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MULTIFACTOR INVESTING: THE NEW REALITY IN EQUITY ALLOCATION

Used correctly, factor investing may perform better than traditional beta, enhancing risk management and diversification within a portfolio and providing opportunities to improve risk-adjusted returns versus market-weighted indexes. Though multifactor investing may sound like an option solely available in an active strategy, technological advances, regulatory requirements and greater innovation are changing the active versus passive debate.

(continued)
How factors tie to a goal can involve several issues. Different goals require different factor considerations. Selecting the proper factors for the goal and how those factors are combined are crucial. It is also very important to understand the different combination strategies and how they differ. Investors considering factor-investing products need to look at how the products work and ask questions about the process. Understanding the “whats” and the “whys” behind any fund sponsor’s “smart beta” or multifactor fund is important to effectively managing your portfolios.

INNOVATIONS IN EQUITY ALLOCATION LEAD TO “SMART BETA”

In recent years, accommodative monetary policy around the globe has driven investors to pursue other portfolio allocation options away from the legacy 60% equity-40% fixed income investing framework. Today, they are more willing to accept new approaches, new areas of investing, new ways of thinking and, consequently, innovative approaches to equity allocation.

Examples of equity product innovation abound and a major result has been an embrace of indexing at multiple levels. Currency hedge strategies associated with an international index can now be implemented via a single trade. Equities are also being used to access commodities through natural resource ETFs. Infrastructure, once limited for average investors mostly to private equity, direct investment, or utilities, are now accessible through various strategies or funds.

Even more important, however, is the evolution of the beta concept to “smart beta.” This transition moves investors away from the traditional market capitalization concept and bases investment selection on one or even multiple factors or characteristics.

There is no question that traditional beta has historically provided investors with several advantages including the representation of an entire market through an indexing approach which includes the potential for low tracking error,1 ease of maintenance, ease of trading and ease of reconstitution.

Used correctly, however, single and multi-factor investing may not only potentially perform better but also enhance risk management and diversification within a portfolio while providing opportunities to improve risk-adjusted returns versus market-weighted indexes.

Though multifactor investing may sound like an option solely available in an active strategy, technological advances, regulatory requirements and greater innovation are changing the active versus passive debate.

As Exhibit 1 shows, fund flows over the last several years reflect strong interest in non-traditionally weighted indexes in the wake of post-crisis de-risking.

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1 Tracking error is a measure of how closely a portfolio follows the index to which it is benchmarked.
What Exactly is Smart Beta?

Smart beta is actually an umbrella term for investment strategies that utilize alternative methods to construct indexes as opposed to traditional market capitalization weighting. Smart beta emphasizes various investment factors or characteristics in a rules-based and transparent way. Such strategies are often called multifactor investing.

The smart beta concept can be traced back to academic research, specifically the capital asset pricing model created by Bill Sharpe in the 1960s. Sharpe turned the algebraic equation for a straight line into a market changing theory. His research determined that sensitivity to market volatility in a given security or portfolio, which he labeled beta, explained 70% to 75% of investors’ returns. The other 25% to 30% he considered alpha.\(^2\)

Expounding on Sharpe’s research, Eugene Fama and Ken French’s seminal work in 1992 found that, while beta was the most explanatory factor, size and value were also important in illuminating portfolio performance. They determined that the level of exposure to value and small capitalization stocks, alongside beta, explained 90% or more of returns, leading to the identification of value and small cap as compensated risk factors. Later in the 1990s, Mark Carhart’s research added a fourth factor, momentum. His research found that when momentum was combined with beta, value and capitalization, at least 95% of returns were explainable.

Today, smart beta strategists apply various multifactor approaches not to explain returns, but rather as a way to get incremental returns into the portfolio and outperform a market-weighted portfolio over the long term.

HOW ETFs CAN HELP

Factor investing is no longer necessarily “active” in the sense that it was formerly understood. The financial landscape that has evolved across the last few decades—driven largely by financial turbulence—presents challenges for individual stock-pickers. An exponential increase in access to information for all investors, low latency and high frequency trading and the explosion in computing power all contribute to the end of unofficial projections of performance that historically circulated quietly among institutional investors.

As advantages for active traders evaporated, the use of factor investing began to rise. In early iterations, single-factor weighted portfolios emerged. Over the last several years, however, quantitative analysis showed a dispersion of factors, with the array of metrics responding differently in the most recent bout of financial disruption. The conclusion was that investors might better enable diversification and manage risk in a portfolio through multiple factor exposures that were not attainable by simply being invested in an index of an entire equity market.

Improvements in technology are permitting easier, more efficient factor capture, allowing research, replication and application in real-world scenarios. Concurrently, passive indexing has grown over the last two decades as a successful way to access equity markets. Smart (or strategic) beta products provide a rules-based framework to combine benefits of both.

ETFs offer an additional level of transparency and consistent approach to factor access that active managers simply do not. Any changes in the index portfolio, as identified by ongoing research, are announced so that investors can prepare. On the other hand, most active managers report holdings on a quarterly basis and if there is a change in the methodology of how they capture or alter exposure to a specific factor, it is made public after the fact.

