Built to Last: A Blueprint for Strategic Portfolio Construction

Advisor Perspectives Webinar: Monday, April 29, 2013

Presented by
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Northern Trust - FlexShares
I. Foundation
# Key Investor Trends

The expectations and opportunities for advisors have never been greater.

<table>
<thead>
<tr>
<th>Trends</th>
<th>Implications</th>
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<tbody>
<tr>
<td>Investor focus has shifted toward achieving specific goals or matching liabilities and away from relative investment performance</td>
<td>Advisors are expanding their service offering to incorporate related expertise such as financial, estate and tax planning</td>
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<tr>
<td>Investors are increasingly wary of the costs of their investments scrutinizing both advisory and product fees</td>
<td>Advisors are evolving both their business model and their fulfillment options to better manage explicit and implicit costs</td>
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<tr>
<td>Investors are seeking more exposure to global markets and non-traditional asset classes in their investment portfolios</td>
<td>Advisors are adopting new investment benchmarks, asset allocation methodologies and fulfillment options</td>
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<td>The effective use of technology and the systematic incorporation of risk management are key differentiators</td>
<td>Advisors are making deliberate choices with respect to custody platforms and investing time and capital in client facing technology</td>
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<tr>
<td>Within the fee-based business model, investors seek to give advisors more or complete discretion</td>
<td>Advisors are adjusting their service model and portfolio construction methodologies to deliver targeted yet scalable solutions</td>
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Investment Philosophy

“Our investment philosophy focuses on the fundamental investor needs of growing assets, managing risk, providing liquidity and generating income. Our principled focus on long-term investor needs serves as a solid foundation for the portfolio construction process.”

There is no guarantee FlexShares ETFs will meet the stated outcome.
The FlexShares Perspective – Capital Appreciation

“A fundamental building block of the portfolio construction process involves aligning long-term goals with targeted investment strategies. Careful assessment of investment objectives, risk tolerance and time horizon enables thoughtful development of growth seeking funds.”

There is no guarantee FlexShares ETFs will meet the stated outcome.
The FlexShares Perspective – Risk Management

“Investing is about being compensated for taking specific risks associated with different asset classes or security types. It also involves mitigating composite risks. These aspects of risk management are key considerations in our product development efforts.”

Risk Management

- Investment strategies seeking to manage specific factor-related risks and mitigate portfolio risks

Target Outcome:
Seek to Manage Risk

Capital Appreciation
- Investment strategies seeking to replicate the performance outcomes of investing in growth-seeking assets
Target Outcome:
Seek Growth with Purpose

Income Generation
- Investment strategies seeking to replicate the performance outcomes of investing in income-generating assets
Target Outcome:
Seek Income for Expected Needs

Liquidity Management
- Investment strategies featuring cash-plus and fixed income solutions with flexible guidelines
Target Outcome:
Seek Liquidity and Flexibility

There is no guarantee FlexShares ETFs will meet the stated outcome.
The FlexShares Perspective – Liquidity Management

“A serious but often underappreciated challenge is lack of liquidity. Alignment between the timing and nature of investment returns and the need to access money from a portfolio is an important consideration in the portfolio construction process.”

There is no guarantee FlexShares ETFs will meet the stated outcome.
“Income generation is a key consideration for investors. Geopolitical, regulatory and market structure changes are driving a clear evolution in this area of portfolio construction. Evolving investor attitudes and needs require tailored products and solutions.”

**Investment strategies featuring cash-plus and fixed income solutions with flexible guidelines**

**Target Outcome:**
Seek Liquidity and Flexibility

**Liquidity Management**
Investment strategies seeking to replicate the performance outcomes of investing in growth-seeking assets

**Target Outcome:**
Seek Growth with Purpose

**Income Generation**
Investment strategies seeking to replicate the performance outcomes of investing in income-generating assets

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**Risk Management**
Investment strategies seeking to manage specific factor-related risks and mitigate portfolio risks

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**Capital Appreciation**
Investment strategies featuring cash-plus and fixed income solutions with flexible guidelines

**Target Outcome:**
Seek Liquidity and Flexibility

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II. Framework
Capital Appreciation

Sound portfolio construction demands that capital appreciation be viewed through the lens of investor objectives. A consideration of several key factors enable what we refer to as growth with a purpose.

- Time Horizon
- Risk-Adjusted Measurement
- Total After-cost Returns
- Beyond Benchmarks
- Fit versus Style
- Home Bias
- The Final Frontier
Risk Management

Sound portfolio construction requires targeted management of specific risks and deliberate mitigation of composite risks.

