



FLEXSHARES
EXCHANGE TRADED
FUNDS

2016

PRESIDENT'S PERSPECTIVES

BUILT BY INVESTORS, FOR INVESTORS

THE SIMPLE TRUTH FROM FLEXSHARES

Investing can be complex. As an investor, you are continually confronted with new opportunities and challenges. What's more, providers offer an ever increasing array of investment products to capitalize on opportunities and address challenges. Simplicity is one of our core values at FlexShares. We believe our investment solutions and insights should be easy to understand. Whether thoughtfully communicating the science behind our investment strategies, or providing cogent investment insights, we strive to simplify the investing experience. Sir Isaac Newton observed that truth is ever to be found in simplicity. We find that simple, yet deliberate, disciplines produce truly innovative investment solutions. Likewise simple, yet careful, exploration produces valuable investment insights. To this end, I offer the following perspectives on the ETF marketplace. My hope is that these unique insights will help simplify your investment experience and encourage your ongoing engagement with FlexShares.

INDUSTRY OVERVIEW

Exchange-Traded Funds (ETFs) continue to be among the fastest growing product categories in the U.S. asset management industry with a 10-year CAGR of 19.45%. In 2016, growth in the U.S. market increased +19.84% from the prior year to \$2.55 trillion in assets as of 12/31/2016. The total assets at year-end (YE) represented a record total for the industry buoyed by record flows of \$284 billion. 2016 flows were driven primarily by U.S. equity (+\$168 billion), which more than doubled its inflows from 2015. Taxable bonds finished with the second most inflows (+\$85 billion), which also marked its largest annual inflow ever up from (+\$58 billion) the prior year. ETFs continue to gain market share among pooled vehicles in the taxable bond category as evidenced by the comparison to the (+\$113 Billion) of inflows for taxable bond mutual funds. Commodities saw the next highest (+\$10 billion) as gold strategies were in favor in the early part of 2016. Over the final quarter of the year, however, gold products experienced notable outflows as investors re-allocated to

equities and to broader based natural resources exposure. While this dampened overall commodity flows relative to the start of the year, the overall results were positive. International equity, which was the star last year, attracted significantly lower flows (+\$9 billion) as investors reduced exposure to developed international markets and currency hedged strategies. Nonetheless, when correcting for the size of the markets, international equities favored emerging markets. Investors in U.S. equities continued to favor the ETF vehicle structure as U.S. equity mutual funds experienced outflows of (-\$91 billion).

In 2016, there were 246 new U.S. ETF listings but 124 fund closures, bringing the YE fund total to 1,972. This represented a record number of closures albeit from a larger base. There was more concentration of fund flows among the top 3 providers as they accounted for \$254 billion, or 90% of fund flows. This compares to 66% during the prior year. One of the biggest drivers in this year-over-

year shift was the rebound at a major competitor from annual outflows in the prior year. Achieving \$100 million in AUM within two years of listing for a new fund is an accepted measure of initial success. A decade ago, nine out of ten ETF listings achieved this milestone versus about one in ten today. During the past two years, 534 new ETFs were listed with 54 (10%) of these funds exceeding the \$100 million AUM milestone. This ratio decreased from 2015, when 13% of funds launched within the trailing two years exceeded the \$100 million milestone.

Competition continues to intensify as new players enter the market. We assert that the keys to success in our industry are evolving due to changing investor attitudes and competitive dynamics. The number of U.S. sponsors has increased from 16 at the end of 2006 to 104 at the end of 2016. A net increase of 13 sponsors occurred in 2016.

