THE NORTHERN FUNDS

advantage

July 2015

Stable Credits, Yield Advantages,

Support High-Yield Bonds

HIGH-YIELD MARKET OFFERS COMPELLING OPPORTUNITIES

With interest rates at or near record-low levels for more than six years, many yield-seeking investors have found refuge in the high-yield bond market. But, given the greater risks and other dynamics associated with high-yield bonds versus investment-grade securities, research and insight are crucial. Northern Trust's Richard Inzunza, senior fixed income portfolio manager, explains why he and his team believe the high-yield market offers compelling opportunities and how they seek to generate solid returns and limit risk.

Overall, we believe the high-yield bond market is attractive compared with other asset classes on a risk-adjusted basis. This is largely due to the average yield available in the high-yield market, combined with a backdrop of generally stable corporate credit fundamentals. This stability has created an environment in which price movements have been minimal, meaning yield has been the primary component of total return (yield plus price changes) among high-yield bonds. And with an average year-to-date yield of approximately 6.3% through June 10, 2015 (according to Barclays U.S. Corporate High Yield 2% Issuer Capped Index) high-yield bonds have provided at least twice the average yield of investment-grade fixed-income securities.

Protection from rising rates

In addition to their yield advantage versus investment-grade bonds, high-yield bonds generally are better insulated from rising interest rates, which many believe are on the horizon. In late 2008, the Federal Reserve (Fed) cut its federal funds rate target to a record-low 0%-0.25%, driving down rates across the yield curve. More than six years later, short-term rates remain in that range, and longer-term interest rates are still historically low. Most market participants expect the Fed to finally begin raising rates during the second half of 2015, although the timing and magnitude of the rate hikes remain unclear. For investment-grade bonds, there is a direct correlation between interest rates and bond prices; when rates rise, prices fall, and vice versa. But that's not always the case with high-yield bonds, which have a greater correlation with credit events than interest rate movements.

Slow growth a positive influence

High-yield bonds also have benefited from the ongoing slow-growth U.S. economic backdrop. Normally, at this point in a typical economic cycle, corporations would be spending more money and pursuing actions that likely would weaken their credit profiles. But in this extended slow-growth environment, corporations generally have maintained conservative spending policies, which has contributed to the stable credit backdrop and attractive valuations in the high-yield market. Accordingly, the high-yield default rate remains below-average, ending the first quarter at 2%, according to Moody's, compared with a 15-year average of 5%. The default rate peaked at nearly 15% in November 2009.

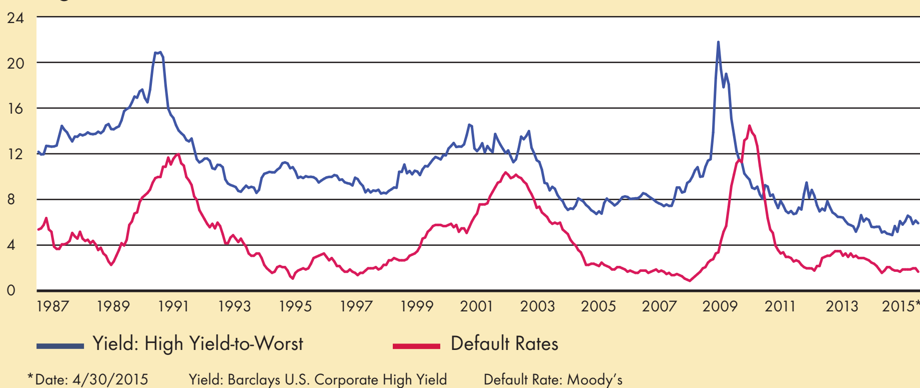
Although we believe the environment for high-yield bonds remains favorable, the market is not without its risks. Understanding and managing those risks (along with focusing solely on high-yield bonds and avoiding equities, leverage, and derivatives) are key components to our goals of generating competitive returns versus the market while preserving capital for our investors.

Avoiding credit-quality extremes

One way we seek to achieve our goals is by minimizing exposure to the extremes of the high-yield credit-quality spectrum. For example, we generally underweight bonds with "BB" credit ratings. Because these are the highest-quality securities within the high-yield universe, conventional wisdom suggests they are the lowest-risk high-yield bonds. That may be the case from a credit perspective, but their higher relative quality means they have a higher correlation with interest rate movements and, therefore, greater interest rate risk. In addition, they generally offer lower yields than the high-yield market as a whole. Accordingly, having significant exposure to securities with "BB" credit ratings means we would also have to have greater exposure to weaker, riskier credits to match or exceed the market's yield. Our preference is to focus on credits in the middle range of the quality spectrum.