- **Specific Risks**
  - Business Risk
  - Credit Risk
  - Interest Rate Risk
  - Reinvestment Risk
  - Currency Risk

- **Composite Risks**
  - Concentration Risk
  - Geographic Risk
  - Inflation Risk
  - Liquidity Risk
  - Tail Risk
Liquidity Management

Liquidity is a function of the investment strategy, underlying assets and choice of vehicle.

• Investment Strategy
  – Asset Allocation
  – Portfolio Constraints
  – Redemption

• Underlying Assets
  – Depth of Market
  – Public Versus Private
  – Fungibility

• Vehicle Selection
  – Managed Account
  – Pooled Investment Vehicle
  – Exchange Traded Product
Income Generation

While traditional approaches to income generation still play an important role, the trade-off between investor objectives and product design have evolved to meet income generation needs.

Reliable versus Fixed Income

- Objectives
  - Safety
  - Liquidity
  - Yield

- Design
  - Distribution
  - Taxation
III. Finishes
Meeting Client Portfolio Needs

With a sound foundation and framework in place, the construction process moves to the finishing phase targeting specific client objectives. In this segment, we consider three representative applications that target client needs.

- Gaining Core Exposure
  - Factor-based methodology
  - Alternatively-weighted indexing

- Hedging Inflation Risk
  - Asset class correlations
  - Time horizon considerations

- Managing Liquidity
  - Strategic allocation
  - New paradigm (liquidity, volatility and yield)
Application: Gaining Core Exposure

The role of global equity exposure in asset allocation continues to evolve demanding expanded approaches to portfolio construction.

<table>
<thead>
<tr>
<th>Geographic Location</th>
<th>Market Cap (in millions)</th>
<th>Percentage</th>
<th>PE Ratio*</th>
<th>Forward PE Ratio*</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>17,180,454.22</td>
<td>47.57%</td>
<td>17.12</td>
<td>14.40</td>
</tr>
<tr>
<td>Developed ex US</td>
<td>14,452,944.38</td>
<td>40.02%</td>
<td>17.19</td>
<td>12.81</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>4,335,128.07</td>
<td>12.00%</td>
<td>12.91</td>
<td>10.20</td>
</tr>
<tr>
<td>Frontier Markets</td>
<td>144,242.94</td>
<td>0.40%</td>
<td>11.79</td>
<td>NA</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>36,112,769.61</strong></td>
<td><strong>100%</strong></td>
<td><strong>14.09</strong></td>
<td><strong>11.41</strong></td>
</tr>
</tbody>
</table>

Source: MSCI (as of 03/29/2013)
* Market-Cap Weighted
Application: Gaining Core Exposure

Empirical research provides a solid foundation for evaluating strategies for optimal core exposure.

• Factor-Based Investing
  – The Fama-French three factor model and Carhart four factor model have identified several factors (Capitalization, Value and Momentum) which explain much of manager out-performance
  – Several studies identify dividends (and there reinvestment) contributing anywhere from 50% to 80% of total returns

• Alternatively Weighted Indexing
  – Indexes that weight a portfolio’s holdings based on various factors can provide:
    • Targeted exposure
    • Forward looking portfolio characteristics
  – All alternatively weighted indices are not created equal
    • Ex: Many dividend-weighted strategies were overweight financials in 2008 and sold at the bottom, when those financials suspended dividends
    • Ex: Equal-weighted strategies provide small cap exposure less efficiently
    • Ex: Many value products use P/E ratios, which is one of the easier ratios to manipulate
Application: Managing Inflation Risk

Inflation hedge – over longer periods, TIPS are not as effective of an inflation hedge as commodity futures and natural resource equities

Correlation to Inflation by Asset Class
Monthly Returns as of 12/31/2012

Past performance is not indicative of future results. Indices are unmanaged, are not investable and are not reduced by fees or expenses.
Application: Managing Inflation Risk

Short Term: 1-5 years

- **U.S. Treasury Inflation Protected Securities**
  - Effective capturing near term unexpected inflation
  - Correlation to CPI
  - Provide inflation hedge and income

Intermediate Term: 5-20 years

- **Global Natural Resource Public Equities**
  - Despite current environment, emerging market demand is expected to continue
  - Long term correlation to CPI
  - Dollar hedge
  - Liquid, transparent, time-tested, universal

Long Term: 20+ years

- **Core Equities**
  - Time-tested, long-term asset class against inflation
- **Private Ownership of Natural Resources**
  - Timberlands, Farmlands, Mineral Rights - but beware of bubbles
- **Real Estate and Infrastructure**
  - Long lived building blocks of economies
Application: Managing Liquidity

• Investors are developing a sharper understanding of the tradeoffs between safety of principal, income and access to funds in managing liquidity.