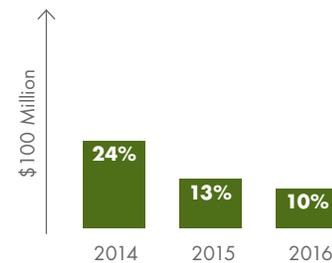
RECORD INDUSTRY FLOWS



Source: Morningstar

\$100 MILLION MILESTONE

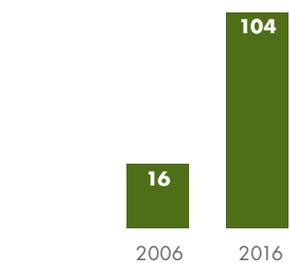
Trailing 3-Year Trend



Source: Morningstar

10-YEARS OF SPONSOR GROWTH

Number of ETF Sponsors



PRODUCT INNOVATION

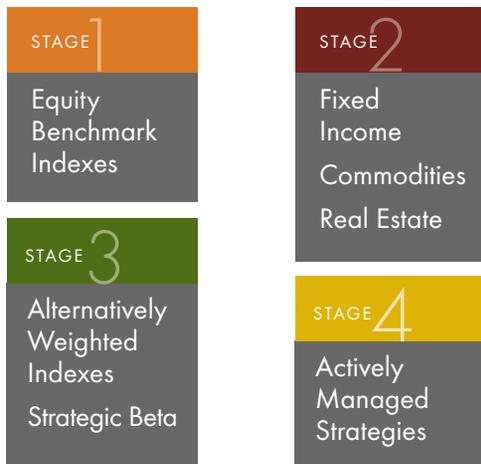
From my perspective, there are four distinctive phases of product innovation in the exchange traded funds market. The first stage focused almost exclusively on broad-based equity benchmark indexes. Institutions were the initial users of these benchmark indexes in tactical applications, such as hedging and transition management. Over time, usage migrated to advisors and other strategic investors, along with products designed to track benchmark indexes, which continue to account for the majority of ETF assets. The second stage of innovation was distinguished by an expansion into a variety of asset classes including fixed income, commodities and real estate. Driven by investor demand for global portfolio exposure and rising demand from advisors, ETFs democratized access to these asset classes. This stage of innovation was also marked by rising awareness and usage among retail investors. The third leg of innovation has been distinguished by investor demand for distinctive investment strategies with particular interest in

funds that track alternatively weighted indexes. A variety of nomenclature is associated with these strategies including fundamentally weighted, factor weighted and the popular "smart beta." While the lexicon may vary, the trend of growing investor demand for alternatively-weighted index strategies is firmly established. The term "smart beta" is increasingly being used by investors and Morningstar® identifies 634 funds with the term "strategic beta," up from 515 funds the prior year. With assets of \$559 billion and inflows of \$50 billion in 2016, this sub-segment continues to experience strong organic growth. It is relevant to note that flows to strategic beta funds fell short of the prior year modestly outpacing the industry growth rate (21% versus 20%). FlexShares is a leader in this segment with 23 of our 25 funds tracking alternatively weighted indices.

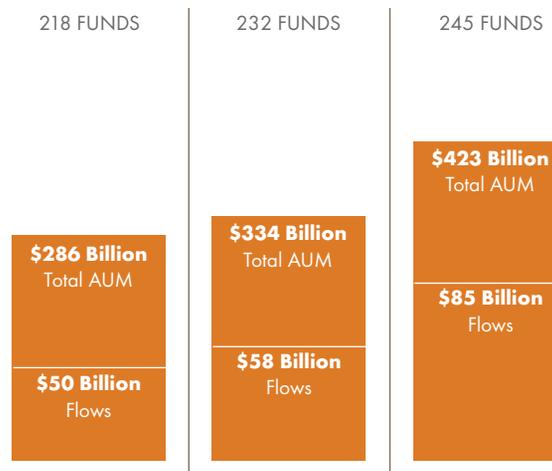
New stages of innovation are generally ignited in the midst of an ongoing phase. The drive toward investment

strategies that efficiently capture compensated risk factors and active risk, has accounted for much of the interest in alternatively weighted index strategies. This trend, coupled with continued fee compression, has given rise to a fourth stage of innovation. The fourth stage of innovation is characterized first by budding interest in actively managed ETFs. Secondly, it is characterized by rising interest in multi-asset class solutions, in which ETFs are the preferred fulfillment vehicle. Actively managed ETFs were first introduced to the market in 2008. At the close of 2016, there were 169 U.S. listed and actively managed ETFs with \$30 billion in assets. While the number of new funds continues to grow, active ETFs only account for just over 1 percent of U.S. ETF assets. Broader utilization of actively-managed ETFs will be aided by targeted regulatory relief, market entry by established active fund managers and the tried and true passage of time. Additionally, asset managers are offering increasingly popular multi-asset

