Equity | Fixed Income | Real Assets

QLC | HYGV | GUNR

How to Prepare Portfolios for Rising Interest Rates

Historical data helps identify assets that may be positioned to fare well when higher rates threaten fixed-income and equity returns

Now, with higher interest rates widely expected, many investors are worried about the potential impact on their investments — and wondering how they should prepare their portfolios.

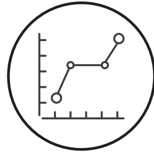
For a good illustration of how investors typically react to the prospect of higher interest rates, look at what happened in January 2022. News that the US Federal Reserve (Fed) might begin raising rates as early as March sparked market volatility that helped to drive general US stocks to their worst monthly performance since March 2020. Bond prices also fell, with yields on the 10-year Treasury recording their largest monthly increase since March 2021[1].

Now, with higher interest rates widely expected, many investors are worried about the potential impact on their investments — and wondering how they should prepare their portfolios. For insights, we can examine how different asset classes have performed during previous periods of rising interest rates.

Our research into the past four Fed rate hike cycles (2015, 2004, 1999 and 1994) suggest that high-yield bonds, factors such as value and quality, and natural resources investments may be well positioned for stronger returns during rising-rate environments.

FIXED INCOME: WATCH DURATION AND CONSIDER HIGH-YIELD BONDS

Because rising interest rates hurt the prices of existing bonds, investors are likely to focus on the potential interest rate risk in their fixed-income allocations. During Fed tightening cycles, the market has historically anticipated rate increases and prices them into the bond market before they happen. Yet there's always uncertainty about the timing, size, and number of rate hikes, which may create additional volatility if actual rate hikes don't match the market's expectations.



So, in rising rate environments, positioning fixed-income holdings on the shorter end of the duration curve may reduce risk.

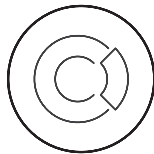
Managing duration in a fixed-income portfolio is one way to address this uncertainty. Our research has found that duration is responsible for the majority of expected returns in fixed-income assets, and bonds with shorter durations are often less sensitive to rising interest rates. So, in rising rate environments, positioning fixed-income holdings on the shorter end of the duration curve may reduce risk.

However, shorter duration bonds also tend to have lower yields, which may not support investors' income goals. In these cases, investors might consider taking on additional credit risk in an effort to potentially boost their portfolio's yields. Our research shows that historically the high-yield segment of the fixed-income markets has performed well during periods of rising interest rates:

High-yield bonds had an average one-year return of 4.3% during the past four Fed rate hiking episodes, versus an average one-year return of 2.0% for investment grade bonds.[2]

High-yield bonds have even outperformed equities during the Fed rate hiking cycles of 2015 and 2004, delivering one-year returns of 12.1% and 10.3% versus equities' 7.7% and 8.7% returns, respectively.[3]

It's also important to look at underlying economic fundamentals and technical issues of supply and demand when considering an allocation to high-yield bonds. In early 2022, strong balance sheets have helped keep defaults low among high-yield issuers. At the same time, our research shows that issues of roughly half of all high-yield bond maturities had been extended to 2028 and beyond, potentially reducing the likelihood of new issuances that could hurt the prices of existing high-yield bonds.



But when interest rates rise, the value of those future earnings in today's dollars may decline.

EQUITIES: FOCUS ON VALUE, QUALITY, AND DIVIDEND YIELD

Just as duration helps determine a bond's sensitivity to rising rates, you can use a similar concept to assess the potential performance of different types of stocks. Equity investors are essentially paying today for a company's future cash flows and earnings. The farther off those cash flows and earnings are, the longer the stock's "duration" — and the greater the risk that higher inflation will hurt that stock's performance.

Think of a fast-growing technology company: Investors may pay high multiples today in anticipation of higher cash flow and earnings in the future. But when interest rates rise, the value of those future earnings in today's dollars declines. That's one reason why technology stocks and other growth equities tend to be more volatile in rising rate environments.

Given these characteristics, we believe natural resources are the most attractive of the real asset categories as investors anticipate higher interest rates.

