Equity | Fixed Income | Real Assets

TDTF | GUNR

TDTT | GQRE

NFRA

Striving to Maximize the Effectiveness of Inflation-Hedging Strategies

How to help avoid introducing unexpected risks into your client's portfolio

Advisors have several options to help clients who want to add an inflation-hedging component to their portfolios. Investments in Treasury Inflation Protected Securities (TIPS) or stocks involved in natural resources, infrastructure and real estate may all be appropriate. But implementing an effective inflation-hedging strategy involves targeting a time frame that may provide the potential for inflation protection, and then examining how specific strategies are constructed to help avoid hidden or uncompensated risks.

HERE ARE IMPORTANT CONSIDERATIONS WHEN SEEKING TO HEDGE INFLATION EXPOSURE ACROSS THREE TIME FRAMES:

Short term (0-5 years)

Intermediate term (5-20 years)

Long term (20+ years)

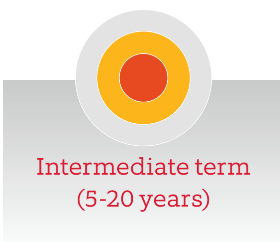
SHORT TERM: CONSIDER TIPS, BUT BEWARE OF DURATION DRIFT

TIPS can be a good option for investors seeking a hedge against unexpected changes in near-term inflation. Interest on these fixed-income securities is tied to the Consumer Price Index for Urban Consumers. If inflation rises suddenly, the income stream on TIPS will rise accordingly. However, this benefit comes with a challenge: Managing the duration of a TIPS strategy.

Duration, is a key measure of a bond's sensitivity to interest rate changes, and TIPS' durations can change frequently with changing inflation expectations. The reason for this is future cash flows, a key determinant of duration, are driven by inflation expectations. If inflation expectations rise or fall, expected future coupons adjust accordingly. For example, a TIPS strategy with a duration of 5 years may see its duration rise if inflation expectations fall—increasing the interest rate risk in a client's portfolio.

To help address the potential of duration drift when using TIPS:

- Consider strategies that manage exposures within a duration band, such as 3 or 5 years, rather than ignoring the risk.
- Examine how the strategy maintains its duration within that band, such as by rebalancing the portfolio regularly to remove securities whose durations have moved beyond the target band due to changes in expected inflation.



INTERMEDIATE TERM: EXAMINE NATURAL RESOURCES, BUT FOCUS ON THE UPSTREAM PORTION OF THE SUPPLY CHAIN

Economic expansions can trigger inflation over longer periods, such as 5 to 20 years. In expansionary economies, investments in natural resources-related companies historically have offered a measure of protection against inflation: When demand is high, the price of raw materials in sectors such as energy, agriculture, metals, timber and water may rise too.

However, these potential inflation-hedging characteristics tend to be more pronounced in the upstream portion of the natural resources supply chain—where companies are harvesting or extracting the resources that are in high demand. Earnings, revenues and cash flow for upstream companies are more correlated to the price of raw materials compared to downstream companies that tend to have higher costs for purchasing, shipping and processing those materials into finished goods.

Consider these features when looking for a natural resources strategy:

- Strategies focused on upstream companies in the natural resources supply chain may provide more exposure to the positive impact of rising prices.
- Upstream companies also may offer more favorable capital appreciation potential versus commodities exposure.

Long term
(20+ years)

LONG TERM: A ROLE FOR REAL ESTATE AND INFRASTRUCTURE, BUT FOCUS ON DIVERSIFICATION

Exposure to real estate and infrastructure companies traditionally has been useful for investors concerned about the impact of long-term inflation. Real Estate Investment Trusts (REITs) may offer the potential for long-term protection because the value of their properties and rent payments have been shown to increase with rising prices. Similarly, infrastructure companies often operate in regulated markets and can pass cost increases on to customers.

When investing in either asset class, though, diversification is critical in seeking to reduce the risk of unintended concentration in specific regions or sectors. For example, many real estate strategies invest only in U.S. REITs, which tend to be more volatile than international REITs. Sector concentration risk is a concern in traditional infrastructure strategies. These tend to be heavily invested in sectors such as pipelines and utilities, making them overly sensitive to energy prices.

To help ensure a REIT or infrastructure investment is properly diversified:

- Consider a real estate strategy with a global approach, which may offer higher potential price appreciation while mitigating some of the volatility we have typically seen in U.S. REITs.
- Look for an infrastructure strategy that's broadly diversified across a range of sectors and projects—including new age infrastructure such as cell towers, broadband internet and social infrastructure like health care facilities and privatized postal services. This exposure to the evolving nature of infrastructure assets may improve the potential for long-term inflation protection.

Reviewing inflation concerns with your clients can help you target appropriate strategies that match their time frame and complement other investments in their portfolios.

For more on FlexShares' approach to inflation-hedging strategies, see our Fund pages on FlexShares.com:

- FlexShares iBoxx® 3-Year Target Duration TIPS Index Fund (TDTT)
- FlexShares iBoxx® 5-Year Target Duration TIPS Index Fund (TDTF)
- FlexShares Morningstar® Global Upstream Natural Resources Index Fund (GUNR)
- FlexShares Global Quality Real Estate Index Fund (GQRE)
- FlexShares STOXX® Global Broad Infrastructure Index Fund (NFRA)

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).

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.

Past performance is no guarantee of future results. There is no guarantee these investment strategies will be successful.

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.

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FlexShares Global Quality Real Estate Index Fund (GQRE) is passively managed and uses 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. It is subject to real estate sector risk in addition to the general risk of the stock market. Investments in foreign market securities involve certain risks such as currency volatility, political and social instability and reduced market liquidity. To the extent that the Fund invests in Emerging markets, those investments may be subject to increased price volatility and may be more susceptible to adverse economic, market, political or regulatory occurrences affecting that country, market, industry, sector or asset class. Investing in securities of real estate companies will make the Fund more susceptible to risks associated with the ownership of real estate and with the real estate industry in general, as well as risks that relate specifically to the way in which real estate companies are organized and operated. Real estate companies may have lower trading volumes and may be subject to more abrupt or erratic price movements than the overall securities markets. The value of real estate securities may underperform other sectors of the economy or broader equity markets. To the extent that the Fund concentrates its investments in the real estate sector, it may be subject to greater risk of loss than if it were diversified across different industry sectors. The Fund is also subject to the risk that its investments will be affected by factors that impact REITs and the real estate sector generally. Investing in REITs involves certain unique risks in addition to those risks associated with investing in the real estate industry in general. REITs whose underlying properties are concentrated in a particular industry or geographic region are also subject to risks affecting such industries and regions. By investing in REITs through the Fund, a shareholder will bear proportionate expenses of the REITs in addition to expenses of the Fund.

FlexShares Morningstar® Global Upstream Natural Resources Index Fund (GUNR) is passively managed and uses 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. It is subject to the global natural resource industry. As the demand for or prices of natural resources increase, the Fund's equity investment generally would be expected to also increase. Conversely, declines in demand for or prices of natural resources generally would be expected to cause declines in value of such equity securities. Such declines may occur quickly and without warning and may negatively impact your investment in the Fund. Investments in foreign market securities involve certain risks such as currency volatility, political and social instability and reduced market liquidity. To the extent that the Fund invests in Emerging markets, those investments may be subject to increased price volatility and may be more susceptible to adverse economic, market, political or regulatory occurrences affecting that country, market, industry, sector or asset class.

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