Highlighting attribution, economic and market analysis

HIGH YIELD FIXED INCOME QUARTERLY UPDATE

March 31, 2017

SUMMARY:

- **Northern Trust's High Yield Fixed Income Fund underperformed the Bloomberg Barclays High Yield U.S. Corporate 2% Issuer Capped Index in the first quarter.**
- **The high yield market remains supported by relatively stable credit fundamentals. Trailing 12-month defaults have slowed and remain concentrated in a few sectors of the market.**
- **The evolution of new government policies, monetary policy, and commodity prices will be the primary drivers of returns moving forward.**

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PHILOSOPHY

Northern Trust's active high yield fixed income group manages portfolios in an effort to generate returns consistent with the high yield market. We use a total return approach to generate alpha through fundamental credit analysis, security selection, and sector allocation. We do not invest in equities, leverage or derivatives. Our investment process is designed to preserve capital and limit risk by constructing well diversified portfolios that are a reflection of our views on the economy, fiscal and monetary policy, and market valuations.

Over time, the Fund has generally been positioned in the mid-range of the credit quality spectrum of the market. The highest quality securities carry a material amount of interest rate risk and the lowest rated securities carry credit and market volatility risk. Over an extended period of time management of credit and interest rate risk is critical for performance.

ECONOMIC AND MARKET BACKDROP: OPTIMISM

Business and consumer optimism expanded across the globe in the first quarter. The promise of President Donald Trump's pro-growth initiatives took many economic sentiment indicators in the U.S. and abroad to their highest levels in the last decade. The high yield market, along with U.S. equities, posted strong returns against this backdrop. The pillars of the Trump plan—tax reform, reduced regulation, and fiscal stimulus—have led investors to believe the U.S. economy can break-out of the slow growth channel that has characterized this economic expansion.

Late in the quarter market optimism was put to its first test. The Republican sponsored healthcare bill to replace the Affordable Care Act was pulled from the floor of the House of Representatives. The bill's failure raised investor concerns that, despite Republican control of Congress, it may be more difficult to pass the president's agenda than previously thought without party unification and bipartisan cooperation.

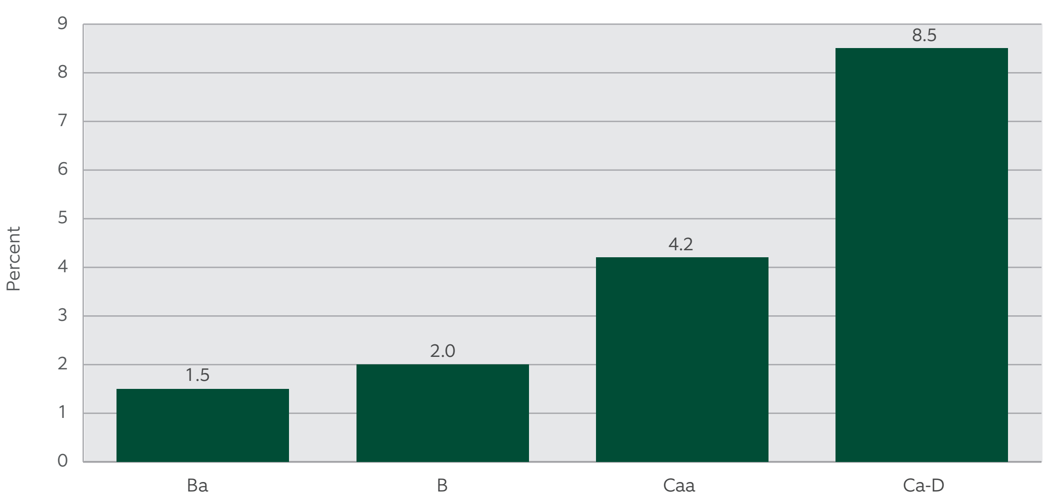
PERFORMANCE

The Trump administration's focus on reduced regulation and growth focused fiscal policy is set against a backdrop of stable economic data and a low unemployment rate. The combination of these factors could lead to faster economic growth and higher interest rates.

