

QDF

QDEF

QDYN

IQDF

IQDE

IQDY

Measuring Dividend Quality

The Case for Quality

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.

“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.* 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.

* Dividends represent past performance, and there is no guarantee they will continue to be paid.

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:



MANAGEMENT EFFICIENCY

Management Efficiency is a quantitative evaluation of a firm's deployment of capital as well as its financing decisions. Firms that aggressively pursue capital expenditures and additional financing generally lose flexibility in both advantageous and challenging portions of the market cycle.



PROFITABILITY

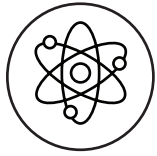
Profitability scores a firm's relative competitive advantage across several different metrics. Firms with wider margins may be better positioned to grow compared to firms with slimmer margins.



CASH FLOW

Cash Flow assesses 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 enjoy a financial cushion during periods of distress.

QUALITY DIVIDEND INDEX PROCESS



STEP ONE

Composite Score Ranking

Non-Dividend Payers Excluded

Management Efficiency + Profitability + Cash Flow



Dividend Quality Score

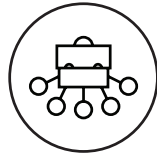


Quintile



Highest Ranked

Lowest Rank (Excluded)

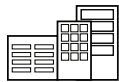


STEP TWO

Diversification Controls



Maximum single security overweight/underweight



Maximum industry group overweight/underweight



Maximum sector overweight/underweight



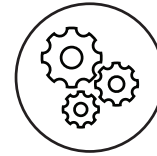
Style exposure minimized



Rebalanced on a quarterly basis (Feb., May, Aug., Nov.)

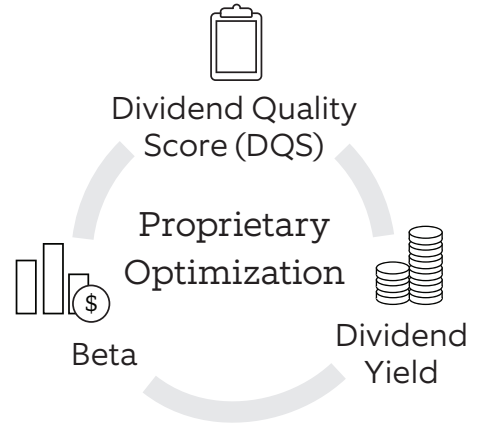


Target a turnover limit of 25% max

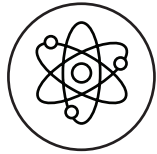


STEP THREE

Proprietary Optimization



INTERNATIONAL QUALITY DIVIDEND INDEX PROCESS



STEP ONE

Composite Score Ranking

Non-Dividend Payers Excluded

Management Efficiency + Profitability + Cash Flow



Dividend Quality Score

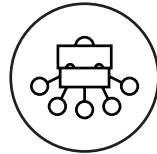


Quintile



Highest Ranked

Lowest Rank (Excluded)

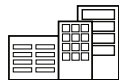


STEP TWO

Diversification Controls



Maximum single security overweight/underweight



Maximum industry group overweight/underweight



Maximum sector overweight/underweight



Maximum country overweight/underweight



Maximum region overweight/underweight



Maximum sector /region overweight/underweight



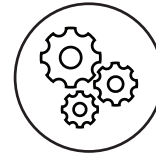
Style exposure minimized



Rebalanced on a quarterly basis (Feb., May, Aug., Nov.)

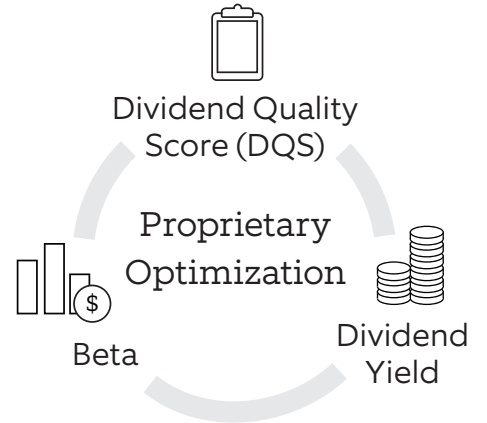


Target a turnover limit of 25% max



STEP THREE

Proprietary Optimization



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 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.

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.

MORE INFORMATION = BETTER DECISIONS

We believe our strategic beta ETF strategies here at FlexShares are among the most innovative in the industry. FlexShares Exchange Traded Funds offer focused ETF strategies that seek to help investors achieve real-world goals, by providing solutions that empower advisors to construct, allocate and manage outcome-oriented portfolios. We would be happy to share our insights on how investors and their advisors can help preserve, protect and grow investment portfolios. Please visit flexshares.com.