• The current market environment, characterized by low interest rates and increased regulatory scrutiny has created investor demand for a broader array of liquidity investment alternatives.

• After identifying and prioritizing the objectives for their liquidity investments, investors may decide to re-allocate liquidity balances into separate products emphasizing Investing liquidity versus preservation liquidity.
IV. Finale
Final Punch List

7 FlexShares Portfolio Management Principles

1. **Investment Objective**: Distinguish between investor goals and needs.
2. **Investment Outlook**: Look ahead after you look behind.
3. **Investment Strategy**: Think critically about benchmarks and asset allocation.
4. **Risk Budgeting**: Demand reward for specific risks.
5. **Risk Mitigation**: Hedge against composite risks.
6. **Investment Discipline**: Monitor conditions, evaluate performance, rebalance holdings
7. **Portfolio Construction**: Consider the benefits and costs of investment products
Appendix
For more resources visit www.FlexShares.com

With dividend ETFs, there's no substitute for quality.

QDF Series: Choose from three levels of market risk depending on portfolio needs.

Learn More

FUND QUICK LOOK

<table>
<thead>
<tr>
<th>FUND</th>
<th>TICER</th>
<th>MARKET PRICE</th>
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<tbody>
<tr>
<td>FlexShares Quality Dividend Index Fund</td>
<td>QDF</td>
<td>28.77</td>
</tr>
<tr>
<td>FlexShares Quality Dividend Dynamic Index Fund</td>
<td>QDYN</td>
<td>28.78</td>
</tr>
<tr>
<td>FlexShares Quality Dividend Defensive Index Fund</td>
<td>QDEF</td>
<td>28.72</td>
</tr>
<tr>
<td>FlexShares Morningstar Global Upstream Natural Resources Index Fund</td>
<td>GURN</td>
<td>34.37</td>
</tr>
<tr>
<td>FlexShares Morningstar U.S. Market Factor Tilt Index Fund</td>
<td>TILT</td>
<td>66.89</td>
</tr>
<tr>
<td>FlexShares Morningstar Developed Markets ex-US Factor Tilt Index Fund</td>
<td>TLTD</td>
<td>55.62</td>
</tr>
<tr>
<td>FlexShares Morningstar Emerging Markets Factor Tilt Index Fund</td>
<td>TLTE</td>
<td>51.76</td>
</tr>
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FEATURED INSIGHTS

Liquidity Commentary
Provides a broad overview of the new liquidity investing paradigm - how we got here, the current regulatory environment and how to adapt to the new paradigm.

Dividend-Focused Indexing
Attempts to help investors meet their income needs while still participating in capital growth through the equity market.

FlexShares Exchange-Traded Funds (ETFs) seek investment outcomes that

A GLOBAL LEADER

FlexShares - An Investor-Centric Approach

FlexShares Product Engineering
A closer look at our investor-centric approach to product
Shundrawn A. Thomas

Managing Director, FlexShares ETF Group
Northern Trust

Shundrawn A. Thomas serves as Managing Director and Global Head of the FlexShares Exchange Traded Funds Group at Northern Trust. In this capacity, he is chiefly responsible for developing long-term strategy, executing operating plans, working with regulatory agencies, managing vendor relationships and attracting and developing talented professionals. He is also responsible for managing financial, operational and reputational risk across the business. Shundrawn serves as a trustee of the registered investment company that oversees the ETF businesses activities. Shundrawn is a member of the six-person executive committee responsible for the overall management of Northern Trust’s asset management business.

Previously, Shundrawn served as President and Chief Executive of Northern Trust Securities, Inc., responsible for overseeing financial management and working with regulators including FINRA and the Securities and Exchange Commission. He also served as Head of Corporate Strategy for Northern Trust Corporation as a direct report to the Chief Executive Officer. In this role Shundrawn supported executive management across key strategic planning initiatives. Prior to joining Northern Trust, Shundrawn served as a vice president for Goldman, Sachs & Co. and held positions in sales, trading and research with Morgan Stanley.

Shundrawn received a B.S. degree in accounting from Florida A&M University and an M.B.A. from the University of Chicago Booth School of Business. Shundrawn currently holds FINRA Series 7, 63, and 24 licenses. He serves on the board of the Florida A & M University Foundation and is also a trustee for Wheaton College. Shundrawn is a member of the Economic Club of Chicago.
Important Disclosure

Before investing carefully consider the FlexShares investment objectives, risks, charges and expenses. This and other information is in the prospectus, a copy of which may be obtained by visiting www.flexshares.com. Read the prospectus carefully before you invest.

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