Fund Focus

FlexShares STOXX® US ESG Select Index Fund

US GREEN KPIs

For investors seeking a focus on select ESG KPIs of US companies

In the past decade, investors have increasingly sought out investment products that incorporate environmental, social and governance (ESG) criteria in their portfolio construction process. Some are seeking ways to align their investment portfolio with their values, while others see ESG criteria as important tools to assess a stock's long-term performance potential. This growing demand has led to a variety of methodologies for implementing ESG strategies, some of which may create risks such as unfavorable industry concentrations and tracking error against market-cap weighted benchmarks.

In this paper, we explain how an approach that integrates analysis of ESG key performance indicators (KPI) into traditional portfolio selection criteria may help overcome the limitations of other ESG strategies, while pursuing the potential for enhanced risk return profile. We then explain the methodology that the FlexShares STOXX® US ESG Select Index Fund uses to generate a diversified core equity ESG portfolio.

THE CHALLENGES OF BUILDING A DIVERSIFIED ESG PORTFOLIO

Our research suggests that there is growing interest in ESG investing among investors who want to align their portfolios with their values, or who believe that ESG criteria can impact a company's long-term business performance. In response, several methods for ESG investing have sprung up over time.

Some strategies exclude companies based on their business activities, such as oil drilling, tobacco products, or weapons production. Others seek to overweight so-called "best in class"[1] ESG companies, those involved in activities with a social or environmental benefit as well as those demonstrating a commitment to add diversity to their corporate boards, and other positive changes.

Some of these approaches may come with important trade-offs, including limited diversification potential and the chance of weaker risk-adjusted performance. For example, excluding companies based on their activities alone could remove entire industries or sectors from investment portfolios, causing a potential increase in tracking error compared to market-weighted benchmarks. Similarly, selecting companies based solely upon their sustainability efforts could concentrate a portfolio in certain sectors.

Many investors have begun implementing ESG strategies that examine select ESG-related key performance indicators reported by public companies in their regulatory filings as a way to further assess a stock's potential risk and returns. We believe that analysis of disclosed ESG data, combined with improved portfolio construction guidelines, may result in a more diversified, ESG tilted core equity investment portfolio. The resulting portfolio could help deliver the potential benefits of ESG investing while avoiding common pitfalls such as insufficient diversification.

APPLYING ESG KPIS IN THE PORTFOLIO SELECTION PROCESS

The FlexShares STOXX® US ESG Select Index Fund is an ETF that seeks enhanced risk return characteristics relative to the broad large-cap US equity market from an ESG portfolio by tracking a custom index, the STOXX® USA ESG Select KPIs Index.[2] STOXX is a leading index provider in Europe, owned by the Deutsche Borse, which operates the largest stock exchange in Germany, and the SIX Swiss Exchange, the leading independent stock exchange in Europe.

3 distinct categories of criteria

Environmental

Social

Governance

The universe of stocks under consideration in the index starts with the U.S.-based companies listed in the STOXX Global 1800 Index.[3] STOXX avoids investing in companies that operate in violation of the UN Global Compact, or have certain business involvement ties with tobacco, thermal coal, unconventional oil & gas, for profit prisons or weapons.

Next, the index employs bottom-up analysis of publicly available data to evaluate more than 150 ESG-related KPIs with broad representation among the three distinct categories of criteria—environmental, social and governance. STOXX pays particular attention to the KPIs its research has shown to have been most influential in determining risk and return. Based on this analysis, each stock receives an aggregate ESG score, and the bottom 50% of companies are excluded from the index.

The custom index's holdings from among the remaining 50% are tilted in favor of constituents with higher aggregate scores in an effort to optimize risk-adjusted return. Finally, constraints are applied in the portfolio construction process to maintain sector and style neutrality compared to the index. In addition, the final portfolio targets holdings of no more than 5% in any single company.

SEEKING IMPROVED DIVERSIFICATION AND ENHANCED RISK/RETURN PROFILE

We believe that measuring the impact of KPIs on a stock's potential risk/return profile provides a holistic and diversified approach to ESG investing—one that identifies sustainable companies while potentially reducing portfolio risk and enhancing long-term investment performance.

Since the risks related to ESG criteria differ across industries, our research indicates it is prudent to evaluate the impact of KPIs on a sector-by-sector basis. By focusing on the ESG criteria that research has shown to be most material in specific sectors/industries, The STOXX USA ESG Select KPIs Index is designed to target companies that exhibit positive risk and return versus a market-cap weighted index. Composite ESG scoring may also help provide wider screening across all three categories of environmental, social and governance criteria.

