Rethinking Ultra-Short Duration Investing

The Case for Investing Liquidity

When the goal is to manage liquidity, investors are developing a sharper understanding of the tradeoffs among safety of principal, income and access to funds.

HOW ARE INVESTORS NOW LOOKING AT LIQUIDITY?

The financial crisis and its aftermath significantly changed the landscape for ultra-short duration fixed income a.k.a. "liquidity investing." Though market dynamics remain in flux, especially globally, there is no going back to the markets, regulation or products of old. As investors became more aware of the shifting dynamics, they began to identify and prioritize their objectives for liquidity investments – and created a need for new vehicles that manage liquidity assets.

LIQUIDITY STRATEGIES IN A CHANGED LANDSCAPE

Due to new global regulations for banks and money market funds as well as supply-and-demand changes, money market yields are extremely low – sometimes even going negative. In the current environment, investors and central bankers have come to view these low yields on top-quality, short-dated fixed income paper as being the new normal. And as many of the recent money market regulatory reforms continue to be implemented, many investors will continue to see increased risks or lower yields on their short-term investments. If they have not already done so, it is time for investors to reexamine their liquidity strategy and investigate new vehicles that better match their goals risk tolerances.

Investors are developing a sharper understanding of the tradeoffs among safety of principal, income and access to funds in managing liquidity. Many now recognize a single product solution may no longer be viable. The regulatory and ultra-low rate environment is forcing them to be more open-minded about the broader menu of investment options available in today's liquidity investing marketplace.

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THE OLD PARADIGM

Prior to the credit crisis, an overabundance of AAA-rated securities were being produced for the fast-growing business of fixed net asset value (NAV) money market funds. This was the result of a confluence of: favorable macro/market conditions, financial innovations, the influence of nationally recognized statistical rating organizations (NRSROs) and accommodating regulators. These securities were available in a broad spectrum of fixed NAV product segments spread across taxable securities (financial, industrial, structured, asset-backed, mortgage-backed) and tax-exempt securities (insured municipal, variable rate demand note (VRDN), state-specific, auction rate). Also, "risk-free" assets were readily available to investors via offerings issued or "guaranteed" by sovereign entities. However, the combination of matrix-based pricing methodologies, overly generous credit ratings and relaxed regulatory oversight masked big problems lurking in the system.

By September 2008, amid sinking issuer credit quality and frozen markets, the old paradigm imploded. It's impossible to forget the shockwaves produced when Lehman Brothers' bankruptcy forced the Reserve Primary Fund "break the buck," and declare a NAV of $0.97 – one of the first times in history any retail money market fund failed to maintain a NAV of one dollar.

The AAA ratings on many insured and structured securities held by money market funds were quickly and severely downgraded. Overnight, attention focused on the credit market, as commercial paper was a major component of money market funds. The meltdown ensued. The Reserve Primary Fund itself was forced to liquidate and many funds holding commercial paper rushed to prop up their funds to avoid collapse. Even unaffected funds faced major redemptions from worried investors. Fearing such a run, the federal government launched the Temporary Liquidity Guarantee Program for money market funds, guaranteeing investors the value of each money market fund share held as of close of business on September 19, 2008, would remain at one dollar per share. Reserve Primary Fund investors, however, were ineligible for this taxpayer-funded insurance plan.

Thus began the erosion of faith in money market funds. After all, if "cash" is no longer safe, what is? Investors in fixed NAV funds could no longer enjoy a single product that delivered attractive returns, high credit quality, daily liquidity and price stability.