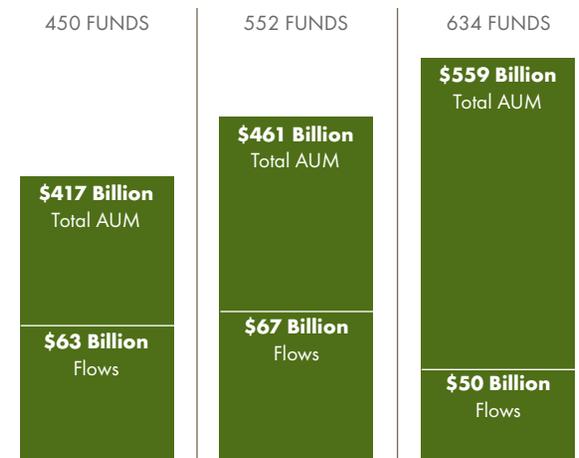
WITNESSED INNOVATION OVER THE YEARS



INCREASE FLOWS TO TAXABLE BONDS



CONTINUED GROWTH IN STRATEGIC BETA



Source: Morningstar

PRODUCT INNOVATION CONTINUED

class products and managed portfolio solutions comprised of ETFs. These solutions may incorporate dynamic or tactical asset allocation and may integrate active and passive components. The trend toward multi-asset class products is a key driver of the emerging fourth stage of product innovation. This phase of innovation is blurring, if not removing altogether, industry distinctions between active and passive portfolio solutions.

Our product strategy at FlexShares remains principally focused on alternatively weighted index strategies with selective implementation of actively managed strategies. The FlexShares' philosophy is built around the way investors think. Investors have clear objectives. We develop investment strategies that seek to meet those objectives. When it comes to delivering an index-based strategy, the index matters. This is why our comprehensive approach, known as Flexible Indexing, entails innovative index construction for each FlexShares fund. The entire development process is centered on investor needs.

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

PRICING

FlexShares ETFs are designed to produce persistent return attributes and serve as valuable components for portfolio construction. Our Flexible Indexing approach emphasizes transparency and cost efficiency to deliver alternatively-weighted index strategies. One of the industry dynamics we track very closely is pricing trends, and in particular expense ratios. While increased competition has resulted in downward pricing pressure in recent years, there are important subtleties to understand.

The weighted average expense ratio for U.S. ETF sponsors was 24.0 basis points (bps) at the end of 2016. Basis points are one hundredth of one percent. This is down from 26.1 bps YE 2015 and 32.9 bps YE 2011. The primary contributors to the pricing shift in 2016, were asset allocations towards lower cost U.S. equity funds, a trend which was especially prevalent during the fourth quarter. The weighted average expense had been slowly dropping as the year progressed, but rapidly picked up over the final three months of the year. The fourth quarter saw a record +\$129 billion in inflows for the U.S. ETF industry, much of which went into broad-based U.S. equity

funds, which tend to have the lowest fees. The industry weighted average expense ratio dropped by 1.2 bps during the fourth quarter, accounting for more than half of the YoY drop of 2.1 bps. The median expense ratio for U.S. sponsors was 72.8 bps at the end of 2016 down from 75.0 bps YE 2015. That median figure had held relatively steady for the prior five years and was 75 bps in 2011.

FlexShares experienced an increase in our weighted average price going from 35.3 to 36.9 bps due to asset allocation shifts and new purchases by clients in favored product categories, including real assets. Our series of funds are competitively priced, ranking 11th lowest by weighted average price among the 104 U.S. ETF sponsors. The relative pricing of FlexShares funds is also favorable when considering our international equity exposure. This reflects our intentional pricing strategy, which seeks to provide exceptional value for price. In 2016, we furthered our efforts to offer competitive pricing by lowering the expense ratios on six of our FlexShares ETFs.

Our series of funds are very competitively priced, ranking in the lowest decile of weighted average price among the 104 U.S. ETF sponsors.

