

Fund Focus

# A Turnkey Approach for Creating Sustainable Portfolios

**Simple, Smart, Sustainable**

*For investors looking for a group of sustainable funds that are designed to provide market-like performance.*

Equity Fixed Income Real Assets

FEUS

FEIG

FEDM

FEHY

FEEM



Demand for Environmental, Social and Governance (ESG)\* strategies is surging.

Companies face growing pressure from regulators and investors to address concerns such as climate change, worker health and safety, and diversity and inclusion. A growing body of research is showing that how they manage these issues is likely to have a material impact on their balance sheets, income statements and share prices.

Investors are increasingly aware of these issues as well. Many want to align their investment strategies with their values; many are coming to recognize that ESG can be a critical driver of portfolio performance as well. While they want to capitalize on opportunity, they also want to manage their ESG-related investment risks.

To date, however, it's been difficult for investors to find core equity and fixed-income strategies that take a consistent approach to incorporating ESG.

That's why FlexShares has developed a new suite of ESG-oriented ETFs. Each of the four funds targets a different core equity or fixed-income asset class. All employ our sophisticated, proprietary risk-assessment methodology to seek an overall improvement in the portfolio's ESG score, with additional emphasis on reducing carbon risk versus the benchmark. These improvements are designed to have minimal tracking error\*\*, so they can help deliver the market exposures that investors expect from their core investments.

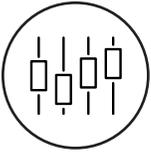
FlexShares ESG & Climate Emerging Market Core Index Fund

FlexShares ESG & Climate US Large Cap Core Index Fund

FlexShares ESG & Climate Developed Markets ex-US Core Index Fund

FlexShares ESG & Climate Investment Grade Corporate Core Index Fund

FlexShares ESG & Climate High Yield Corporate Core Index Fund



*This paper offers an overview of the scoring methodology that FlexShares uses to assess companies' financially relevant sustainability issues based on their sector and industry, as well as the degree of carbon risk individual companies carry. We then explain the portfolio construction process that helps us pursue material improvements in ESG ratings and carbon risk, while maintaining core equity and fixed-income exposures.*

## A DELIBERATE SCORING METHODOLOGY

Growing interest in sustainable investing has spawned a range of new ESG data sets. But variations in criteria creates a confusing and inconsistent mix of ratings. One data provider may rank a particular company as a sustainability leader, while another provider gives the same company a lower score. To offer a consistent measure of sustainability, FlexShares' core ESG ETFs use the new ESG Vector Score developed by Northern Trust Asset Management — the investment advisor for FlexShares ETFs.

The ESG Vector Score is designed to focus on ESG-related business issues most likely to impact a company's financial performance — and ultimately, a portfolio's investment return. Our scoring methodology employs a framework established by the Sustainable Accounting Standards Board (SASB), that identifies 26 categories of general sustainability issues that affect company performance. Then, SASB determined which of those issues are most relevant to a particular sector or industry.

- By identifying material issues within specific sectors and industries, we can assess risks facing one company that are not applicable to another. For example: Food retailers and distribution companies may have higher risks related to product labeling and labor practices.
- Energy and utility companies typically face higher risks related to carbon emissions.
- Financial companies have higher risk around issues of data security.

Because our scoring methodology specifically addresses the potential financial health of a company, it's applicable across both equity and fixed-income strategies.

## HISTORICALLY AWARE AND FORWARD-LOOKING

While SASB scoring helps measure a company's historic performance on sustainability issues, our methodology also considers how a company's ESG risk may change in the future. This forward-looking assessment, is adapted from the thematic framework developed by the Task Force on Climate-Related Disclosures (TCFD). The TCFD framework measures key elements around governance, reporting, strategy and risk assessment to help determine how effectively a company is managing its carbon-related risks. Northern Trust Asset Management adapted that framework to cover all financially material sustainability issues identified by SASB.

We believe this approach offers a transparent, consistent and actionable way to identify sustainability leaders. We can differentiate between two companies with similar ESG scores by examining which company is better positioned, and demonstrably committed, to manage material sustainability risks in the future. The goal is to identify and mitigate sustainability risks before they impact the company's financial statements — and the portfolio's performance.

*The ISS carbon risk rating methodology measures a company's carbon emissions as well as the specific carbon- and climate-related challenges*

## ADDRESSING THE ECONOMIC IMPACT OF CLIMATE CHANGE

We appreciate that climate change is a top concern among many companies, investors and regulators around the world. Each strategy in our core ESG ETF suite incorporates a special focus on carbon risk in addition to other components of the overall ESG score.

We've partnered with Institutional Shareholder Services (ISS), a leading provider of ESG data specializing in carbon risk. The ISS carbon risk rating methodology measures a company's carbon emissions as well as the specific carbon- and climate-related challenges — physical, financial, regulatory and technological — that represent material risks to a company's operations and long-term performance.

Like the SASB's framework that identifies financially material sustainability issues for each sector, ISS examines each company's carbon emissions, efforts to reduce its carbon footprint, and potential exposure to carbon-risk relative to other companies in its industry. These sector/industry-specific ratings inform a detailed analysis on the holdings we select for our strategies. For example:

Two energy companies may have similar emissions exposures and carbon footprint.



**Energy company A**  
may be aggressively diversifying into alternative energy sources



**Energy company B**  
may **not** be as aggressively diversifying into alternative energy sources

The company with a clearly defined plan to manage its current and future carbon risk will receive a higher carbon-risk rating, making it a better candidate for potential inclusion.

