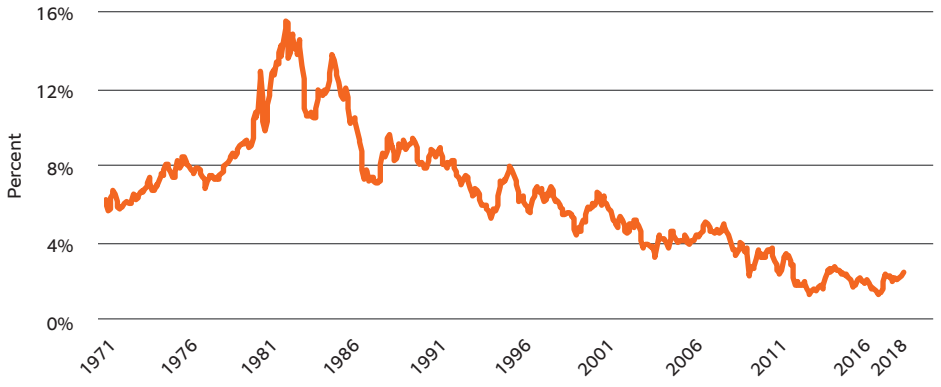
Scenario Planning

Expectations for Interest Rates

An entire generation of advisors and investors has grown up observing interest rates that only go down and bond prices that only go up. But with potentially volatile interest rates, investors may experience losses in their fixed income portfolios if they don't adapt to a variety of different scenarios.

10-YEAR INTEREST RATES

Historical Comparison Jan 1971 – Feb 2018



Long-term interest rates are those paid by government bonds maturing in ten years. They are generally averages of daily rates, measured as a percentage. Past performance is not indicative of future results. One cannot invest directly in an index. For illustrative purposes only, not representative of an actual investment. Source: OECD (2018), Long-term interest rates (indicator).

This guide takes a look at three FlexShares strategies to help investors pursue their financial goals amid uncertain interest rates.

SKOR
LKOR

MBSD

BNDC

FACTORS DRIVING INTEREST RATES

Economic Growth We believe one of the most important factors in determining why interest rates change is the supply of funds available from lenders and the demand from borrowers. Since 2008, however, available funds have dwindled due to the effects of increasing regulations on lenders.

Fiscal and Monetary Policy In a booming economy, many firms may need to borrow funds to expand their plants, finance inventories and even acquire other firms. Governments will also borrow if they spend more money than they raise in taxes. Historically, a high level of government expenditures and borrowing makes it hard for companies and individuals to borrow, leading to what's known as a "crowding-out" effect. This situation may keep the demand for capital at a high level and interest rates higher than they otherwise might be.

Another major factor affecting why interest rates change is driven by actions taken by central banks, like the Federal Reserve, which can alter the money supply to try to manage the economy and control inflation. When governments "loosen" monetary policy, more money is created. This makes interest rates lower because more money is available to lenders and borrowers alike. If the supply of money is lowered by withdrawing money from banks, monetary policy is "tightened," which causes interest rates to rise.

Inflation Another key factor influencing why interest rates change is inflation. Investors want to preserve their "purchasing power," so if inflation is high and threatens to go higher, investors will demand higher interest rates before lending money for more than the shortest of terms.

SKOR

LKOR

MODERNIZING LEGACY CREDIT RATINGS

Several years of global central bank intervention and regulatory change have created new opportunities for fixed income product innovation. Though legacy active and index products remain the preferred choices for bond investors, the tide is starting to turn as both asset managers and investors confront a changed investment landscape. Legacy corporate credit indexes reflect the composition and characteristics of the broad corporate bond market but fail to provide readily investible benchmarks that serve the needs of investors. Add to it that traditional sources for credit information – nationally recognized statistical rating organizations (NRSROs) – have not kept up with the times in the fixed income credit sector and you have a market that is more than ready for a contemporary approach to credit evaluation.

Developed in collaboration with Northern Trust's quantitative research and index groups, the Northern Trust Corporate Bond Credit Scoring process is a fully objective credit evaluation method to construct innovative corporate credit indexes, with no reliance on NRSRO ratings. Instead, the procedure evaluates debt issuers based on factors such as management efficiency, profitability and market solvency, which are then sorted and ranked within five macro industry sectors. The process produces credit evaluations that update with greater frequency and specificity than NRSRO credit ratings when measured against future credit spread and bond price movements.