High yield issuers will benefit from this economic environment and are generally insulated from higher interest rates as their reduced credit risk outweighs the impact of higher rates. In our view, high yield companies generally have stable credit metrics. They enjoy moderate interest coverage and few near-term maturities as a result of an extended period of accommodative monetary policy. In this environment we believe lower quality issuers whose bonds are more sensitive to credit fundamentals and less sensitive to movements in interest rates may appreciate most. Accordingly, the Fund was underweight BB rated issuers and overweight B and CCC's throughout the quarter.

The Fund underperformed the Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index by 47 basis points in the quarter. Performance of the lowest rated securities in the Index substantially outperformed higher quality credits. The returns of the lowest rating category Ca-D exceeded the returns of CCC securities. Both of these materially exceeded the returns of B rated securities, while BB rated securities lagged behind.

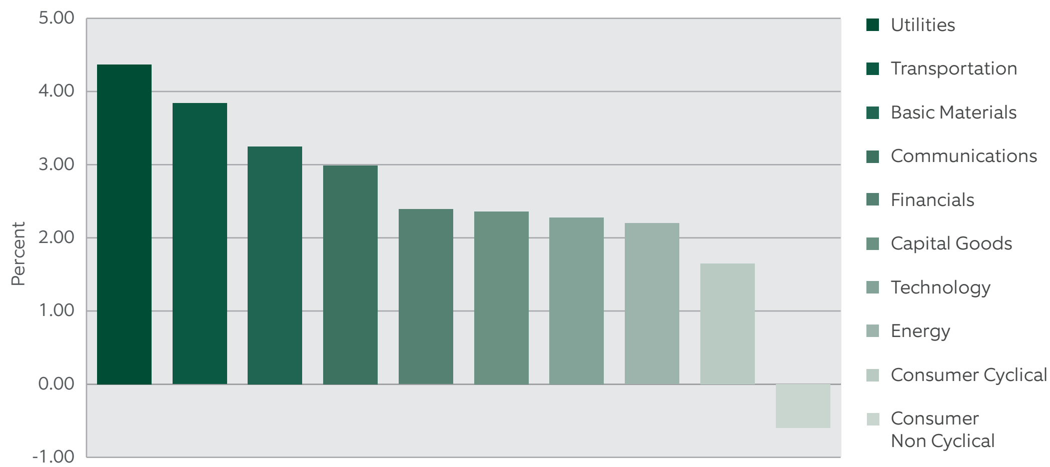
EXHIBIT 1: YTD EXCESS RETURN BY QUALITY



SOURCE: Northern Trust Fixed Income; Barclays Live

Our overweight to oil field service, banking, and metals, contributed to performance. Overweight positions in independent energy and underweight positions in media cable and pharmaceuticals detracted. The market yield-to-worst ended the quarter at 5.84%. By rating, BB's closed the quarter yielding approximately 4.52%, B's at 5.76%, and CCC's at 8.94%.

