Quality in Action

Investing in Dividends in Uncertain Times

SUMMARY

With U.S. interest rates at record lows and investors potentially looking for ways to bolster investment returns, equities that have historically offered high dividend yields[1] look comparatively attractive. But our opinion is that with those yields frequently comes additional potential risks – both the risk from outsized sector bets and the risk that those historical yields may not be sustainable. This risk can be exacerbated by the challenges businesses across many industries are currently facing during this global pandemic and by the requirement that public companies receiving government aid may have to cut their dividends. When investing in a dividend strategy, we would therefore suggest investors consider the following:

- **A dividend strategy that invests in quality companies.**
  Focusing on quality dividend payers may help to identify companies that are comparatively financially strong, and are therefore more likely to continue to return capital to shareholders in the form of dividends. Our view is that this focus may also help investors to avoid companies that are less healthy over the long term.

- **A strategy that avoids outsized sector weights.**
  Our research suggests that historically, many dividend funds have often pursued a yield strategy while loading up on investments in historically dividend-rich sectors and therefore potentially introducing uncompensated risk to the portfolio due to a large sector weighting. A fund with 25% of its holdings in the Energy sector, for example, may have been disproportionately impacted during the recent price and production skirmish between Saudi Arabia and Russia, as compared to a fund with a sector weight closer to that of the underlying benchmark.

- **Avoid a strategy that requires underlying companies to have dividend payment or growth history.**
  Some strategies use historical consecutive dividend payments or dividend growth as a criteria for index inclusion potentially as an attempt to proxy quality. In an environment where some companies could be potentially reducing or eliminating dividends , even on a temporary basis, those reductions may be felt by funds as they see their eligible investment universe potentially shrink considerably, and even consistently for many years, as some funds require 10- or even 20-year consecutive dividend payment track records for stocks to be included within the portfolio.

Through a carefully constructed approach that sources income from all parts of the economy and pays close attention to company fundamentals, investors may be able to maintain healthy dividend yields in this environment. The FlexShares suite of Quality Dividend Index ETFs combines a multi-dimensional approach to assessing the quality of prospective investments with the yield factor, while potentially managing risk by avoiding significant sector bets as compared to the underlying benchmark. As a result, investors may enjoy a more stable dividend yield with comparatively less risk.

OUTLOOK FOR DIVIDEND PAYMENTS

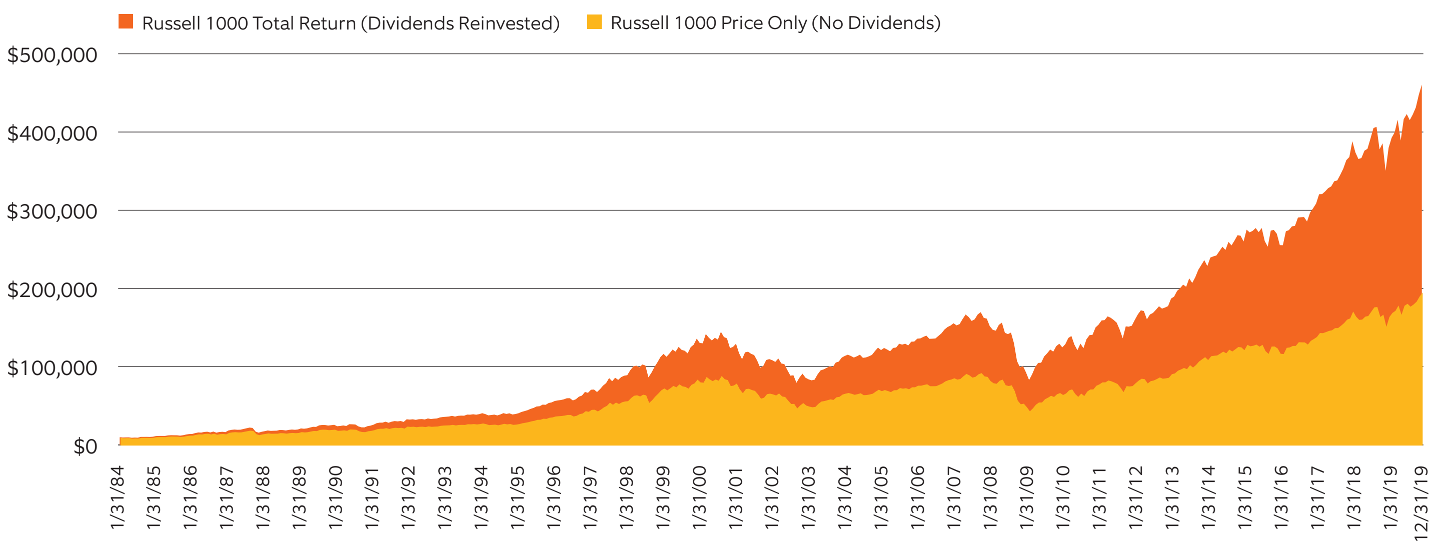
According to the Wall Street Journal, since the beginning of March 2020, dividend payments have been slashed as companies are faced with a combination of sharply declining revenues and regulatory restrictions; with companies prioritizing liquidity and solvency over returning capital to shareholders.[2] For investors that rely on dividend income, this could create a significant problem. There are, however, ways to potentially insulate your portfolio from cuts that are disproportionately impacting specific sectors, or comparatively less-solvent companies.