THE NEW PARADIGM

The Securities and Exchange Commission (SEC) moved quickly to protect investors. To further reduce money market fund investment risk, amendments to SEC Rule 2a-7 governing the types of securities held by money market funds were issued in January 2010. The amendments required higher cash (or similarly liquid vehicle) ratios at daily and weekly intervals, redefined "illiquid" securities, restricted lower quality securities in fund makeup, and imposed stricter maturity limits on fund components. Building upon those reforms, in mid-2014 the SEC further mandated all institutional money market funds adopt a floating NAV, forcing the daily share prices of the money market funds to fluctuate along with changes in the value of the funds' underlying investments. Despite these developments, both the undermined NRSROs and regulators are still struggling to revamp how and whether the ratings process can serve investors in liquidity and related products, and how implementation of new regulations will actually roll out.

Nevertheless, the ultra-short duration fixed income market has moved forward. As investors embrace the new paradigm as well as begin to better understand their liquidity needs, we feel that they will likely decide to reallocate liquidity assets into separate products that emphasize "preservation liquidity" versus "investing liquidity."

Investors seeking preservation liquidity gravitate towards federally insured bank deposits and short-term treasuries. Though "safe" 2a-7 money market funds are still available, their income levels are extremely modest due to their investment restrictions. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, neither the Federal Reserve nor U.S. Treasury can intercede to rescue these funds.

PRESERVATION LIQUIDITY VS. INVESTING LIQUIDITY

PRESERVATION LIQUIDITY	INVESTING LIQUIDITY
Any safety net or emergency funds (e.g., "six months of living expenses") that require absolute principal stability despite opportunity costs or inflation impacts	The conduit of flows between asset classes, where absolute stability of principal is NOT required
Often mandated by a contractual or regulatory requirement	May be mandated by a contractual or regulatory requirement
Focus on safety considerations does not vary based on environmental considerations and/or outlook	Balancing of income, access and risk objectives may vary based on environmental considerations and/or outlook
Competitive returns and fees not a primary focus	Competitive returns, fees, opportunity costs and inflation impacts are carefully evaluated

Investing liquidity, on the other hand, represents ultra-short fixed income investments, positioned strategically or tactically with other risk-based asset classes that can tolerate a modest degree of transactional price variability in order to earn an income return.

To help investors capitalize on the opportunities presented by the new paradigm, FlexShares introduced the Ready Assets Variable Income ETF, or RAVI, an ultra-short duration ETF with a variable NAV.

For investors seeking ready liquidity and a more competitive yield, but with minimal principal volatility, the marketplace developed the variable NAV (VNAV) alternative to the traditional 2a-7 money market mutual fund, such as our RAVI fund. VNAV products may generate superior income versus preservation liquidity options, with the potential tradeoff of some minor principal volatility. VNAV ETFs and other non-2a-7 money market products generate more competitive yields by investing in a diversified portfolio of investments options from a broad slice of the investable universe (i.e., securities having sector exposures and maturities that fall just outside the restrictions imposed by SEC Rule 2a-7).

APPLYING THE NEW PARADIGM

To help investors capitalize on the opportunities presented by the new paradigm, FlexShares introduced the Ready Assets Variable Income ETF, or RAVI, an ultra-short duration ETF with a variable NAV. Based on decades of Northern Trust fixed income investing experience, RAVI is designed for investing liquidity. We believe the fund's investment guidelines allow it to capture investment opportunities not available to investors in preservation products as it seeks to provide competitive income, ease of access and minimal principal volatility.

RAVI is actively managed to effectively balance a mix of overnight, short-term and slightly longer term vehicles among its assets — all investment grade debt, including U.S. and non-U.S. public and private securities. Its ETF structure offers investors a wide range of asset components in order to meet liquidity objectives.

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**.

DEFINITION

Duration is a measure of the sensitivity of the price – the value of principal – of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years.

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.

FlexShares Ready Access Variable Income Fund (RAVI) is actively managed and does not seek to replicate a specified index. Additionally, the Fund may invest without limitation in the fixed income and debt securities of foreign issuers in both developed and emerging markets. The Fund is at 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 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. Also, the Fund is "non-diversified" under the Investment Company Act of 1940, and may invest more of its assets in fewer issuers than diversified funds.

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