Offsetting Home Country Bias with Quality

IQDF | IQDE | IQDY

INCOME GENERATION

The world can potentially be productive terrain for finding quality dividend yields.

For decades, dividend income has been a crucial component of a stock investor's total return, often surpassing capital appreciation in volatile markets for many investors. Dividends are also valued in an interest rate environment of falling yields on bonds and rates at or near zero when income-seeking investors typically widen their search for yield to meet their retirement and spending goals.

Blindly focusing on yield in the international sector, however, could be dangerous to an investment portfolio's health. Often, a seemingly generous dividend yield may actually signify a weak share price tied to negative news not yet revealed in the quarterly dividend. This explains why we believe investors in international dividend stocks must be confident that the dividend being paid is sustainable over the long term, meaning that the payout is well covered and the payer company has the potential to grow it over time.[1]

ACROSS THE GLOBE, MOMENTUM BUILDS

For the first time since 2007, the world's major economies are growing in sync with all 45 countries tracked by the Organization for Economic Cooperation and Development (OECD) on track to grow this year.[2]

HISTORICAL AND PROJECTED GDP GROWTH

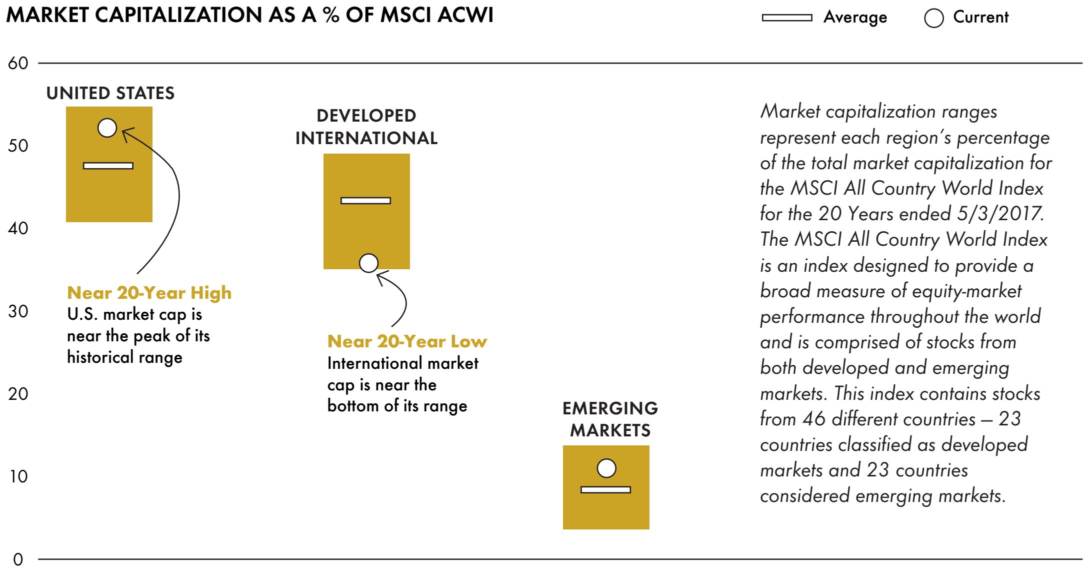
Sources: International Monetary Fund, World Economic Outlook Database, April 2017; MSCI; RIMES; Thomson Reuters. 2017 GDP figures are estimates.

	2016	2017
UNITED STATES ↑	+1.6	+2.3
EUROPE →	+1.7	+1.7
JAPAN →	+1.0	+1.2
EMERGING MARKETS ↑	+4.1	+4.5
CHINA →	+6.7	+6.6

[1] *Dividends represent past performance and there is no guarantee they will continue to be paid.*
[2] *Zumbrun, Josh. "Global Economies Grow in Sync." Wall Street Journal. 23Aug2017.*

Nowhere, however, in our opinion is that more apparent than in the U.S. which has been driven by continued and increased consumer spending. This has propelled market capitalizations to ever-higher levels for U.S. equities with U.S. stocks nearing the top of their historical range.[3]

MARKET CAPITALIZATION AS A % OF MSCI ACWI



Market capitalization ranges represent each region's percentage of the total market capitalization for the MSCI All Country World Index for the 20 Years ended 5/3/2017. The MSCI All Country World Index is an index designed to provide a broad measure of equity-market performance throughout the world and is comprised of stocks from both developed and emerging markets. This index contains stocks from 46 different countries – 23 countries classified as developed markets and 23 countries considered emerging markets.

AND THE SEARCH FOR YIELD GOES ON

According to the US Census bureau, there are nearly 50 million people over age 65 in the US with more reaching this age every year. For many of them who are retiring baby boomers, the search for dividends as they move into the next phase of their lives is forcing them to search far and wide. We believe that dividends have always played a significant role in driving equity returns and helping investors meet their financial goals. Dividend income may be especially important during those retirement years.