DISTRIBUTION

There are three trends of particular interest as it pertains to ETF distribution. The first trend illuminates the industry response to the changing regulatory environment. One of the most notable consequences of the financial crisis has been the acceleration in the pace and breadth of regulatory changes in the U.S. fund industry. The impact has touched all major aspects of registered fund businesses including investment activities, trading and distribution. It is also important to note that this is a global trend spanning major developed markets and economies. Whether we consider the SEC's recently enacted Money Market Fund Reform Rules, the implementation of the DOL Fiduciary Rule, or the SEC's proposed Liquidity Rule, business and distribution models are being irrevocably altered. This regulatory shift has necessitated compulsory and anticipatory changes by fund providers, which I refer to as regulatory responsiveness. While recent changes in the political landscape in the U.S. may impact the timing and nature of regulatory changes, key aspects have strong momentum. To borrow an old quip, we might refer to certain shifts in the regulatory landscape as delayed but not denied. The attendant rising costs of compliance, coupled with greater requirements for transparency and suitability, have favored index strategies and the ETF vehicle in particular. The increased risk and complexity of managing fiduciary mandates and smaller accounts is also fueling a drive toward more automation. These shifts taken as a whole are accelerating the move toward more efficiently priced products with simple fee structures, which is favorable for the distribution of ETFs.

The second trend, strategic use of ETFs by institutional users, is one that I've previously highlighted. ETFGI uses reported holdings to illuminate trends among institutional users of ETFs. The most recent December 2016 survey identified approximately 4,000 global institutional users of ETFs. The research results depict not only an increased percentage of institutional ETF users, but also notable increases in the

number of products and the length of holding periods among users. Greenwich Associates has specifically highlighted the trend toward strategic usage of ETFs by institutions in their annual surveys over the past 5 years. Their 2016 Surveys suggest nearly 70 percent of institutional ETF assets are characterized as strategic in nature. Fixed income has become a notable area of focus as institutions make significant changes to their fixed income portfolios in response to liquidity constraints, as well as regulatory and market structure changes. A fall 2016 survey by Greenwich Associates noted that 1/3 of respondents who are institutional ETF users allocate between 10-30% of their fixed income assets to ETFs. Interestingly about 1/3 of all the institutional ETF users who responded to the survey also indicated plans to increase their investments in fixed income ETFs during the following 12 months. These developments will drive expanded product development of fixed income ETFs and will generate notable opportunities to distribute ETFs to institutional asset owners and asset managers.

The third trend is the rapid growth of multi-asset class solutions. While passive strategies have accounted for a dominant share of flows into registered funds, the second largest category is multi-asset class products (MACS). MACS are the fast growing product category in asset management and the rapid growth is directly correlated with the growing acceptance of ETFs as a primary fulfillment vehicle.

While difficult to track, it is estimated that ETFs comprise about half of portfolio holdings in multi-asset class solutions. What is clear is that ETFs are taking a growing share of fulfillment in multi-asset class solutions and are a preferred vehicle for this application. The aforementioned trend on the strategic use of ETFs by institutions such as public funds, foundations, endowments and asset managers, as well as broad acceptance by financial advisors, intersects with the growth in multi-asset class solutions. As institutions

and advisors continue on the relentless drive toward more efficient investment solutions, multi-asset class solutions will be a growing area of focus. Evolution of institutional offerings, coupled with direct to investor solutions delivered through digital investment advisory offerings, will shape many of the distribution opportunities in the ETF market.

Evolving client preferences, regularly changes and technological advancements, require dynamic shifts in distribution approaches. Taken together, these driving forces are reshaping business and distribution models. This is also occurring at a more accelerated rate than what the industry has experienced in the past. Our FlexShares strategy involves constant evaluation and engagement with all distribution channels that align with our value proposition.

THE THREE ETF DISTRIBUTION TRENDS



PRODUCT DEVELOPMENT

Our decisions to launch specific strategies are supported by comprehensive research, as well as analysis of industry and competitive trends. This empirically driven approach to ETF product development is a core tenet of our strategy. Investors can benefit from our dedication to advancing the science of index design and select actively managed strategies. FlexShares listed 3 new funds during 2016 bringing our total fund offering up to 25. We continue to pursue our mission of delivering outcome-oriented funds that allow investors to achieve the fundamental objectives of growing assets, mitigating risks, generating income and managing liquidity. Our focus on long-term investors, emphasis on alternatively-weighted index strategies and empirically driven approach are characteristics that distinguish FlexShares among ETF providers.