This also addresses corporate bond liquidity challenges by optimizing a carefully selected subset of all credit issuers from which illiquid, orphaned and small lot names have been removed. Then, multiple factors are taken into account to aid in developing improved corporate bond indexes, including the characteristics of issuers' total debt structure, minimum exposure percentages and odd-lot trade restrictions. These indexes underlie FlexShares SKOR and LKOR ETFs.

Potential Portfolio Benefits – **SKOR & LKOR**

Innovative credit evaluation method, with no reliance on NRSRO ratings

Efficient, economical corporate credit investing in an ETF structure with intra-day market trading, tax efficiency and transparency

Rules-based credit scoring methodology enabling funds to efficiently replicate the legacy credit index's exposures

MBSD

MORTGAGE-BACKED INNOVATION

Since their introduction in 1970, mortgage-backed securities (MBS) have provided investors with quality fixed income returns. They typically offer such desirable investment characteristics as strong credit quality, attractive yields, diversification versus other fixed income sectors, frequent issuance and liquid trading markets. The key concern is the effect of prepayments on their performance and valuations. This contraction of effective duration requires constant monitoring and frequent adjustment by investors.

Given the end of the quantitative easing era with the anticipated volatility in interest rates, the underlying mortgages held in low-coupon MBS pools have a reduced likelihood of being refinanced (resulting in longer effective durations for MBS). In this environment, investors may be open to a new MBS product designed to help manage that potential issue.

Yield-to-Worst (YTW) represents the lowest potential yield received on a bond without an issuer default. Effective duration is how sensitive an investment is to a change in interest rates. You will often see it expressed as a number of years – the higher the number, the more volatile the expected change.

10 YEAR COMPARISON AVERAGE YIELD TO WORST & DURATION

Jan 2008 - Jan 2018

AVERAGE	BBC AGG	FIXED RATE MBS	U.S. CREDIT	TREASURY
Yield to Worst	2.80	3.23	3.77	1.68
Duration (Yrs)	5.16	3.86	6.72	5.60

Historical data is from the Bloomberg Barclays Capital Aggregate Bond Index (BBC AGG) and three of its subsectors (Agency Fixed-Rate MBS, U.S. Credit and U.S. Treasury). BBC AGG is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The Fixed Rate MBS Index is a component of the BBC AGG Index and tracks agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC). The U.S. Credit Index is a component of the BBC AGG Index and measures the investment grade, US dollar-denominated, fixed –rate, taxable corporate and government-related bond markets. The Treasury Index is a component of the BBC AGG Index and measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.

As demonstrated in the chart, MBS has achieved a comparable level of YTW to other fixed income vehicles, with a lower effective duration over the last 10-year time frame. This essentially means that over this time frame, investors in fixed rate MBS have received a higher YTW with less price volatility. Consequently, investors will potentially benefit by choosing products that effectively manage duration to maintain this historical advantage.

To provide a more efficient way to manage MBS duration/interest-rate risk, the ICE BofAML® Constrained Duration US Mortgage Backed Securities Index seeks to deliver a strategy with monthly rebalancing and variability of effective duration within a band of 3.25 to 4.25 years. This index underlies FlexShares MBSD ETF.

Potential Portfolio Benefits – **MBSD**

Passive, rules-based, fixed-rate MBS index designed to manage MBS duration/ interest-rate risk

Captures the attractive attributes of MBS while attempting to minimize the undesirable ones

