes without taking on unintended risks that may occur when allocating separately to individual real asset categories.

This fund’s goal is to provide investors with a core real assets allocation that helps address their inflation-hedging, diversification and income needs. ASET is, in a sense, a “fund of funds.” It gains exposure to real assets by investing in three FlexShares ETFs: FlexShares Morningstar Global Upstream Natural Resources Index Fund (GUNR), FlexShares STOXX Global Broad Infrastructure Index Fund (NFRA) and FlexShares Global Quality Real Estate Index Fund (GQRE). The strategy applies a proprietary optimization to the three underlying funds in an effort to minimize the volatility of returns and to lower risk.

Given the complexities of real asset investing, we applied modern portfolio theory (MPT) in designing this product. Our approach allows risk and return characteristics to be evaluated on the overall portfolio following the addition of real assets. In considering two popular MPT methods—mean variance and minimum variance—we believe an unconstrained minimum variance optimization is preferred. The minimum variance optimization provides a solution designed to:

- Minimize risk;
- Reduce the complexities associated with identifying standard deviation and expected return assumptions, which may vary with economic cycles;
- Streamline the portfolio optimization process; and
- Validate the diversification benefits of real assets broadly.
We broadly define our “optimal” allocation as one that minimizes the total portfolio variance without constraining expected return. Also important, this methodology can be implemented across the full spectrum of investment objectives (i.e., maximum growth to maximum income), and in our opinion, makes for a very robust starting point. Furthermore, this optimal asset allocation approach to real asset classes has historically achieved the two portfolio-focused objectives of inflation-hedging and improved risk-adjusted return. (Investors should note that our optimization analyses established that including TIPS does not benefit the multi-asset solution and they should be implemented tactically.)

Since real assets typically benefit from stable inflation-adjusted returns, the inflation-hedging impact of this optimized real asset solution is obvious when it is added to the 60% equity/40% fixed income blend, as shown in Exhibit 4. The traditional equity/fixed income blended portfolio exhibited increasing correlation to inflation when combined with the optimized real asset solution.

EXHIBIT 4: CORRELATION OF 60/40 PORTFOLIO AND REAL ASSETS RETURNS VS. ONE-MONTH LAG INFLATION

As shown in Exhibit 5, this same approach has also historically led to comparatively lower risk, and improved risk-adjusted return measured by annualized Sharpe Ratio. This result is attributed to the return behavior of the real asset class. Real assets participate in economic growth cycles and, because of their income-producing elements; help mute the effects of economic slowdowns. This may smooth the return profile and diversify the combined portfolio, potentially leading to greater risk-adjusted returns.
INVESTORS LOOKING FOR DIVERSIFICATION WILL KEEP LOOKING TOWARD REAL ASSETS

Given rolling environmental, resource scarcity and inflation/disinflation concerns, the need for new sources of portfolio diversification has never been stronger. In the hunt for unique sources of return, we believe now is the time to consider real assets in your portfolio construction. Real assets may play a key role in driving global growth and providing strategic long-term investors with a new way to construct a more efficient and balanced overall portfolio.

We believe an allocation to real asset classes in a traditional portfolio is beneficial for investors looking to minimize risk and also address income and capital appreciation objectives. It may provide improved inflation-adjusted annualized returns in periods of rising inflation and downside protection through income, along with equity-like upside. FlexShares’ turnkey approach, our Real Assets Allocation Index Fund, may appeal to investors looking to streamline their real asset allocation selection process and diversify using a real asset portfolio.

FOR MORE INFORMATION

Contact FlexShares at 1-855-FlexETF (1-855-353-9383) or visit flexshares.com for any questions you may have about our real assets solution design strategy discussed in this paper, or to learn more about any of the FlexShares family of ETFs.
1Source: Pension and Investments; data represents the average real asset allocation of the top 1000 Defined Benefits Plan sponsors, June 30, 2005 to June 30, 2014.

2Source: MSCI, Bloomberg, Morningstar Indexes, FTSE, Barclays; data as of January 31, 2016; represents the compounded annualized monthly returns for Global Natural Resources, Real Estate, Infrastructure, U.S. Equities and Blended Fixed Income over the data range available for each index; Global Natural Resources – Morningstar Global Upstream Natural Resources Total Return Index, Global Real Estate – FTSE EPRA/NAREIT Developed Index, Global Infrastructure – Morningstar Global Equity Infrastructure Net Total Return, Equities – MSCI World Total Return Equity Index, Fixed Income – Barclays Global Aggregate Bond Index. The data range for all indexes March 31, 2006 – January 31, 2016. All Real Asset indexes contain publically traded equity securities. An investor cannot invest directly in an index.