\(^2\) A measure of performance on a risk-adjusted basis. Alpha, often considered the active return on an investment, gauges the performance of an investment against a market index used as a benchmark, since they are often considered to represent the market’s movement as a whole.
FLEXIBLE INDEXING: PUTTING INVESTOR OBJECTIVES FIRST

The FlexShares approach to index design is investor-centric. Whether institutional or individual, investors have real-world investment objectives that we organize into four basic goals: growing assets, managing risk, generating income and maintaining liquidity. Before considering asset class, FlexShares considers how best to achieve the given goal. Which factors we choose and their tied to the goal are critical.

To qualify for inclusion in an index’s design, factors must persist over time. We begin with skepticism that potential factors are simply anomalies of a particular economic, regulatory or theoretical period. Our analysis looks to ensure factors that are consistent through time and across markets. Any potential characteristics not borne out by research or empirical evidence will not persist in the future and do not maintain their efficacy. They are simply not valid.

How factors tie to a goal can involve several issues. Different goals require different factor considerations. For example, in a capital appreciation strategy, we must look at various time windows: long, intermediate or short-term factors. We also must focus on the best way to mitigate risk.

Selecting the proper factors for the goal and how those factors are combined is crucial. It is also very important to understand the different combination strategies and how they differ.

1. **Target each factor independently.** Create sub-indices and combine into one process. In our opinion, this is an inefficient approach. The separate sub index for each factor combined will each contain some equities that do not qualify.

2. **Apply selected factors in succession.** This may arguably be better than targeting each alone but in reality, only the last factor applied will be maximized.

3. **Target all factors, in concert.** Combining factors that are negatively correlated with one another. This process works to “smooth” the factor cycle, not only eliminating equities that do not meet the various factor criteria, but also maximizing exposure to those that do.

A simplified example of how the third strategy may be the most beneficial to portfolio performance is to look at investing in the quality factor. Top-quality companies carry a premium (they are generally overvalued) and therefore provide less excess return. Companies with stronger performance are undervalued. Combining quality and value factors simultaneously may identify high-quality companies that are undervalued.

Though equities presented the most logical starting point for factor investing, due to the depth and breadth of historical data, we are also applying factor investing in our fixed income products.

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3 Correlation is the extent to which the values of different types of investments move in tandem with one another in response to changing economic and market conditions. Correlation is measured on a scale of -1 to +1.
ASK THE RIGHT QUESTIONS

A combination of traditional market-weighted and factor investing, using the right factors of course, may work best to avoid risk and gain exposure for broader diversification and return. Advisors considering factor-investing products need to look at how the products work and ask questions about the process. Understanding the “whats” and the “whys” behind any fund sponsor’s smart beta or multifactor products is important to effectively managing your portfolio.

Ask how a particular product may fit within the portfolio. Ask about the goal of the product. Is it capital appreciation, minimizing volatility, other? Ask why the particular factors were selected, how they were combined and how they tie to the goal. No factor is a “silver bullet” that works in all market environments. Factors go through cycles and it is important to research when you may be able to expect various factors to underperform and why? Conversely, understanding in what market situation might they potentially outperform?

What is the future of factor investing? How can it be improved? As the evolution of smart beta continues, we see the emergence of “refined multifactor models,” exhibiting more and better ways to potentially capture factor exposures; more efficient factor capture for sustained performance over time and increased focus on how best to combine factors for maximized return. This is all part of our intellectual pursuit to improve the science of asset management at FlexShares.

Pursuing Quality as a Factor

The word “Quality” appears rather frequently in the FlexShares product group. As a demonstration of our research methodology, here is a synopsis of our approach to identifying quality companies.

Our quality research was initially based on an income generation mandate. The question we posed was, “How do you gain confidence that a given company’s dividend is well-covered and capable of growing over time?” In other words, we looked to avoid overpaying for yield. After pursuing various methodologies — dividend history, financials, a momentum factor — we found that what worked best was to look at the financial health of the company. We applied three lenses to our study:

Management efficiency. We found that capital deployment is actually the hallmark of management efficiency. The more aggressive managers are in their capital deployment, the more likely they are to be poor-quality companies.

Profitability. This is our way of judging competitive advantage. Companies that are in a stronger competitive position tend to do better because they have the ability to take advantage of new opportunities. Such companies more often dictate to the environment rather than being reactive, whether in an up or down market.

Cash flow. This factor is critical — and universal. We have found it to be a strong indicator across all markets, not just dividend payers. We have applied this lens in our real estate product, our recently launched quality large cap product and several international products as well.
FOR MORE INFORMATION
At FlexShares, everything we do and every decision we make starts and ends with the investor in mind. A hallmark of our asset management philosophy is transparency. Call 1-855-FlexETF (1-855-353-9383) or visit us at flexshares.com for more detailed information.

An investment in FlexShares is subject to investment risk, including the possible loss of principal amount invested. Funds’ returns may not match the returns of their respective Indexes. The Funds may invest in emerging and foreign markets, derivatives and concentrated sectors. In addition, the Funds may be subject to asset class risk, small cap stock risk, value investing risk, non diversification risk, fluctuation of yield, income risk, interest rate/maturity risk, currency risk, passive investment risk, inflation protected security risk, market risk and manager risk. For a complete description of risks associated with each Fund, please refer to the prospectus.

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. FlexShares ETFs are distributed by Foreside Fund Services, LLC, not affiliated with Northern Trust.

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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.