Access to a diverse basket of hundreds of MBS via one ETF ticker and transaction

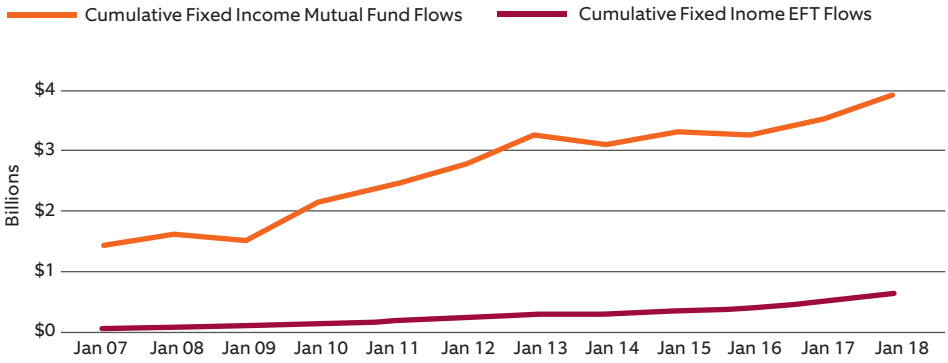
BNDC

ACTIVE MANAGEMENT + ETF STRUCTURE

We believe fixed income investments can provide diversification benefits while serving as a buffer from equity market volatility. Many investors have historically preferred active fixed income management, because of the manager's ability to make active decisions about interest rate risk, sector positioning, credit risk, and yield curve positioning. That preference, however, may be changing.

CUMULATIVE FLOWS

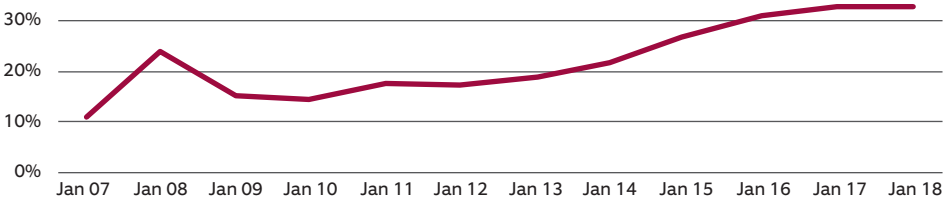
Bond Mutual Funds & Bond ETFs Comparison Jan 2007 - Jan 2018



Source: Morningstar, January 2018. Past performance is not indicative of future results.

PERCENTAGE FLOWS

Fixed Income ETF Flows to Fixed Income Mutual Fund Flows Jan 2007 - Jan 2018



Source: Morningstar, January 2018. Past performance is not indicative of future results.

Demand for fixed income ETF products has grown rapidly, as evidenced by their rising share of overall bond asset flows. Investors appreciate the advantages of the ETF structure, which include intra-day market trading, tax efficiency and transparency. We believe in harnessing the combined strengths of an experienced, active portfolio management team with the delivery advantages of an ETF - this philosophy powers the BNDC ETF.

Potential Portfolio Benefits – **BNDC**

Diversified and actively managed fund designed to bring the institutional bond know-how of Northern Trust to individual investors

Combined expertise of Northern Trust Corporation and Northern Trust Asset Management

Combines top-down decision making implemented within the portfolio with passive ETF solutions

FlexShares Fund Lineup

EQUITY

- **TILT** — FlexShares Morningstar® U.S. Market Factor Tilt Index Fund
- **TLTD** — FlexShares Morningstar® Developed Markets ex-U.S. Market Factor Tilt Index Fund
- **TLDH** — FlexShares Currency Hedged Morningstar® DM ex-U.S. Factor Tilt Index Fund
- **TLTE** — FlexShares Morningstar® Emerging Markets Factor Tilt Index Fund
- **TLEH** — FlexShares Currency Hedged Morningstar® EM Factor Tilt Index Fund
- **ESG** — FlexShares STOXX® US ESG Impact Index Fund
- **ESGG** — FlexShares STOXX® Global ESG Impact Index Fund
- **QLC** — FlexShares U.S. Quality Large Cap Index Fund
- **QDF** — FlexShares Quality Dividend Index Fund
- **QDEF** — FlexShares Quality Dividend Defensive
- **QDYN** — FlexShares Quality Dividend Dynamic Index FundIndex Fund
- **IQDF** — FlexShares International Quality Dividend Index Fund
- **IQDE** — FlexShares International Quality Dividend Defensive Index Fund
- **IQDY** — FlexShares International Quality Dividend Dynamic Index Fund