We believe this bottom-up approach parallels best practices employed by a wide swath of portfolio managers when they evaluate, sort and select companies for other types of investments. Employing diversification controls for style and sector exposure may further enhance diversification, which we believe may help avoid the risks associated with ESG strategies such as exclusionary screening.

CONCLUSION

While ESG investments have grown in popularity, our belief is that the criteria used to evaluate ESG performance are not universally applicable across sectors. As a result, common selection methodologies may make ESG portfolios prone to sector concentrations and tracking error that unnecessarily limit opportunities.

The FlexShares STOXX US ESG Select Index Fund is designed to use a bottom-up approach to portfolio selection to help improve sector diversity and manage potential tracking error. By relying on a methodology that applies ESG scoring early in the selection process, the Fund integrates ESG principles with more traditional portfolio analysis tools to maintain a diversified core equity investment strategy while tilting toward ESG criteria. This methodology, along with sector and security constraints, may offer the potential for a broadly diversified ESG portfolio that can help align an investor's portfolio with their values.

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 The best in class terminology refers to a specific type of strategy incorporating ESG into the investment process that selects companies that are leaders relative to peers in implementing ESG principles.

2 The STOXX USA ESG Select KPIs Index is an optimized index designed to provide broad market exposure that is tilted toward U.S. companies that score better with respect to a small set of ESG characteristics and to provide the potential for attractive risk-adjusted performance relative to the STOXX USA 900 Index.

3 The STOXX Global 1800 Index provides a broad yet liquid representation of the world's most developed markets with a fixed number of 1,800 components equally drawn from Europe, the Americas and the Asia/Pacific region.

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. Foreside and FlexShares and STOXX® are not related.

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. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns. An ESG investment methodology that includes and excludes issuers and assigns weights to issuers by applying non-financial factors, such as ESG factors, such ESG investment methodology may underperform the broader equity market or other investment products that do or do not use ESG investment criteria.

FlexShares STOXX® US ESG Select Index Fund (ESG) is a passively managed fund that invests in United States equities 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. Northern Trust does not attempt to take defensive positions in any market conditions, including declining markets.

ESG Investment Risk is the risk that because the Index Provider includes and excludes issuers and assigns weights to issuers in the Underlying Index by applying non-financial factors, the Fund may underperform the broader equity market or other funds that do or do not use ESG investment criteria. Although the Underlying Index is designed to measure a portfolio of companies with certain ESG characteristics, there is no assurance that the Underlying Index or Fund will be comprised of such securities or that companies that have historically exhibited such characteristics will continue to exhibit such characteristics.

Concentration Risk is the risk that, to the extent the Fund's investments are concentrated in the securities of issuers in a particular region, country, market, industry, sector or asset class, the Fund may be subject to increased price volatility. **Authorized Participant Concentration Risk** is the risk that the Fund may be adversely affected because it has a limited number of institutions that act as authorized participants. **Derivatives Risk** is the risk that the use of futures and options on futures may pose risks in addition to and greater than those associated with investing directly in securities and other instruments, may be illiquid or less liquid, more volatile, more difficult to value and leveraged so that small changes in the value of the underlying instrument may produce disproportionate losses to the Fund.

Non Diversification Risk is the risk that Fund performance may depend on the performance of a small number of issuers because the Fund may invest a large percentage of its assets in securities issued by or representing a small number of issuers. **New Fund Risk** is the risk that the Fund will not grow to or maintain an economically viable size, in which case it may experience greater tracking error to its Underlying Index than it otherwise would at higher asset levels, or it could ultimately liquidate without shareholder approval. **Equity Securities Risk** is the risk that the values of the equity securities owned by the Funds may be more volatile and under perform other asset classes and the general securities markets. **Passive Investment Risk** is the risk that the Fund is not actively managed.

High Portfolio Turnover Risk is the risk that active and frequent trading of the Fund's portfolio securities may result in increased transaction costs to the Fund. **Tracking Error Risk** is the risk that the Fund's performance may vary substantially from the performance of the Underlying Index. The Fund's performance may vary from the performance of the Underlying Index for a number of reasons including that the Fund incurs operating expenses that the Underlying Index does not and that the Fund accepts custom baskets.