Flexible Indexing is the moniker of our distinctive approach to delivering alternatively weighted index strategies. Our approach involves a comprehensive process that spans from concept through index construction, as well as product design and development. Our ETFs don't simply track an index. They are purposeful investment solutions, distinct from benchmarks.

IMPORTANT RISK DISCLOSURE

FlexShares STOXX US ESG Impact Index Fund (ESG) and the FlexShares STOXX Global ESG Impact Index Fund (ESGG) are passively managed and use a representative sampling strategy to track their underlying index respectively. Use of a representative sampling strategy creates tracking risk where the Fund's performance could vary substantially from the performance of the underlying index. The Funds are subject to environmental, social and governance (ESG) Investment Risk, which is the risk that because the methodology of the Underlying Indices selects and assigns weights to securities of issuers for non-financial reasons, the Funds may underperform the broader equity market or other funds that do not utilize ESG criteria when selecting investments. The Funds are also at increased risk of industry concentration, where it may be more than 25% invested in the assets of a single industry. For ESGG, investments in foreign market securities involve certain risks such as currency volatility, political and social instability and reduced market liquidity. The Funds 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 Funds could lose more than the principal amount invested.

FlexShares Core Select Bond Fund (BNDC) is actively managed and does not seek to replicate a specified index. The Fund is subject to increased credit and default risk, where there is an inability or unwillingness by the issuer of a fixed income security to meet its financial obligations, debt extension risk, where an issuer may exercise its right to pay principal on an obligation later than expected, as well as interest rate/maturity risk, where the value of the Fund's fixed income assets will decline because of rising interest rates. The Fund is subject to increased underlying fund risk, where the Fund's investment performance and its ability to achieve its investment objective may be directly related to the performance of the Underlying Funds in which it invests. The Fund may also be subject to increased concentration risk as it may invest more than 25% of its assets into the securities of a single developed market. Additionally, the Fund may invest without limitation in mortgage or asset-backed securities, which puts it at increased risk for interest rate/maturity risk, debt extension risk, and prepayment (or call) risk.

SUMMARIES OF THE NEW FLEXSHARES FUNDS

FlexShares® STOXX US ESG Impact Index Fund (NASDAQ Listed, Ticker: ESG) and the FlexShares® STOXX Global ESG Impact Index Fund (NASDAQ Listed, Ticker: ESGG).

Two new environmental, social and governance (ESG) funds that seek to provide exposure to an optimized index designed to provide broad market exposure that is tilted toward U.S. companies that score better with respect to a select set of ESG characteristics. The index-based funds are designed to provide the potential for attractive risk-adjusted performance through a proprietary model based on select ESG criteria while constraints are utilized in an effort to minimize overall risk within the strategy.

FlexShares® Core Select Bond Fund (NYSE Listed, Ticker: BNDC) is an actively managed ETF that seeks to provide attractive risk-adjusted performance by investing in a portfolio of fixed-income securities that is designed to achieve optimal potential for total return after taking into account various sources of investment risk. The Fund adjusts its allocations to securities based on Northern Trust Investment's assessment of potential changes in interest rate levels, the shape of the yield curve and credit spread relationships while seeking to balance the potential for return and risk emphasizing liquidity and diversification across a spectrum of U.S. dollar denominated investment-grade[†] fixed income securities.

[†] Investment Grade is any security rated by S&P BBB or higher OR by Moody's Baa3 or higher



Shundrawn A. Thomas
President of FlexShares

LOOKING FORWARD

As an ETF sponsor of choice, FlexShares leverages deep investment expertise, collaborative relationships with investing clients and a rich fiduciary culture to deliver distinctive ETFs. Our portfolio management capabilities in index management, quantitative research, fixed income, and multi-asset class solutions, provide a rich set of capabilities that enable innovative product. Our business principles and core values are the drivers of our distinctive approach. In 2017, we will continue to provide innovative ETF solutions and unique investment insights in an effort to serve as your trusted fund advisor. And we will deploy our expertise in a manner that ensures that our value proposition is not only sophisticated, but simple.

IMPORTANT RISK DISCLOSURE

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 summary prospectus and full 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.

*Source: All facts & figures are from Morningstar
All data as of December 31, 2016*