The same article, as of 27 April 2020, cites that investor expectations for dividend payments as priced in dividend futures, are indicating a decline of 20% for the S&P 500 Index over the next 12 months while 81 U.S. companies and public investment funds (including REITs) have suspended or canceled their dividends year-to-date, the highest number since 2001. As a comparison, 55 companies had eliminated dividends over the prior ten years. Another 135 companies have reduced their payouts to shareholders year-to-date.[3]

A portion of the realized and expected cuts are coming from companies that are taking advantage of the federal government's CARES Act, which prohibits companies that take loans from the program to pay a dividend (or buyback shares) until the loan is repaid plus a period of one year. There isn't a great historical precedent for this; banks receiving Troubled Asset Relief Program (TARP) funds during the Global Financial Crisis in 2008 had to ask for government permission to increase their dividend payments, but were permitted to continue paying dividends to their shareholders.

How significant is the contribution of dividends to total return? Exhibit 1 below shows the contribution of dividends to total return over time. In addition to providing approximately a quarter of the market's total return over the past 40 years, we believe that due to the economic cycle historically, dividend payments have been more consistent than company earnings while being a potentially stabilizing component of an equity investor's total return.

EXHIBIT 1 : HYPOTHETICAL GROWTH CHART OF $10,000 INVESTED IN RUSSELL 1000



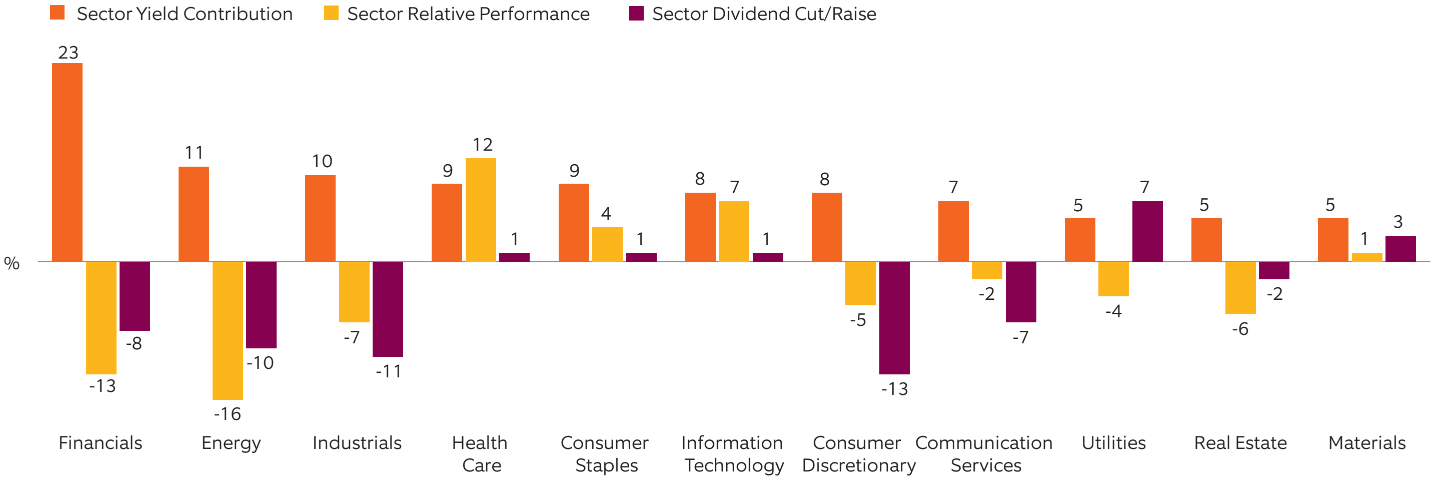
Dividends Contribution to Total Return by Decade (Annualized)					
	1980s	1990s	2000s	2010s	Since Inception
Income Return	2.40%	2.48%	1.79%	2.04%	2.76%
Total Return	9.90%	18.11%	-0.49%	13.54%	11.98%