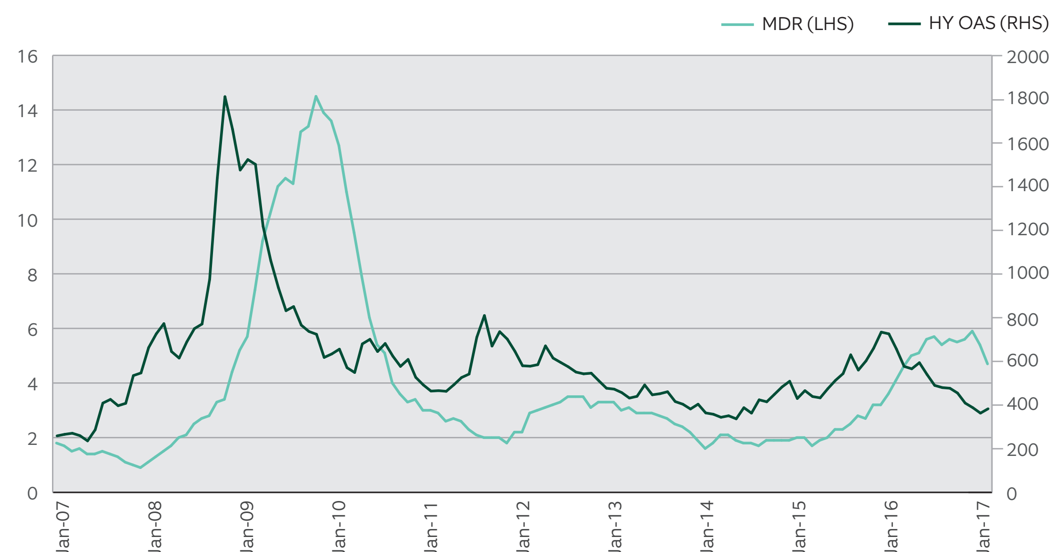
EXHIBIT 2: HIGH YIELD SECTOR YTD RETURNS



SOURCE: Northern Trust Fixed Income; Barclays Live

While commodity related sectors have been revalued over the last 12 months, there's also been a surge of bankruptcies for these firms. We believe defaults have peaked and will subside in 2017. Indeed, Moodys trailing 12 month default rate has been moving lower in the past few months.

EXHIBIT 3: HIGH YIELD INDEX OPTION ADJUSTED-SPREAD VERSUS MOODY'S DEFAULT RATE



SOURCE: OAS is from Barclays Capital 2% Capped Index, Defaults is from Moodys

The Fund maintained exposure to bank loans in the quarter in select situations that offer attractive relative value. Bank loans are an asset class that's closely aligned with high yield bonds. Both represent an extension of credit to non-investment grade borrowers and approximately 80% of high yield issuers also have bank loans on their balance sheets. These instruments are an important tool for portfolio managers that provide them additional flexibility, particularly when market volatility is high.

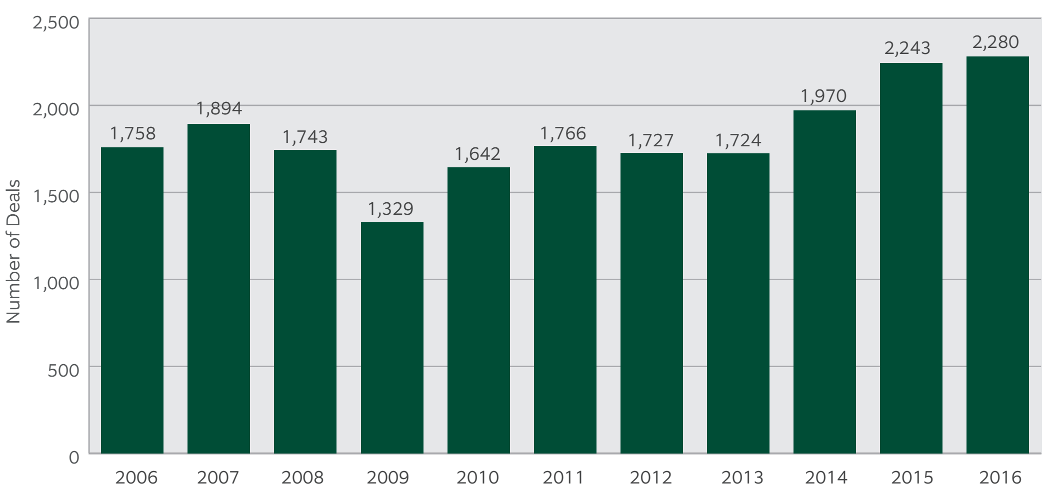
While both high yield bonds and bank loans may provide investors with the potential for more income than investment-grade bonds, a few key differences exist that we believe make bank loans a more suitable and less volatile investment. Bank loans are floating rate instruments priced off Libor. Therefore, loans effectively help mitigate interest rate risk that fixed rate bonds can't. They're also secured by the assets of the borrower and hold a senior position in an issuer's capital structure. The secured position and seniority creates an instrument with a lower level of credit risk. Generally, the reduced interest rate and credit risk tends to lead bank loans to exhibit less volatility than high yield bonds and provide more income than investment-grade bonds.