In contrast, certain classes of equities may not suffer as much when interest rates increase, due to their shorter "duration." Our research has found that factors such as value, quality, and dividend yield look attractive in rising rate environments:

PERFORMANCE COMPARISON OF THREE DIFFERENT FACTORS TO THE MSCI USA INDEX DURING THE PAST FOUR FED RATE HIKE CYCLES:

The value factor has delivered a 10.0% average one-year return.[4]	The quality factor delivered a 9.7% average one-year return.[5]	Dividend yield delivered an 8.8% average one-year return.[6]

This data can't guarantee how stocks will perform in every rising rate scenario. But we believe that diversifying equity holdings across multiple factors may help manage the impact of interest rate hikes better than an equity allocation concentrated in large growth stocks.

REAL ASSETS: CONSIDER NATURAL RESOURCES

Many investors hold real assets for their inflation-hedging potential, but it's important to recognize that not all types of investments in the real assets category respond to the same macroeconomic factors. Real estate and infrastructure investments, for example, carry interest rate sensitivity that may hurt their returns when rates rise.

In contrast, natural resources investments typically haven't suffered when interest rates increase. Instead, their returns have historically been more sensitive to changes in the equity markets and economic growth prospects, particularly in emerging markets. In fact, natural resources provided the highest one-year returns of the major asset classes during the past four Fed rate hiking episodes, averaging 25.0%[7].

Given these characteristics, we believe natural resources are the most attractive of the real asset categories as investors anticipate higher interest rates. There is some risk that rising interest rates could slow economic growth and negatively impact natural resources investments, but we believe that the Fed will pause its rate hikes before reaching that point.

The key to helping clients navigate these periods is to pre-position portfolios for potential interest rate changes before they happen.

A DIVERSIFIED APPROACH TO MANAGING INTEREST RATE RISK

The exact timing and magnitude of any rate increase is always uncertain, and the impact of rising rates can show up in many parts of a portfolio. The key to helping clients navigate these periods is to pre-position portfolios for potential interest rate changes before they happen.

Looking at potential interest-rate sensitivity across fixed-income and equity allocations can help ensure your clients are exposed to assets that are more likely to withstand the pressures of rising rates — but that are still well diversified to manage the market's reactions should future rate movements not match expectations.

For more on how asset classes and factors perform under different economic conditions, see our articles:

- Inflation Doesn't Necessarily Spell Doom for High-Yield Bonds
- Factors for All Seasons
- Seeking An Efficient Way to Gain Commodities Exposure

For more on FlexShares' investing strategies, see our fund pages:

- FlexShares High Yield Value-Scored Bond Index Fund (HYGV)
- FlexShares US Quality Large Cap Index Fund (QLC)
- FlexShares Morningstar® Global Upstream Natural Resources Index Fund (GUNR)

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 Bloomberg, 10-Year Treasury Rate, March 1, 2021 – January 31, 2022.

2 Source: Bloomberg. Comparison of the Bloomberg Aggregate Bond Index (Agg) performance and the Bloomberg Barclays High Yield 2% Capped Index returns for four full year time frames of 1994, 1999, 2004, and 2015. Indexes are unmanaged and cannot be invested in directly. Index performance does not reflect any fees or expenses. Performance of an index is not illustrative of any particular investment. **Past performance does not guarantee future results.**

3 Source: Bloomberg. Comparison of the MSCI USA Index performance and the Bloomberg High Yield 2% Capped Index returns for two full year time frames of 2004 and 2015. Indexes are unmanaged and cannot be invested in directly. Index performance does not reflect any fees or expenses. Performance of an index is not illustrative of any particular investment. **Past performance does not guarantee future results.**

4 Source: Bloomberg. Comparison of the MSCI Barra "Value" factor index versus the MSCI USA Index performance returns for four full year time frames of 1994, 1999, 2004, and 2015. Indexes are unmanaged and cannot be invested in directly. Index performance does not reflect any fees or expenses. Performance of an index is not illustrative of any particular investment. **Past performance does not guarantee future results.**

