THE NORTHERN FUNDS

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High Hopes *for* High-Yield Securities

CREDIT STRENGTHS, LARGER COUPONS FUEL INVESTOR INTEREST

The search for yield in today's relatively low interest rate environment has led many investors to high-yield securities. Even as consensus expectations for rising rates intensify, many investors are turning to high-yield bonds and non-U.S. sovereign debt for attractive return potential. Northern Trust's Richard Inzunza, senior fixed income portfolio manager, and Claire Meier, sovereign analyst, international fixed income, explain why.

There are two key underlying factors making high-yield and non-U.S. sovereign debt particularly attractive alternatives for today's yield-seeking investors:

- Strong credit fundamentals in the U.S. and Europe support the securities.
- Higher coupons help lift returns and provide a cushion against rising rates.

Strong credit backdrop

In general, credit fundamentals for high-yield securities remain strong. Since the 2008 financial crisis, many U.S. corporations have been able to refinance their maturing bonds, removing potential triggers for an increase in the default rate and injecting some stability into credit fundamentals. At the same time, these companies have been able to lower the interest rate on their debt — given the Federal Reserve's ongoing efforts to help keep interest rates low — and further improve their credit fundamentals.

On a historical basis, default rates for U.S. and European high-yield bonds are extremely low. For example, in November 2009, one year after the financial crisis erupted, the default rate for U.S. high-yield bonds was 15%, according to Moody's Investors Service, a securities rating firm. By April 2014, the U.S. high-yield default rate had tumbled to 2%. Similarly, the default rate among speculative-grade European bonds was 2.5% at the end of the first quarter of 2014, according to Moody's.

Since mid-2012, when the European Central Bank stated it would do "whatever it takes" to support the euro and the region's struggling debt markets, yields have declined. Even in some of the hardest-hit (and riskiest, from an investment perspective) countries, including Spain, Portugal and Greece, yields have steadily tumbled and bond issuance has met with healthy demand. This represents a rapid return to faith in the region's debt markets and demonstrates ongoing investor demand for yield.

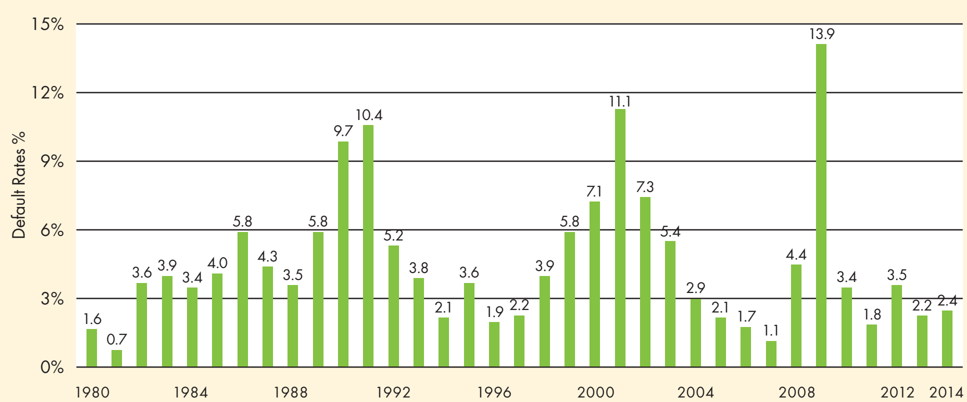
Coupons provide a cushion

The higher coupons characteristic of high-yield bonds and sovereign debt securities mean investors are not entirely reliant on price appreciation to generate attractive total return (price change plus coupon income). In addition, these higher coupons may provide a cushion in a rising-rate environment.

Since peaking in the early 1980s, U.S. interest rates generally have been on a downward trend, culminating in July 2012 when the yield on the benchmark 10-year Treasury note hit a record low of 1.38%. Most investors believe the 30-year fixed income bull market is in its final stages, and a period of rising interest rates (and, accordingly, declining bond prices) is on the horizon.

But, unlike most investment-grade bonds, high-yield bonds are less sensitive to rising interest rates. Their yields are usually high enough that a general increase in interest rates doesn't have as big an influence on spreads (the difference in yield between

Moody's U.S. Default Rate 1980–2014



Source: Moody's

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Treasury and non-Treasury securities of similar maturity) as it does for lower-yielding investment-grade bonds. Also, when rates are on the upswing, it generally means the economy is stable or improving. And when the economy is stable or improving, credit risk — the primary risk associated with high-yield bonds — typically wanes.

The benefits of active management

The high-yield market is large and complex, and it is not a liquid market, so there is no efficient way to pursue an index strategy for the high-yield asset class. Instead, a better approach may be to invest in actively managed high-yield mutual funds.

In an actively managed fund, investment managers can minimize exposure to interest rate risk — a key consideration in today's rate environment. In addition, actively managed funds seek to reduce exposure to default risk. Today's default rate is low, but in the same way the market is likely at the low point in the interest rate cycle, it also may be at the lowest point in the default cycle. Managing default risk likely will be an important factor going forward. Furthermore, actively managed mutual funds help investors avoid industry-specific risks by underweighting or avoiding industries experiencing negative pressures.

To learn more about high-yield investing with Northern Funds, including information about specific funds, risks and expenses, please call **800-595-9111** or visit **northernfunds.com**.

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.

International Risk: International investing involves increased risk and volatility.

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AVAILABLE IN AUGUST

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

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