THE NORTHERN FUNDS

January 2015

advantage

Active *vs.* Passive:

Opposing or Complementary Strategies?

REFRAMING THE INVESTMENT LANDSCAPE WITH A MIXED APPROACH

The debate between active (attempting to beat a benchmark) and passive (tracking a benchmark) equity investing is ongoing and polarized. Passive proponents point to the challenges of consistently striving to generate benchmark-beating results as evidence of the active strategy's shortfalls. The active camp insists the dynamic nature of the financial markets provides opportunities for talented managers to outperform. At Northern Trust, of course we offer both options to clients, but ask: Why does it have to be one or the other?

Because alpha (a risk-adjusted measure of excess return versus a benchmark) is difficult to achieve, mainstream thinking suggests investors should use actively managed mutual funds when they believe a fund manager is exceptionally skilled and able to generate attractive risk-adjusted performance, relative to a benchmark, over time. Passive-investing proponents believe maintaining market exposure delivers more consistent results at lower costs.

Moving to the middle

Although we generally agree with this mainstream thinking, we also believe it oversimplifies the debate and positions the camps at opposing ends. Instead, we believe in the middle of the extremes there is a solution supported by evidence and theory.

The oversimplification likely comes from the widely used, Nobel Prize-winning Capital Asset Pricing Model (CAPM) theory, which allocates security returns into alpha and beta (a measure of risk relative to a benchmark), or "skill" and "the market." At its heart, the CAPM assumes investors expect greater returns for taking on more risk.

Tailoring factor exposure to a fund's goals

Our solution to the age-old active vs. passive conflict comes from our research, which suggests most active managers' performance is embedded in the biases (risk factors) that comprise the stock screening process. These typically include market capitalization, valuation, volatility, momentum, and yield. At Northern Trust, the process also includes our proprietary measure of quality. By constructing funds that aim to efficiently capture these factors, we seek to deliver attractive risk-adjusted returns.

Each of these factors captures different risk preferences of different investors. For example, risk-averse investors may shun stocks with strong value characteristics, while risk-seeking investors may favor stocks with high volatility scores. Given the existence of these multiple betas, our fund managers do not have to commit to either end of the active/passive spectrum. Instead, they can move along the spectrum, selecting the combination of risk factors that best suits their fund's investment strategy and adjusting exposure to the specific factors based on the fund's goals.

3 pillars of equity fund management

Our approach intentionally focuses on the compensated factors while smoothing out the uncompensated factors, such as sector and industry concentrations. Beyond that, we concentrate on three "pillars" in building our equity mutual funds:

- **Implement portfolios efficiently.** We developed a "Factor Efficiency Ratio" to help our fund managers manage unintended risks in their fund strategies. Such risks are typically uncompensated and therefore hamper a strategy's risk/return profile.
- **Embrace quality.** We believe quality is a key component of the investment process and can improve a fund's risk/return profile by smoothing out periods of underperformance.
- **Stay straightforward, but shrewd.** We strive to build funds that are easy to understand while maintaining market savvy. The factors should be well constructed, using combinations of signals in an effort to improve success across business cycles. We believe examining various measures of a factor, such as different indicators of value and quality, can help reduce the volatility that may result during periods of market stress and when relying on a single, often simple, measure. For example, a stock's price/book ratio* is one readily available and fairly simple measure of value, but it's not the only indicator and may not always be the best gauge.

Our extensive research and design efforts indicate adherence to these three pillars may improve risk-adjusted results over time. We

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believe investors should look beyond the single-factor CAPM theory guiding many investment strategies and instead focus on a multidimensional approach, which we believe offers better outperformance potential.

****Price-to-book ratio*** *is a ratio used to compare a stock's market value to its book value. It is calculated by dividing the current price of the stock by the latest quarter's book value per share.*

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

Northern Funds **2014 Tax Materials**

What?	When?	Who?
Year-end Statements	January 8	All shareholders.
Corporate DRD Letter	January 31	Corporate shareholders who may be eligible for the dividends received deduction (DRD).
Required Minimum Distribution Letter	January 31	Investors who will reach age 70½ in 2015 reminding them of minimum distribution requirements.
1099-DIV	January 31*	Shareholders in nonretirement accounts who received taxable distributions and exempt-interest dividends in 2014.
1099-Q	January 31*	Shareholders in 529 plan accounts or Education Savings Accounts (ESAs) who redeemed or exchanged shares in 2014.**
1099-R	January 31*	Shareholders who received Individual Retirement Account (IRA) distributions in 2014.
1099-B	February 15*	Shareholders (excluding those in money market funds and retirement accounts) who redeemed or exchanged shares in 2014. (Includes cost basis information.)
1042-S	March 15	All nonresident alien shareholders who received dividends or capital gains distributions from a nonretirement account or distributions from an IRA or employer-sponsored plan.
5498-ESA	April 30	ESA shareholders who made contributions for 2014.
5498	May 31	IRA shareholders who made contributions for 2014, including rollover contributions.

* Shareholders in the Global Real Estate Index Fund and the Multi-Manager Global Real Estate Fund will not receive tax information for those funds until February, as Real Estate Investment Trusts (REITs) often don't provide complete tax information until after the calendar year-end.

** Northern Funds does not offer 529 plan accounts.

If a date falls on a non-business day or holiday, the Internal Revenue Service (IRS) due date is the next business day.

Note: Northern Funds does not provide tax reporting for corporate accounts (other than S corporations), institutional accounts, and Northern Trust trust accounts.

Northern Trust to report IRA fair market values

According to Internal Revenue Service (IRS) regulations, financial organizations must report the year-end fair market value of the retirement accounts of individuals with required minimum distributions (RMDs).

If you're responsible for an RMD in the 2014 tax year, we included the fair market value of your Northern Funds IRA as of December 31, 2014, on your December 2014 year-end statement. We will report this figure to the IRS via Form 5498. If you have any questions, please call the Northern Funds Center at **800-595-9111**.

Northern Trust earns **'best private bank'** title

For the sixth-consecutive year, *Professional Wealth Management* and *The Banker* magazines named Northern Trust the "Best Private Bank in the United States." The two magazines, both published by the Financial Times Group, also named Northern Trust the "Best Private Bank for Socially Responsible Investing."

An international panel of industry professionals examined several quantitative and qualitative factors in selecting award winners. The judges said Northern Trust is one of the leading institutions in terms of innovation, client-centered strategy, and quality of advisers.

"While the customer service standards and investment strategies of competitor firms in the U.S. are improving, Northern Trust is still managing to stay at the head of the pack," said *Professional Wealth Management* Editor-in-Chief Yuri Bender, one of the judges.

To learn more, visit **northerntrust.com/best**.

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NORTHERN FUNDS

Managed By NORTHERN TRUST 125 YEARS

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.