Practice Management Insights

The ETF Creation/ Redemption Process

How does it work? And why is it so important?

Not all investors want to look under the hood of the instruments they choose for their portfolios. That certainly seems to be true of ETFs in general — few investors understand the mechanics of an ETF's share structure or why they matter. In fact, there are several reasons. The creation/redemption process is actually the mechanism that makes ETFs typically less expensive to own, and generally more transparent and tax efficient than mutual funds. Perhaps most important, it's the reason ETFs have the ability to maintain liquidity, trading throughout the day at prices that reflect the fluctuating market value of their respective underlying securities.

HOW THE PROCESS BEGINS

There are two scenarios that prompt the creation process to begin. One is the launch of a brand new ETF with an SEC-approved plan. The other is an investor's placement of a very large order for shares that may not be available at the moment due to a large stream of orders on that particular trading day. In either case, an Authorized Participant (AP) is contacted by the plan sponsor (the ETF manager) or by a block desk assisting in that large trade. An AP could be an investment bank, a broker-dealer, a market maker, or even the sponsor itself.

Responding to the request, the AP borrows or buys (or already is holding) the names and quantities of the securities that either exactly mirror or are a representative sampling of those in the ETF's portfolio in order to build what is called a "creation basket." Though an AP may buy varying sizes of securities bundles, 50,000 shares is the number commonly designated as one creation unit for a given ETF.

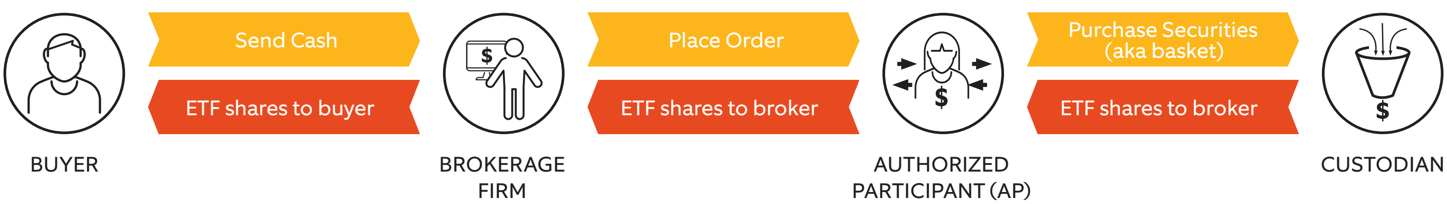
This basket of underlying securities is then held in a trust or by the fund, which in turn provides the AP with "shares" of the ETF — actually legal claims on the shares held in trust. The AP may hold those shares or sell some or all of them on a stock exchange where investors can purchase them as they would any publicly traded stock. Because this is an "in-kind" trade of securities for securities, it is tax-exempt, hence, the tax efficiency attribute of ETFs.

FLEXSHARES EXAMPLE

Here's how the creation process would work for an order of FlexShares Quality Dividend Index Fund:

- FlexShares publishes a list of holdings that constitute the ETF's creation basket
- The AP then reviews this list and assembles the basket by purchasing the necessary securities in the market
- Once the basket of securities is assembled, the AP arranges for delivery to FlexShares
- Upon receiving the basket in good order, FlexShares initiates delivery of 50,000 shares of FlexShares Quality Dividend Index Fund to the AP
- The AP delivers the ETF shares to your account to fulfill the order

CREATION/REDEMPTION PROCESS



THE REDEMPTION PROCESS IS SIMPLY THE OPPOSITE OF THE CREATION PROCESS

Generally, individual investors simply sell their ETF shares on the open market just as they purchased them. Large institutional investors have a second option, however. If they want to sell enough ETF shares to equal a creation unit, they may choose to exchange or redeem them for the underlying securities. In this case, the original creation unit is closed and the redeemer receives the actual securities. Again, this represents an in-kind trade and is a tax-exempt event.

ARBITRAGE AND EQUILIBRIUM

The creation/redemption process is also the mechanism that enables the market price of an ETF to stay within a tight range of the value of its underlying securities.* The laws of supply and demand dictate that an ETF's price will fluctuate according to market environment and sentiment. Because APs can add shares of an ETF into and remove shares out of the market as needed to balance supply and demand, they also can assume the important role of arbitrager. If an ETF's shares begin to trade at a premium to the value of its underlying securities, APs can create shares by buying the cheaper underlying securities and exchanging them for ETF shares. Conversely, if that ETF's shares are priced lower than that of their underlying assets, APs can buy those discounted shares and redeem them for the currently more valuable underlying securities. While they profit from the spread in either situation, APs also help investors by keeping the market-determined price of a given ETF's shares in very close equilibrium to that of its underlying securities basket.

*ETFs are subject to commission costs each time a buy or sell is executed. Depending on the amount of trading activity, the low costs of ETFs may be outweighed by commissions and related trading costs compared to mutual funds.

SOURCES: Investopedia.com, ETF.com, Understand ETFs.org, Investment Company Institute

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**.

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Your Financial Professional

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. The Funds are subject to the following principal risks: asset class; authorized participant, calculation methodology; commodity; concentration; counterparty; currency; derivatives; dividend; emerging markets; equity securities; financial sector, fluctuation of yield; foreign securities; geographic; high portfolio turnover; income; industry concentration; inflation; infrastructure-related companies; interest rate; issuer; liquidity; large cap; management; market; market trading; mid cap stock; MLP; momentum; natural resources; new funds; non-diversification; passive investment; privatization; securities lending; small cap stock; tracking error; value investing; and volatility risk. A full description of risks is in the prospectus.

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