How to Invest in Turbulent Times? Quality may be the Answer.

QLC | QDF | QDEF | QDYN
GQRE | IQDF | IQDE | IQDY

CAPITAL APPRECIATION

Given the extremely volatile market environment, we cannot over-emphasize the importance of the quality factor in choosing equities that can survive and even thrive.

HOW SHOULD THE QUALITY FACTOR BE DEFINED?

The concept of quality in many asset classes is not new, but its application to equity selection has gained traction in the last few years. Quality can help meet investment objectives as a single factor or in combination with other factors. Intuitively, it makes sense that high-quality companies should have better overall performance than low-quality companies. Unfortunately, however, unlike other equity factors such as value or size, there is no generally accepted definition of quality.

Often, the quality metric is simply related to some measure of profitability. Many asset managers include quality in a multi-metric definition, for example, combining return on equity,[1] debt-to-equity ratio[2] and earnings variability.[3] Or, as in the Russell U.S. Equities Indices, return on assets plus leverage plus earnings variability. Another variation is the F score, developed by Joseph Piotroski. It combines nine metrics, including net income, operating cash flow, return on assets, stability of earnings, leverage, liquidity issuance, gross margins and asset turnover. The issue is hotly debated and there are countless methodologies in the marketplace.

Interestingly, in its continuing research of the quality factor and how to apply it in a scoring methodology, FlexShares' parent company, Northern Trust , concluded that "quality" includes those features of a company that particularly appeal to risk-averse investors. Further, their empirical evidence has shown that the higher returns of high-quality companies have, in fact, been associated with considerably lower levels of risk. If that seems counter-intuitive to the most widely used pricing model in finance–the Capital Asset Pricing Model (CAPM)[4]– that's because it is.

CAPM assumes universal risk aversion on behalf of investors. That's not actually the case with human behavior. Investors are heterogeneous. The risk averse seek low-volatility stocks in search of "peace of mind." As quality erodes, risk increases. High-volatility stocks are most attractive to risk-seeking investors, who bid up the price of these lower-quality equities and consequently reduce their returns. The result: high-quality stocks typically outperform low-quality names because low-quality/high-volatility names are relatively expensive versus high-quality/low-volatility names.

HOW DOES FLEXSHARES JUDGE QUALITY?

High-quality companies exhibit certain characteristics. The FlexShares quality scoring process includes detailed assessments of each company compared to its peers, using fundamental factors that are empirically tested, supported by academic research and applied quantitatively. Below are the pillars of our methodology.

- **Management efficiency:** a quantitative evaluation of a firm's deployment of capital as well as its financing decisions. Research shows firms that aggressively pursue capital expenditures and additional financing lose flexibility in both advantageous and challenging portions of the market cycle.
- **Profitability:** a determination of a firm's relative competitive advantage across several different metrics. Firms with wider margins are better positioned to grow compared to firms with slimmer margins.
- **Cash flow:** an assessment of 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 provide a financial cushion during periods of distress

We apply this methodology to companies on a sector basis in order to:

- Provide an "apples-to-apples" comparison, since different sectors — such as utilities and technology companies — vary considerably in how they profile;
- Find quality companies in every sector without concentrating in certain pockets of the market; and
- Prevent unintended stock selection and weighting biases caused by a dramatic sector drift from the starting universe.

The result is a growing body of ETF products that can appeal to risk-averse investors and help them achieve stronger risk-adjusted returns through the most turbulent of market environments.

FLEXSHARES QUALITY ETFS

Eight of our 22 ETFs have the word "Quality" in their name.

For decades, dividend income has been a crucial component of a stock investor's total return, often trumping capital appreciation in volatile markets. Dividends are especially valued in this recent environment of falling yields on bonds, with interest rates near zero, when income-seeking investors typically widen their search for yield to meet their financial goals. Historically, quality and yield have not been highly correlated,[5] but our research indicates that the combination may produce compelling results as it serves to smooth each respective factor's cycle.

FlexShares Quality Dividend Index Fund (QDF) utilizes our proprietary dividend quality scoring (DQS) methodology in an effort to select companies well-positioned for success, as well as for protecting future dividends during various market and economic environments. It is a core stock market option that helps investors meet their income needs by providing exposure to the long-term growth potential of U.S. dividend-paying securities.

FlexShares also offers a defensive and a dynamic quality dividend fund. Investors who wish to shift their equity exposure toward lower beta[6] (volatility), less cyclical stocks may be interested in the **FlexShares Quality Dividend Defensive Index Fund (QDEF)**.