Source: Bloomberg. As of 31 January 1984 through 31 December 2019. **Past performance is no guarantee of future results.** It is not possible to invest directly in an index. All performance figures assume reinvestment of dividend and capital gains. Performance 1-year and less are cumulative; performance over 1-year are average annualized total returns. This information is for illustrative purposes only and is not representative of any specific investment.

It is important to remember that dividend cuts will differ in degree across sectors, regions and companies. We believe it is the sectors and companies that may suffer fundamental deteriorations due to the stagnating economy that are the most susceptible to dividend cuts. As seen in Exhibit 2 as of April 30, 2020, some of the highest dividend-payers reside in the worst-performing sectors, with the most significant dividend cuts.

EXHIBIT 2: GICS SECTOR[4] CATEGORY COMPARISON WITHIN THE MSCI WORLD INDEX

We believe relying heavily on historical high yield sectors such as financials, energy, industrials and consumer discretionary, can be detrimental to yield and performance.



Source: Bloomberg. As of 31 January 2020 to 30 April 2020. **Past performance is no guarantee of future results.** It is not possible to invest directly in an index. All performance figures assume reinvestment of dividend and capital gains. Performance 1-year and less are cumulative. This information is for illustrative purposes only and is not representative of any specific investment.

POTENTIAL PITFALLS TO AVOID

For investors looking to maintain a healthy level of potential dividend yield in the current environment, we believe they should consider a "DIA" approach:

- Diversify the source of dividends across sectors and regions,
- Integrate a fundamental and multi-dimensional measure of what we call the "Quality factor" to provide an indication of a company's ability to sustain and grow earnings and cash flows and hence potentially dividends, and
- Avoid strategies that include dividend track records as a component of underlying index construction.

Diversifying the Source of Dividends

Historically, high dividend-paying companies tend to be focused in mature industries and hence tend to be concentrated in certain sectors. Our research suggests that half of the MSCI World Index dividend yield is contributed by four sectors: Financials, Industrials, Consumer Discretionary and Energy. Consequently, we believe many high-dividend strategies have historically focused on high-income payers that may result in significant sector and regional bets and may concentrate the source of dividends in an effort to achieve income objectives.

Relying heavily on one sector for dividends can be a recipe for disaster, as was observed during the Global Financial Crisis in 2008 when companies within the Financial sector experienced a dividend reduction of 60%.[5] In the current environment, according to Bloomberg, as of 31 March 2020, high-dividend payers are sourcing two-thirds of their yield from the four sectors where we believe dividends are most at risk.

We believe that a high-income portfolio that diversifies its sources of income, and therefore may help avoid unintended sector bias, is essential to elude the potential adverse impact of dividend concentration.

Consider a Quality Plus Approach

Historically, a successful dividend investing strategy has been about identifying companies that consistently paid dividends and grew dividend pay-outs over the long term. Seeking out dividends without considering a company's future ability to maintain them is akin to buying high yield debt without considering its default likelihood.