SPOTLIGHT SECTOR – SOFTWARE

In 2011, Marc Andreessen famously quipped[1], "software is eating the world." Indeed, the world's 1000 largest corporate R&D spenders have invested an increasingly larger percentage of their R&D budget on software development, amounting to 21% in 2015 as estimated by PwC[2]. In North America, the trend was even more pronounced, reaching 24%. PwC's study further found that companies who allocated at least 25% of their R&D budgets to software experienced faster revenue growth than their peers. Advances in software technology along with the desire to enhance revenue growth and remain competitive are driving this secular shift.

Interest in software has led to an active merger and acquisition environment for strategic and financial buyers, setting record highs. Volumes are widely expected to remain strong in 2017 given continued search for growth and an abundance of financing availability.

EXHIBIT 4: SOFTWARE INDUSTRY M&A DEALS



SOURCE: Software Equity Group, as of 2016

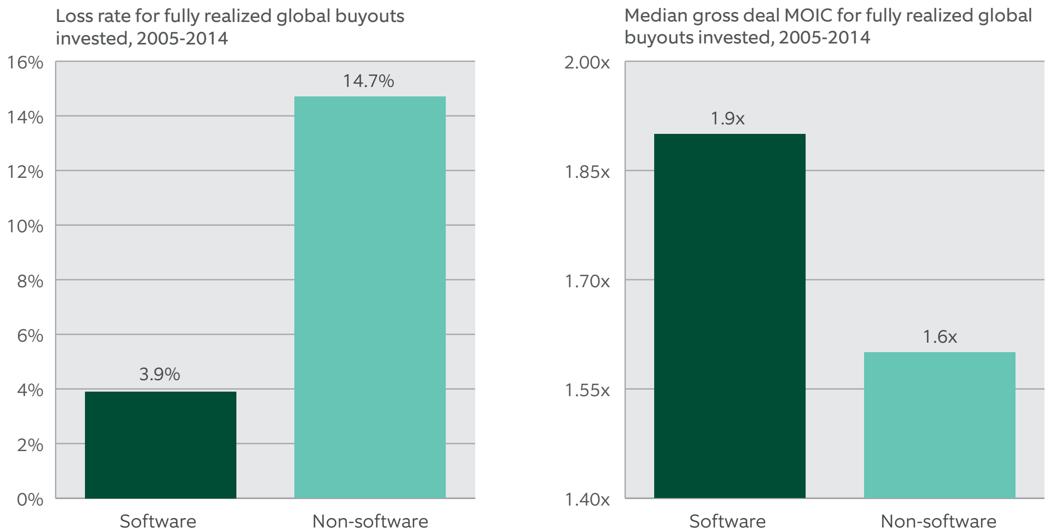
Since 2010, private equity investors have actively participated in software leveraged buyouts according to Bain & Company. A number of the larger deals led to target companies accessing the high yield market, including three of the ten largest. Currently, software comprises 1.4% of the Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index.