3Source: MSCI, Bloomberg, Morningstar Indexes, FTSE, Barclays; The data range for all indexes March 31, 2006 – January 31, 2016.; represents the correlation of monthly returns for Global Natural Resources, Real Estate, Infrastructure, U.S. Equities and Blended Fixed Income with 1 month lagged U.S. Consumer Price Index Non-Seasonally Adjusted over the data range available for each index; Global Natural Resources – Morningstar Global Upstream Natural Resources Total Return Index, Global Real Estate – FTSE EPRA/NAREIT Developed Index, Global Infrastructure – Morningstar Global Equity Infrastructure Net Total Return, Equities – MSCI World Total Return Equity Index, Fixed Income – Barclays Global Aggregate Bond Index. The data range for all indexes March 31, 2006 – January 31, 2016. All Real Asset indexes contain publically traded equity securities.

4Source: Bloomberg, Morningstar Indexes, FTSE; The data range for all indexes March 31, 2006 – January 31, 2016.; represents the correlation of monthly returns with 1month lagged U.S. Consumer Price Index Non-Seasonally Adjusted over the data range available for each index; Global Natural Resources – S&P Global Natural Resources Total Return Index, Global Real Estate – Dow Jones Global Select REIT TR Index, Global Infrastructure – S&P Global Infrastructure Net Total Return. Data range for all indexes June 30, 2005 – June 30, 2015. All Real Asset indexes contain publically traded equity securities.

5Equity/Fixed Income Blend with Real Assets; Blend / Real Asset Allocation – The Blend is 60% Equities – MSCI World Total Return Equity Index, 40% Fixed Income – Barclays Global Aggregate Bond Index. The Real assets Allocation is 11% Global Natural Resources – Morningstar Global Upstream Natural Resources Total Return Index, 39% Global Real Estate – FTSE EPRA/NAREIT Developed Index, 50% Global Infrastructure – Morningstar Global Equity Infrastructure Net Total Return. The data range for all indexes March 31, 2006 – January 31, 2016. All Real Asset indexes contain publically traded equity securities.

6Source: Bloomberg, Morningstar Indexes, FTSE; The data range for all indexes March 31, 2006 – January 31, 2016.; represents the correlation of monthly returns with 1 month lagged U.S. Consumer Price Index Non-Seasonally Adjusted over the data range available for each index; Global Natural Resources – S&P Global Natural Resources Total Return Index, Global Real Estate – Dow Jones Global Select REIT TR Index, Global Infrastructure – S&P Global Infrastructure Net Total Return. Data range for all indexes June 30, 2005 – June 30, 2015. All Real Asset indexes contain publically traded equity securities.

7Equity/Fixed Income Blend with Real Assets; Blend / Real Asset Allocation – The Blend is 60% Equities – MSCI World Total Return Equity Index, 40% Fixed Income – Barclays Global Aggregate Bond Index. The Real assets Allocation is 11% Global Natural Resources – Morningstar Global Upstream Natural Resources Total Return Index, 39% Global Real Estate – FTSE EPRA/NAREIT Developed Index, 50% Global Infrastructure – Morningstar Global Equity Infrastructure Net Total Return. The data range for all indexes March 31, 2006 – January 31, 2016. All Real Asset indexes contain publically traded equity securities.
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 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; interest rate/ maturity risk; issuer; management; market; market trading; mid cap stock; 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.

In addition, the FlexShares Real Assets Allocation Index 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 a 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.

The consumer price index (CPI) measures changes in the price level of a market basket of consumer goods and services purchased by households.

Correlation, in the world of finance, is a statistical measure of how two securities move in relation to each other.

There are two major factors in mean variance analysis: variance and expected return. Variance represents how spread out the data set of numbers are, such as the variability in daily or weekly returns of an individual security. The expected return is a subjective probability assessment on the return of the stock. Statisticians use variance to see how individual numbers relate to each other within a data set. Within investment theory, a minimum variance within a portfolio is the optimal portfolio in a world with zero risk premium.

The Sharpe Ratio is a measure for calculating risk-adjusted return, and this ratio has become the industry standard for such calculations.