The FlexShares Quality Dividend Dynamic Index Fund (QDYN) offers investors a fund index populated by the relatively riskier and cyclically driven stocks that qualify under our dividend quality scoring process.

FlexShares US Quality Large Cap Index Fund (QLC) is designed to replace traditional large cap equity products by focusing on capital appreciation rather than yield. The strategy seeks to capture the compensated risk factor by freeing up the index design to examine additional factors. The selection process applies the quality factor, then adds value and momentum qualifiers to help ensure the fund does not include too much mid-cap exposure, while it expands the universe of quality names by not relying solely on dividend payers to achieve objectives.

Originally, when we explored applying our DQS methodology beyond common stocks, we determined that using a cookie cutter application of the DQS template to every asset type did not work. Real estate investment trusts (REITs), because of their tax requirement to pass on the majority of their earnings directly to their unit holders, did not produce the same financial data as common stocks, such as net income. So we re-examined the metrics driving the DQS score and modified the methodology for the REIT space.

Many real estate equity strategies have a focus on value, but may omit an evaluation of a holding's financial strength. In addition, some approaches may disregard the direction and size of price movement trends, which can lead to value traps. The strategy behind **FlexShares Global Quality Real Estate Index Fund (GQRE)** is to try to counter these challenges by maximizing exposure to quality, value and momentum factors. GQRE offers investors a quality equity portfolio that provides exposure to the inflation-hedging qualities and long-term capital growth potential of global real estate.

Global stocks offer investors exposure to a broader range of income opportunities. **FlexShares International Quality Dividend Index Fund (IQDF)** applies the DQS strategy to international dividend-paying securities. FlexShares also offers the **FlexShares International Quality Dividend Defensive Index Fund (IQDE)** and the **FlexShares International Quality Dividend Dynamic Index Fund (IQDY)**.

FOR MORE INFORMATION

Contact FlexShares at 1-855-FlexETF (1-855-353-9383) or visit flexshares.com for any questions about our methodologies and design strategies or to learn more about the FlexShares family of quality ETFs.

1 Return on equity or ROE is a profitability ratio that measures the ability of a firm to generate profits from its shareholders investments in the company. In other words, the return on equity ratio shows how much profit each dollar of common stockholders' equity generates.

2 Debt to equity ratio is a financial ratio indicating the relative proportion of shareholders' equity and debt used to finance a company's assets.

3 Earnings variability is defined as the differences in a publicly traded company's year-on-year earnings or earnings per share in both positive and negative directions. Earnings variability is sometimes considered a negative sign as investors do not know whether the company's earnings in one year can be sustained in the next.

4 The Capital Asset Pricing Model or CAPM describes the relationship between risk and expected return and that is used in the pricing of risky securities. The general idea behind CAPM is that investors need to be compensated in two ways: time value of money and risk.

5 Correlated is a statistical measure of how two securities move in relation to each other.

6 Beta is defined as a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.

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.

The FlexShares Quality Dividend Suite of Funds are passively managed and use a representative sampling strategy to track the underlying indexes. Use of a representative sampling strategy creates tracking risk; the performance could vary substantially from that of the underlying index. The Funds are at increased dividend risk, as the issuers of the underlying stock might not declare a dividend, or the dividend rate may not remain at current levels. The Funds are also at risk of industry concentration, where they may be more than 25% invested in the assets of a single industry. The Funds may also be subject to volatility risk, where volatility may not equal that of the underlying index. IQDF, IQDY, and IQDE are subject to foreign securities risk, and may be more susceptible to adverse economic, market, political or regulatory risk.

FlexShares Global Quality Real Estate Index Fund is more susceptible to risks associated with the ownership of real estate and with the real estate industry in general, as well as risks that relate to how real estate companies are organized and operated. Real estate companies may have lower trading volumes and may be subject to more abrupt or erratic price movements than the overall market. The value of real estate securities may underperform other sectors of the economy or broader equity markets. To the extent that the Fund concentrates its investments in the real estate sector, it may be subject to greater risk of loss than if it were diversified across different industry sectors. REITs whose underlying properties are concentrated in a particular industry or geographic region are also subject to risks affecting such industries and regions. By investing in REITs through the Fund, a shareholder will bear proportionate expenses of the REITs in addition to expenses of the Fund.

FlexShares®

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