5 Source: Northern Trust & Bloomberg. Comparison of the Northern Trust "Quality" factor index versus the MSCI USA Index performance returns for four full year time frames of 1994, 1999, 2004, and 2015. Indexes are unmanaged and cannot be invested in directly. Index performance does not reflect any fees or expenses. Performance of an index is not illustrative of any particular investment. **Past performance does not guarantee future results.**

6 Source: Northern Trust & Bloomberg. Comparison of the MSCI Barra "Dividend Yield" factor index versus the MSCI USA Index performance returns for four full year time frames of 1994, 1999, 2004, and 2015. Indexes are unmanaged and cannot be invested in directly. Index performance does not reflect any fees or expenses. Performance of an index is not illustrative of any particular investment. **Past performance does not guarantee future results.**

7 Source: Bloomberg. S&P Global Natural Resources Index performance returns for four full year time frames of 1994, 1999, 2004, and 2015. Indexes are unmanaged and cannot be invested in directly. Index performance does not reflect any fees or expenses. Performance of an index is not illustrative of any particular investment. **Past performance does not guarantee future results.**

DEFINITIONS

Duration is a measure of the sensitivity of the price of a fixed-income investment to a potential change in interest rates.

Bloomberg High Yield 2% Capped Index is an issuer-constrained version of the Bloomberg US Corporate High-Yield Index that measures the market of USD denominated, non-investment grade, fixed-rate, taxable corporate bonds.

Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

Bloomberg Aggregate Bond Index broadly tracks the performance of the U.S. investment-grade bond market is designed to represent the full range of investment-grade bonds traded in the U.S. It is composed of more than 10,000 issues.

MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market. With 602 constituents, the index covers approximately 84% of the free float-adjusted market capitalization in the US.

Value factor distinguishes between value stocks and growth stocks using the ratio of book-value of equity to market capitalization.

Quality factor utilizes the Northern Trust approach that attempts to measure companies that have sustainable competitive advantages and have generated sustainable shareholder value over time. We do this by measuring characteristics including strong profitability, consistent and strong levels of cash flows, and prudent deployment of capital by an efficient management team.

Dividend factor computes a predicted dividend yield using the past history of dividends and the market price behavior of a stock.

S&P Global Natural Resources Index includes 90 of the largest publicly-traded companies in natural resources and commodities businesses that meet specific investability requirements, offering investors diversified and investable equity exposure across 3 primary commodity-related sectors: agribusiness, energy, and metals & mining.

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.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. 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.

Investing in both actively and passively managed funds involves risk and principal loss is possible. Active investing has higher management fees because of the manager's increased level of involvement while passive investing has lower management and operating fees. Actively managed funds may have higher portfolio turnover than passively managed funds. Excessive turnover can limit returns and can incur capital gains.

FlexShares High Yield Value-Scored Bond Index Fund (HYGV) invests in high yield securities, which are considered highly speculative, and is subject to greater credit risk, price volatility and risk of loss than if it invested primarily in investment grade securities. There is a higher risk that an issuer will be unable to meet principal and interest rate payments on an obligation and may also be subject to more substantial price volatility due to such factors as interest rate sensitivity, market perception of credit worthiness of and general market liquidity than if the fund invested in investment grade securities. The fund may invest in distressed securities, which generally exposes the fund to risks in addition to investing in non-investment grade securities. These risks can adversely impact the Fund's return and net asset value. When interest rates rise, the value of corporate debt can be expected to decline. The value of the securities in the Fund's portfolio may fluctuate, sometimes rapidly and unpredictably at a greater level than the overall market. The Fund may invest in derivative instruments. Changes in the value of the derivative may not correlate with the underlying asset, rate or index and the Fund could lose more than the principal amount invested. The Fund will concentrate its investments (i.e., hold 25% or more of its total assets) in a particular industry or group of industries to approximately the same extent that the Underlying Index is concentrated. The fund is also subject to the risk that the Fund's investment in companies whose securities are believed to be undervalued will not appreciate in value as anticipated.

FlexShares US Quality Large Cap Index Fund (QLC) 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. Additionally, the Fund is 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 Fund is also is at increased risk of industry concentration, where it may be more than 25% invested in the assets of a single industry. Finally, the Fund may also be subject to increased volatility risk, where volatility may not equal the target of the underlying index.

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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