Software deals tend to have high leverage and purchase price multiples relative to other industries as they are actively investing in growth opportunities. This creates a drag on near-term cash flows, leading to gross leverage of 7.0x or higher. It is not unusual for the most junior bonds to have "CCC" bond ratings and high yields with this kind of leverage. Nevertheless, several factors can make securities of software companies attractive for investors:

- Strong revenue growth potential: Software companies' investments in growth initiatives generally lead to increased penetration in existing markets and expansion into adjacent services and new markets. This in turn accelerates revenue growth. As these companies mature and reach scale, margins can expand quite dramatically, culminating in strong free cash flow and deleveraging.
- Mission-critical: Many high yield issuers in the software space provide mission-critical support to their customers. At the same time, these services often comprise a relatively small portion of client budgets.
- High percentage of recurring revenues: Many software companies have contractually secured subscription based revenue models. Renewal rates are generally strong as switching to a new provider can disrupt a client's business.
- Recession-resistant: Given the mission-critical and contractual nature, revenues historically have remained stable in recessionary environments.
- Strong macroeconomic tailwinds: Ongoing technological advances suggest the software industry will continue to benefit from strong and growing demand.

In its latest global private equity report, Bain & Company noted that software buyouts generated higher deal returns and lower loss rates than leveraged buyouts of non-software firms. This can benefit high yield investors too.

EXHIBIT 5: SOFTWARE BUYOUTS LOSS RATES & MEDIAN DEAL RETURNS

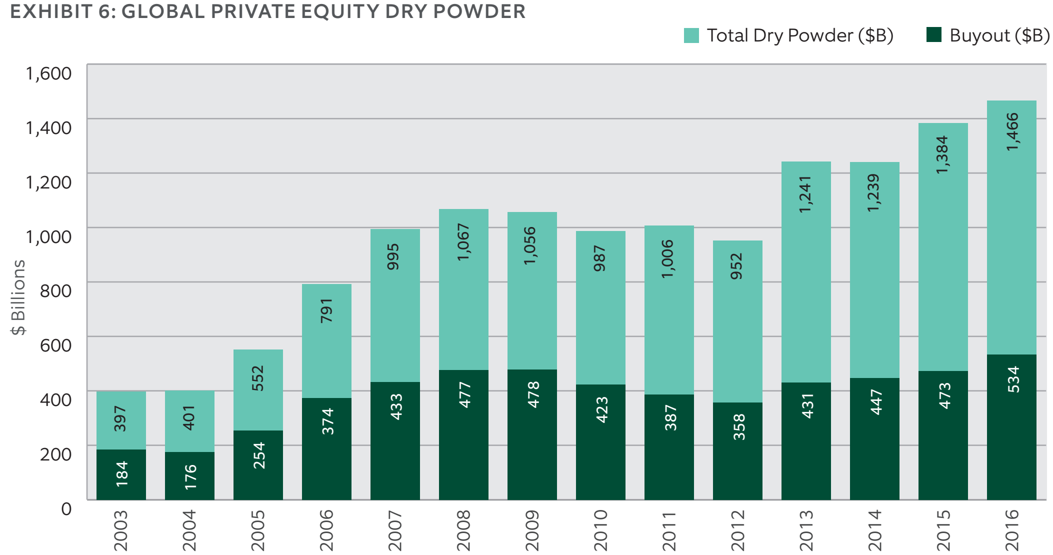


Notes: Loss rate is the equity capital invested in deals realized below cost, net of any recovered capital, divided by the total invested capital and expressed as a percentage; MOIC = multiple of invested capital
SOURCE: CEPRES; Bain & Company, Inc., "Global Private Equity Report 2017"

An additional attractive factor for high yield investors relates to the relatively high percentage of equity provided by sponsors since 2015, reaching as high as 50%. Historically, 20% to 30% was more the norm. Should this trend continue, high yield investors may benefit from a greater equity cushion, enhancing overall credit quality.

Private equity firms are expected to remain active in the software space given a record level of dry powder. Bain & Company estimates that private equity funds had nearly $1.5 trillion of dry powder at the end of 2016, with a record $534 billion allocated for buyouts. Limited partners are flush with cash as distributions have exceeded contributions since 2011. Relatively attractive returns for private equity investments in recent years have further contributed to a robust fund raising environment. According to PitchBook and Raymond James, 11 new funds exceeding $5.0 billion each were launched in 2016. Time will tell how private equity funds will deploy this capital, but secular trends suggest ongoing investment is likely in software.