Continued on the next page

Continued from the previous page



Research drives security selection

Within this framework, we strive to maximize return potential and minimize risk through fundamental credit analysis, seeking a diversified mix of companies with improving or stable credit profiles. Our experienced team of industry and financial analysts thoroughly researches potential investments to determine if they meet our goals and provide the best relative value versus other opportunities. We also consider macroeconomic factors in building the portfolio. A change in our outlook for a security likely would cause us to sell the holding. We also will sell a security if it has performed well and no longer offers attractive relative value versus other credits.

Interest rate uncertainty, slow global growth, and ongoing tensions in the Middle East should continue to be the greatest potential sources of broad market volatility in the coming months. Nevertheless, we believe the high-yield market remains relatively attractive and continues to be broadly supported by stable credit fundamentals and a low default rate. Security selection and avoiding credit issues should remain a key to performance this year. N

Bond Risk: Bond funds will tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price, especially for longer-term issues and in environments of rising interest rates.

High-Yield Risk: Although a high-yield fund's yield may be higher than that of fixed-income funds that purchase higher-rated securities, the potentially higher yield is a function of the greater risk that a high-yield fund's share price will decline.

Past performance is no guarantee of future results. Investing involves risk including the possible loss of principal. There can be no guarantee that any investment strategy will be successful.

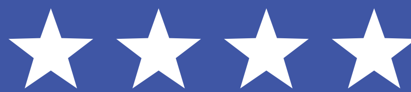
The credit ratings, expressed in Standard & Poor's nomenclature, range from AAA (extremely strong capacity to meet its financial commitment) to D (in default). Ratings are relative and subjective and are not absolute standards of quality. For more information, please visit www.standardandpoors.com

Summary Prospectuses Available in July

In July, Northern Funds will deliver summary prospectuses to shareholders. If you have more than one fund, we'll combine the summary prospectuses into a single mailing.

Alternatively, you may receive your summary prospectus, and other Northern Funds reports, electronically via e-delivery. Once you register for e-delivery, you'll receive an email when the document is available. The email will contain a link that will take you directly to the document. To sign up for e-delivery, please visit **northernfunds.com/e-delivery** and choose "Sign Up for e-Delivery."

High Yield Fixed Income Fund Earns 4-Star Rating



The Northern High Yield Fixed Income Fund earned a four-star rating from Morningstar for the overall and three-year periods ended May 31, 2015 out of 603 high yield bond funds.

The Fund is designed for long-term investors willing to assume the additional risks associated with investing in high-yield securities, including above-average share price fluctuations.

Visit **northernfunds.com/morningstar** to learn more about all of Northern Funds 4-star mutual funds.

Past performance is no guarantee of future results. Ratings reflect fee waivers in effect; in their absence, ratings may have been lower.

High Yield Fixed Income received 4 stars for the 3-year rating among 603 high yield bond funds, 4 stars for the 5-year rating among 516 funds and 3 stars for the 10-year rating among 360 funds.

Star ratings are based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The overall rating is a weighted average of the 3-, 5-, and 10-year (if applicable) returns. 5 stars = top 10% of funds in an asset category; 4 stars = next 22.5% of funds; 3 stars = next 35%; 2 stars = next 22.5% and 1 star = next 10%. A fund must be in existence three years to be rated. Ratings are subject to change monthly.

©2015 Morningstar, Inc. All Rights Reserved. Morningstar and/or its content providers are the proprietors of this information; do not permit its unauthorized copying or distribution; do not warrant it to be accurate, complete or timely; and are not responsible for damages or losses arising from its use.

contact us

by phone call 800-595-9111, Monday thru Friday, 7:00 a.m. – 7:00 p.m. Central Time

automated information line call 800-595-9111, 24 hours a day, 7 days a week

online visit northernfunds.com

by mail write to Northern Funds, P.O. Box 75986, Chicago, Illinois 60675-5986

Please carefully read the prospectus and summary prospectus and consider the investment objectives, risks, charges and expenses of Northern Funds before investing. Call 800-595-9111 to obtain a prospectus and summary prospectus, which contains this and other information about the funds.

NOT FDIC INSURED
May lose value / No bank guarantee

©2015 Northern Funds. Northern Funds are distributed by Northern Funds Distributors, LLC, Three Canal Plaza, Suite 100, Portland, Maine 04101, not affiliated with Northern Trust.

ADV NWL 7/15