But many times, higher yield is the result of a decline in a security's overall price. These seemingly "cheap" high-yielding stocks may be yield traps where the price decline makes them attractive from a yield perspective, but only in the short-term because the market may be pricing in the impaired fundamentals that may precede dividend cuts or worse, even bankruptcy.

We argue that investors should take a "Quality Plus Approach" which is to consider companies that have sustainable competitive advantages and have generated sustainable shareholder value over time. Information on a firm's "Quality Plus" may help assess the sustainability of pay outs by measuring characteristics including strong profitability, consistent and strong levels of cash flows, and prudent deployment of capital by an efficient management team to arrive at a Dividend Quality Score (DQS).

THE DQS METHODOLOGY EXAMINES COMPANIES THROUGH THREE LENSES:

MANAGEMENT EFFICIENCY

A quantitative evaluation of a firm's deployment of capital and its financing decisions. Firms that aggressively pursue capital expenditures and additional financing generally lose the flexibility to respond to both advantageous and challenging portions of the market cycle.

PROFITABILITY

A way to measure a firm's relative competitive advantage. Firms with wider profit margins may be better positioned to grow compared with firms that have slimmer margins.

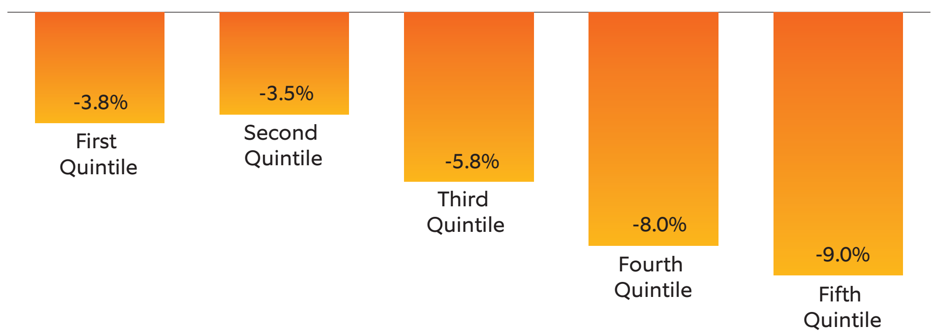
CASH FLOW

An assessment of a company's liquidity levels. A firm that cannot meet its debt obligations and day-to-day liquidity needs will be poorly positioned to take advantage of future opportunities and may not have enough financial cushion to withstand periods of distress.

If an investor does a comparison of the five “Quality” tiers, using the Northern Trust DQS process to evaluate and then categorize all members of the MSCI World Index, they would find that each quintile (or 20% of the total companies in the MSCI World Index which would be 540) would show an average per share dividend reduction within each quintile for the first 4 months of 2020. However, they would also find that the dividend reduction was greatest amongst those companies that had been categorized within the third, fourth and fifth quintile.

In Exhibit 3 below, we took all 2,700 companies found in the MSCI World Index and applied the DQS process and ranked them. We then divided the group into five “Quality” quintiles with 540 companies in each quintile. We then calculated, based on dividend reduction notices from 31 January 2020 to 30 April 2020, what the percentage change in dividend income would be if an individual invested equally in all the companies in a given quintile.

EXHIBIT 3: DIVIDEND CUTS PER QUINTILE



Source: FactSet. As of 31 January 2020 to 30 April 2020.

Using this analysis, as of 16 April 2020, of the 36 companies that had cut their dividends since the onset of the Covid-19 crisis, 24 of them ranked in the lowest two quintiles of Quality, as determined by the Northern Trust Quality scoring system.

Avoid strategies that require dividend payment or dividend growth history.
Some strategies, perhaps as an attempted proxy for quality, may use historical consecutive dividend payments or dividend growth as criteria for index inclusion. Even in better economic conditions, we believe there is a better way than requiring a 10- or 20-year history of consecutive dividend payments or dividend growth which may exclude younger companies and disproportionately impact certain sectors. For example, companies found within the Information Technology sector that are reshaping the world’s economy may be left out. Instead of presumably using a dividend payment history or a history of increasing dividends as a proxy for quality, we recommend using a multidimensional definition of quality, and potentially sourcing yield from a broader swath of the economy.