FIXED INCOME

- **TDTT** — FlexShares iBoxx® 3-Year Target Duration TIPS Index Fund
- **TDTF** — FlexShares iBoxx® 5-Year Target Duration TIPS Index Fund
- **MBSD** — FlexShares Disciplined Duration MBS Index Fund Index Fund
- **SKOR** — FlexShares Credit-Scored U.S. Corporate Bond Index Fund
- **LKOR** — FlexShares Credit-Scored U.S. Long Corporate Bond Index Fund
- **BNDC** — FlexShares Core Select Bond Fund
- **RAVI** — FlexShares Ready Access Variable Fund

REAL ASSETS

- **GUNR** — FlexShares Morningstar® Global Upstream Natural Resources Index Fund
- **NFRA** — FlexShares STOXX® Global Broad Infrastructure Index Fund
- **GQRE** — FlexShares Global Quality Real Estate Index Fund
- **ASET** — FlexShares Real Assets Allocation Index Fund

REAL WORLD GOAL

- CAPITAL APPRECIATION
- INCOME GENERATION
- RISK MANAGEMENT
- LIQUIDITY MANAGEMENT

FIND OUT MORE

The FlexShares approach to index-based 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) or visit www. FlexShares.com.

IMPORTANT INFORMATION

Before investing, carefully consider the FlexShares investment objectives, risks, charges and expenses. This and other information is in the full prospectus and summary prospectus, a copy 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.

The FlexShares Credit-Scored US Corporate Bond Index Fund (SKOR) and the FlexShares Credit-Scored US Long Corporate Bond Index Fund (LKOR) are 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. They are subject corporate bond risk, which is the risk that the issuer is unable to meet principal and interest rate payments on the obligation and may also be subject to price volatility due to such factors as interest rate sensitivity, market perception of credit worthiness of and general market liquidity. When interest rates rise, the value of corporate debt can be expected to decline. The Funds may invest in derivative instruments. Changes in the value of the derivative may not correlate with the underlying asset, rate or index and the Funds could lose more than the principal amount invested. The Funds are also non-diversified meaning the Fund's performance may depend on the performance of a small number of issuers because the Funds may invest a large percentage of assets in securities issued by or representing a small number of issuers.

FlexShares Disciplined Duration MBS Index Fund (MBSD) 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 credit risk, which is the risk that the inability or unwillingness of an issuer or guarantor of a fixed-income security, or a counterparty to a TBA, repurchase or other transaction, to meet its payment or other financial obligations will adversely affect the value of the Fund's investments and its returns. Changes in the credit rating of a debt security held by the Fund could have a similar effect. Debt extension risk is the risk that an issuer will exercise its right to pay principal on an obligation held by the Fund (such as a mortgage-backed security) later than expected. This may happen during a period of rising interest rates. Under these circumstances, the value of the obligation will decrease and the Fund will suffer from the inability to invest in higher yielding securities. Mortgage-backed pass-through securities risk is the risk of investing in mortgage-backed securities issued by a U.S. Agency. These securities may not be backed by the full faith and credit of the U.S. government. As interest rates rise, bond prices fall, reducing the value of fixed income investments.

The ICE BofAML® Constrained Duration US Mortgage Backed Securities Index is the intellectual property (including registered trademarks) of ICE BofAML® and/or its licensors ("Licensors"), which is used under license. The securities based on the Index are in no way sponsored, endorsed, sold or promoted by ICE BofAML ® and its Licensors and neither of the Licensors shall have any liability with respect thereto.

FlexShares Core Select Bond Fund (BNDC) is actively managed and does not seek to replicate a specified index. The Fund is subject to increased credit and default risk, where there is an inability or unwillingness by the issuer of a fixed income security to meet its financial obligations, debt extension risk, where an issuer may exercise its right to pay principal on an obligation later than expected, as well as interest rate/maturity risk, where the value of the Fund's fixed income assets will decline because of rising interest rates. The Fund is subject to increased underlying fund risk, where the Fund's investment performance and its ability to achieve its investment objective may be directly related to the performance of the Underlying Funds in which it invests. The Fund may also be subject to increased concentration risk as it may invest more than 25% of its assets into the securities of a single developed market. Additionally, the Fund may invest without limitation in mortgage or asset-backed securities, which puts it at increased risk for interest rate/maturity risk, debt extension risk, and prepayment (or call) risk.

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Your Financial Professional

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