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

INVESTOR-CENTRIC FOCUS. DISCIPLINED APPROACH. DISTINCTIVE ETF SOLUTIONS

At FlexShares, our focus is on understanding and responding to investor needs. We design funds that seek to meet specific investment objectives and we continually work to help investors become well-educated consumers of Exchange Traded Funds. We freely share our knowledge and expertise to help investors make informed decisions on how ETFs can best help them achieve their long-term goals.

Capital Appreciation:

Investment strategies seeking to replicate the performance outcomes of investing in growth-seeking assets

Target Outcome:

Seek Growth with Purpose

Income Generations:

Investment strategies seeking to replicate the performance outcomes of investing in income-generating assets

Target Outcome:

Seek Income for Expected Needs



Risk Management:

Investment strategies seeking to manage specific factor-related risks and mitigate portfolio risks

Target Outcome:

Seek to Manage Risk

Liquidity Management:

Investment strategies featuring cash-plus and fixed income solutions with flexible guidelines

Target Outcome:

Seek Liquidity and Flexibility

EQUITY

TILT FlexShares Morningstar® U.S. Market Factor Tilt Index Fund	ESG FlexShares STOXX® US ESG Impact Index Fund	QDYN FlexShares Quality Dividend Dynamic Index Fund
TLTD FlexShares Morningstar® Developed Markets ex-U.S. Market Factor Tilt Index Fund	ESGG FlexShares STOXX® Global ESG Impact Index Fund	IQDF FlexShares International Quality Dividend Index Fund
TLDH FlexShares Currency Hedged Morningstar® DM ex-U.S. Factor Tilt Index Fund	QLC FlexShares U.S. Quality Large Cap Index Fund	IQDE FlexShares International Quality Dividend Defensive Index Fund
TLTE FlexShares Morningstar® Emerging Markets Factor Tilt Index Fund	QDF FlexShares Quality Dividend Index Fund	IQDY FlexShares International Quality Dividend Dynamic Index Fund
TLEH FlexShares Currency Hedged Morningstar® EM Factor Tilt Index Fund	QDEF FlexShares Quality Dividend Defensive Index Fund	

FIXED INCOME

TDTT FlexShares iBoxx® 3-Year Target Duration TIPS Index Fund	SKOR FlexShares Credit-Scored U.S. Corporate Bond Index Fund	BNDC FlexShares Core Select Bond Fund
TDTF FlexShares iBoxx® 5-Year Target Duration TIPS Index Fund	LKOR FlexShares Credit-Scored U.S. Long Corporate Bond Index Fund	MBSD FlexShares Disciplined Duration MBS Index Fund
RAVI FlexShares Ready Access Variable Fund		

REAL ASSETS

GUNR FlexShares Morningstar® Global Upstream Natural Resources Index Fund	QGRE FlexShares Global Quality Real Estate Index Fund	NFRA FlexShares STOXX® Global Broad Infrastructure Index Fund
ASET FlexShares Real Assets Allocation Index Fund		

FIND OUT MORE

The FlexShares approach to index-based investing is, first and foremost, investor-centric and goal oriented. We pride ourselves on our commitment to developing products that are designed to meet real-world objectives for both institutional and individual investors. If you would like to discuss the attributes of any of the ETFs discussed in this report in greater depth or find out more about the index methodology behind them please don't hesitate to call us at 1-855-FlexETF (1-855-353-9383) or visit www.FlexShares.com.

DEFINITIONS

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.

Payout ratio is the dividend per share divided by earning per share.

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.

IMPORTANT INFORMATION

Before investing, carefully consider the FlexShares investment objectives, risks, charges and expenses. This and other information is in the prospectus and a summary prospectus, copies 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. A full description of risks is in the prospectus.

An investment in the FlexShares Quality Dividend funds suite (QDF, QDEF, QDYN, IQDE, IQDF, IQDY) are passively managed and use a representative sampling strategy to track their underlying index. Use of a representative sampling strategy creates tracking risk where the Fund's performance could vary substantially from the performance of the underlying index along with the risk of high portfolio turnover. The Funds are subject to numerous risks including loss of principal. Highlighted risks: dividend (issuers of underlying stock might not declare a dividend, or dividend rate may not remain at current levels); concentration (more than 25% of assets in a single industry); currency (foreign currencies may fluctuate in value relative to the US dollar, adversely affecting IQDE, IQDF & IQDY investments); emerging markets (countries potentially less liquid and subject to greater volatility); foreign securities (IQDE, IQDF & IQDY typically invest at least 80% of assets in ADRs and GDRs); and volatility (volatility may not equal target of Underlying Index). Investments in foreign market securities involve certain risks such as currency volatility, political and social instability and reduced market liquidity. To the extent that the Funds invest in Emerging markets, those investments may be subject to increased price volatility and may be more susceptible to adverse economic, market, political or regulatory occurrences affecting that country, market, industry, sector or asset class. See prospectus for full description of risks. Beta is a statistical measure of the volatility, or sensitivity, of rates of return on a portfolio or security compared to a market index.

MANAGED BY NORTHERN TRUST

CONTACT US

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