Thanks to the measurability of carbon exposure, each strategy in our core ESG ETF suite is able to target a 50% reduction in aggregate carbon emissions and carbon reserves relative to its respective benchmark, while also targeting an overall improvement in carbon risk rating.

We believe this approach will deliver core investing strategies that are better positioned to benefit from the ongoing transition to a low-carbon economy.

## 10 YEARS OF DISCIPLINED PORTFOLIO CONSTRUCTION

Over the past decade, we've refined our disciplined, systematic approach to serve a broad range of investment objectives — such as reducing volatility or providing high dividend yields — while balancing desired exposures to investment factors such as size, value and momentum.

Now, we are applying FlexShares' quantitative investing expertise to incorporate ESG objectives in core strategies while maintaining market-like exposure.

### Here is how we do it:



#### Step 1. Identify the investment universe

- For each strategy, we've selected a representative starting index to cover four segments of the domestic and international equity markets and the US fixed-income market.
- We first screen each index to eliminate companies on our custom ESG exclusion list: UN Global Compact violators, or companies involved with tobacco, weapons or thermal coal. For the FlexShares ESG & Climate Emerging Market Core Index Fund we also include screening elements around governance issues and state-owned entities. These exclusions are based on Northern Trust Asset Management's 30 years of experience in managing sustainable strategies.

#### Step 2. Integrate ESG and carbon risk metrics

- We score each company that remains in the index, based on our proprietary ESG Vector Score to identify potential sustainability leaders and laggards in each sector.

#### Step 3. Employ risk controls and optimization

- Using those scores, we select and weight each portfolio holding to optimize the portfolio's overall ESG score in an effort to improve overall ESG score, carbon risk rating, and reduce carbon emissions while minimizing potential for tracking error relative to the parent index.
- For equity funds, these controls maintain similar sector weightings as the fund's benchmark index. In fixed-income funds, we seek similar exposures to the benchmark's term and credit risk. Our international strategies include constraints to maintain country and region exposures equal to their benchmarks.

#### Step 4. Review and rebalance

- We perform quarterly rebalancing for equity strategies and monthly rebalancing for fixed-income strategies to minimize tracking error and ensure adherence to our sustainability objectives.

## FIVE INDIVIDUAL STRATEGIES FOR GLOBAL CORE COVERAGE

The four strategies in our ESG ETF suite offer the building blocks of a diversified core portfolio for individuals or model portfolios. Together, they provide broad market exposure, the risk characteristics of core benchmarks and holistic integration of key sustainability criteria.

### EQUITY

### FIXED INCOME

- 1 FlexShares ESG & Climate U.S. Large Cap Core Index Fund (FEUS)**  
Target exposure: U.S. large-cap stocks
- 2 FlexShares ESG & Climate Developed Markets ex-US Core Index Fund (FEDM)**  
Target exposure: Large- and mid-sized companies in developed markets
- 3 FlexShares ESG & Climate Emerging Market Core Index Fund (FEEM)**  
Target exposure: Large- and mid-sized companies in emerging markets



- 4 FlexShares ESG & Climate Investment Grade Corporate Core Index Fund (FEIG)**  
Target exposure: US investment-grade bonds across the full yield curve
- 5 FlexShares ESG & Climate High Yield Corporate Core Index Fund (FEHY)**  
Target exposure: US high-yield bonds across the full yield curve

## SUSTAINABLE INVESTING: THE FUTURE HAS ARRIVED

Given the extraordinary growth of ESG investing, there is no reason to think demand will stall anytime soon. Company leaders, investors and regulators are seeing and embracing the role sustainability plays in creating stable economies, markets and companies. ESG and sustainability considerations are fast becoming an essential component of fundamental investment analysis.

Building on our experience in managing quantitative and sustainable strategies, we are delighted to combine our proprietary exclusionary screening, ESG scoring and climate related data, and well defined portfolio construction constraints to offer strong sustainability profiles in a suite of core strategies. These funds remain true to the traditional core approach while meeting the growing demand for investments that target conscientious corporate governance, low environmental impact and socially responsible business practices.

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## FIND OUT MORE

The FlexShares approach to 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).

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## FOOTNOTE

\* ESG investing is defined as utilizing environmental, social, and governance (ESG) criteria as a set of standards for a company's operations that socially conscious investors use to screen potential investments.

\*\* Tracking error is the difference between the returns of an ETF and its benchmark index.

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## 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](http://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 ESG & Climate Developed Markets ex-US Core Index Fund (FEDM), FlexShares ESG & Climate Emerging Markets Core Index Fund (FEEM), FlexShares ESG & Climate High Yield Corporate Core Index Fund (FEHY), FlexShares ESG & Climate Investment Grade Corporate Core Index Fund (FEIG) and the FlexShares ESG & Climate US Large Cap Core Index Fund (FEUS) 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. Fund returns may not match the return of the respective indexes. The Funds are subject to the following principal risks: ESG Investing; corporate bond; concentration; Income; currency; derivatives; LIBOR; emerging markets; equity securities; fluctuation of yield; foreign securities; geographic; industry concentration; interest rate / maturity risk; issuer; large cap; management; market; market trading; new funds; non-diversification; passive investment; privatization; small cap stock; tracking error; turnover; Authorized Participant concentration; liquidity; high yield and volatility risk. A full description of risks is in the prospectus.