In the US, we believe that this increasing demand for dividend income has in part driven valuations for many traditional dividend payers high above their long-term averages. For investors willing to look for these dividends outside the US, there are a significant number of companies in both developed and emerging international markets with historically high dividend yields.[4]

STOCKS WITH YIELDS OF 3% AND HIGHER AS OF DECEMBER 31, 2016[5]

[3] *MSCI All Country World Index, as of 21/31/2016.*
[4] *MSCI and Dividend.com, 12/31/2016.*
[5] *MSCI and Dividend.com, 12/31/2016.*

FLAWED DIVIDEND STRATEGIES MAY CLOUD INVESTOR JUDGEMENT

Through the years, several strategies have been widely applied to avoid overpaying for dividend-driven yield. First, longevity. If a company has paid a dividend for a long time, investors trust it is likely to continue paying a future dividend. The alternative, focusing on dividend growth over time, views a reduction in the distribution as a red flag the dividend may either not be paid in the future or may actually be pared back further.

Both approaches are flawed in that they:

- React to a reduced dividend only after it happens, resulting in holding the dividend-paying security until the next rebalance, well after the market reflects the negative dividend news into the stock price
- Require a long history of dividend payouts (often a decade or two) in order to properly evaluate a company, which means newer dividend payers are excluded from consideration
- Tend to downplay recent changes in the macro environment that may drastically affect the company's ability to maintain or grow its dividend

A third strategy is using the payout ratio to evaluate a dividend payer's financial health. Payout ratio is the dividend per share divided by earnings per share. 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.

So, how can investors judge a "sustainable" yield?

We believe there is a better approach. One that involves focusing on the core financial health of the underlying dividend-paying company.

IMPORTANCE OF CORE FINANCIAL HEALTH

Measuring a company's core financial health makes it possible to evaluate the likelihood that it will 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 the actual financial health of the organization, the FlexShares' Dividend Quality Score (DQS) is designed to provide insight into how well positioned a dividend-paying company is for success, and how protected future dividends are under current market/economic environments.

DQS EXAMINES COMPANIES USING THREE LENSES FOR ITS DIVIDEND QUALITY INDEX METHODOLOGY:

Management Efficiency	Profitability	Cash Flow
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 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 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.

For international dividend payers, the DQS score evaluates dividend-paying equities across all of these lenses, ranks companies on a sector basis and evaluates firms on both a regional and sector basis. This not only ensures an "apples-to-apples" comparison – profiling like firms against each other – it also serves to identify quality companies in every sector and country, supporting diversification through the construction process and opportunity set.

INTERNATIONAL QUALITY DIVIDEND INDEX PROCESS

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.

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.

MAXIMIZING QUALITY AND YIELD

Quality and yield have not been highly correlated historically, but the combination looks to produce compelling results as it serves to smooth each respective factor's cycle.

FlexShare's International DQS process is designed to maximize quality and yield while putting several diversification controls into effect for large cap securities. 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. Additionally, the strategy seeks to limit non-targeted factors by placing relative sector, security, style and market volatility (beta) bounds based on the parent universe.

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 International Quality Dividend Suite includes three funds.

ETF TICKERS	FUNDS
TARGETS A BETA **CLOSE TO** THE MARKET UNIVERSE'S BETA	
IQDF	FlexShares International Quality Dividend Index Fund
TARGETS A BETA **LESS THAN** THE MARKET UNIVERSE'S BETA	
IQDE	FlexShares International Quality Dividend Defensive Index Fund
TARGETS A BETA **GREATER THAN** THE MARKET UNIVERSE'S BETA	
IQDY	FlexShares International Quality Dividend Dynamic Index Fund

MORE INFORMATION = BETTER DECISIONS

Our opinion is that the more informed the buyer, the more successful and satisfying the purchase. When the subject at hand is equities, the necessary information is not always readily available to the individual investor. That's why at FlexShares, we believe our approach to "intelligent construction" is invaluable in guiding individuals to high-quality decisions in their investment choices Deconstructing the evaluation process into several single-focus measures, then objectively scoring each to arrive at a final judgement is the core of our quality assessment methodology.

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.**

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; commodity; concentration; counterparty; currency; derivatives; dividend; emerging markets; equity securities; fluctuation of yield; foreign securities; geographic; income; industry concentration; inflation-protected securities; infrastructure-related companies; interest rate / maturity risk; issuer; large cap; management; market; market trading; mid cap stock; MLP; momentum; natural resources; new funds; non-diversification; passive investment; privatization; small cap stock; tracking error; value investing; and volatility risk. A full description of risks is in the prospectus.

FlexShares International Quality Dividend Index Fund (IQDF), FlexShares International Quality Dividend Defensive Index Fund (IQDE) and the FlexShares International Quality Dividend Dynamic Index Fund (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. 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 at increased risk of industry concentration, where it may be more than 25% invested in the assets of a single industry. The Funds may be more susceptible to adverse economic, market, political or regulatory occurrences affecting that country, market, industry, sector or asset class. Finally, the Funds may also be subject to increased volatility risk, where volatility may not equal the target of the underlying index. See prospectus for a full description of risks.

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