But our concerns about approaches that rely on dividend payment history are amplified in an environment where companies may be reducing or eliminating dividends, even on a temporary basis, as those funds may see their eligible investment universe shrink considerably, and potentially for many years. Further, strategies that use dividend payment history as a proxy for quality may have to sell positions following a dividend cut. Unfortunately, prior to selling, they had no potential means of predicting a company's likelihood of actually continuing to pay a dividend - so we believe they are selling after the fact.

CONCLUSION

Investors may benefit by investing in the FlexShares U.S. Quality Suite which consist of ETF's that utilize a quality process that attempts to identify and predominately invest in companies that are deemed to be in higher tiers of quality. Each fund attempts to do this by tracking a custom index. Northern Trust Investments Inc. (NTI) is the investment adviser for FlexShares ETFs.

Each index starts with the Northern Trust 1250 Index[6], which represents 1,250 large and mid-capitalization U.S. public companies, NTI first eliminates all non-dividend paying stocks. Then, they apply a proprietary, multi-faceted Dividend Quality Score (DQS) to measure a company's core financial health and evaluate whether it may increase (or decrease) its future dividends.

The DQS score evaluates dividend-paying equities across all these lenses and ranks companies in each sector. This approach helps ensure an "apples-to-apples" comparison because different financial characteristics may be appropriate in different sectors. It also identifies quality companies in every sector, supporting diversification in the initial index construction process.

NTI ranks all stocks in a sector by DQS score and divides the list into quintiles, with quintile 1 comprising the highest-ranked companies and quintile 5 comprising the lowest-ranked firms. The index eliminates all stocks in quintile 5, and then diversifies holdings according to rules such as maximum overweights / underweights for individual stocks, sectors and industries.

Through a carefully constructed approach that sources income from all parts of the economy and pays close attention to company fundamentals, we believe that investors can maintain healthy dividend yields even in this environment. Our FlexShares Quality Dividend Index ETFs (U.S. and International series) combine a multi-dimensional approach to assessing the quality of prospective investments with the yield factor, while managing risk by not taking significant sector bets as compared to the underlying benchmark. As a result, investors may enjoy a more stable dividend yield with comparatively less risk.

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).

FOOTNOTES

1 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.

2 Vigna, Paul. Wall Street Journal. "Companies are Suspending Dividends at Fastest Pace in Years." 28 April 2020.

3 Ibid

4 Bloomberg. The Global Industry Classification Standard (GICS) is an industry taxonomy developed in 1999 by MSCI and Standard & Poor's (S&P) for use by the global financial community. The GICS structure consists of 11 sectors, 24 industry groups, 68 industries and 157 sub-industries into which S&P has categorized all major public companies. GICS is used as a basis for S&P and MSCI financial market indexes in which each company is assigned to a sub-industry, and to a corresponding industry, industry group and sector, according to the definition of its principal business activity.

5 Hirtle, Beverly. Federal Reserve Bank of New York Staff Reports, no. 666. April 2016.

6 The Northern Trust 1250 Index is designed to provide broad-based exposure to the U.S. equity markets, with a bias toward large and mid-capitalization companies. In an effort to include a greater number of dividend-paying companies, a constituent limit of 1250 is used at the time of each annual reconstitution.

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 Quality Dividend Index Fund (QDF), FlexShares Quality Dividend Defensive Index Fund (QDEF) and the FlexShares Quality Dividend Dynamic Index Fund (QDYN) are passively managed and use a representative sampling strategy to track its 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. Additionally, the Funds are at increased dividend risk, as the issuers of the underlying stock might not declare a dividend, or the dividend rate may not remain at current levels. The Funds are also is at increased risk of industry concentration, where it may be more than 25% invested in the assets of a single industry. Finally, the Funds may also be subject to increased volatility risk, where volatility may not equal the target of the underlying index.