EXHIBIT 6: GLOBAL PRIVATE EQUITY DRY POWDER



SOURCE: Preqin; Bain & Company, Inc., "Global Private Equity Report 2017"

One factor that could impact volume levels and deal structures depends on tax reform. An elimination or reduction in interest deductibility could lead to sponsors pursuing other funding structures.

The software sector presents attractive investment opportunities for high yield bond investors. While leverage can run high, this is somewhat offset by a combination of attractive bond yields and a unique business model that can include superior long-term growth. Of course, a few of them do not play out. As always, careful scrutiny of end markets, customer concentrations, quality and experience of management and sponsors, and covenants is critical for assessing the ability of the issuer to execute on its strategy successfully, ultimately rewarding high yield investors.

Notes

[1]Marc Andreessen, "Why Software is Eating the World," *Wall Street Journal*, 8/20/11

[2]2016 Global Innovation 1000 Study, "Software-as-a-Strategy," from Strategy&, PwC's strategy consulting business: The annual report investigates trends at the world's 1000 largest corporate R&D spenders.

TABLE 1: PERFORMANCE AS OF MARCH 31, 2017

NORTHERN FUNDS	1-Year Return	3-Year Avg. Annual Return	5-Year Avg. Annual Return	10-Year Avg. Annual Return	Avg. Annual Since Inception	Gross Expense Ratio	Net Expense Ratio	Inception Date
Northern High Yield Fixed Income[1,2]	13.07%	2.99%	5.70%	5.78%	5.94%	0.82%	0.81%	12/31/98
Benchmark: Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index	16.39%	4.58%	6.82%	7.54%	7.13%	–	–	–

Performance quoted represents past performance and does not guarantee future results. Investment return and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than that shown here. Performance data current to the most recent month end is available by calling 800-595-9111.

The Advisor has agreed to reimburse certain expenses of the Fund. The contractual reimbursement arrangement is expected to continue until at least July 31, 2017. After this date, the contractual arrangements may be terminated if it is determined to be in the best interest of the Fund and its shareholders. In the absence of fee waivers, yield, total return, growth since inception and dividends would have been reduced. Total return is based on net change in NAV assuming reinvestment of distributions.

Annualized for periods greater than one year.

[1]**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.

[2]**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.

Alpha: Measures a fund's risk-adjusted performance and represents the difference between a fund's actual performance and its expected performance, given its level of risk.

Basis Points (bps): Unit of measure used in quoting yields, changes in yields or differences between yields. One basis point is equal to 0.01%, or one one-hundredth of a percent of yield and 100 basis points equals 1%.

Barclays U.S. Corporate High Yield 2% Issuer Capped Index is an unmanaged index that measures the market of U.S. dollar-denominated, non-investment-grade, fixed-rate, taxable corporate bonds. It is a version of the Barclays High Yield Corporate Bond Index except it limits its exposure of each issuer to 2% of the total market value and redistributes any excess market value Index-wide on a pro-rata basis.

Beta: Beta represents the systematic risk of a portfolio and measures its sensitivity to a benchmark.

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.

ERISA: Employee Retirement Income Security Act of 1974 (ERISA) enacted rules for U.S. qualified plans to help protect the retirement assets.

Option-adjusted spread (OAS) is the difference in yield between two fixed income securities (generally between a fixed income security with credit risk and a comparable treasury bond), adjusted for differences in duration and embedded options.

Yield-to-Worst (YTW) is the lowest potential yield that can be received on a bond assuming options available to the issuer are exercised.

References to specific securities within the utilities sector were made in an effort to highlight relevant news in the high yield sector during the period. For a full list of holdings for Northern High Yield Fixed Income Fund, please visits northernfunds.com. Holdings are subject to change and current and future portfolio holdings are subject to risk.

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.

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