INVESTMENT STRATEGY COMMENTARY

NORTHERN TRUST HIGH YIELD FIXED INCOME FUND

Given the recent rate hike and volatility in the high yield market, investors are concerned about the performance of their investments. Northern Trust's High Yield Fixed Income team offers their insights.

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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 potential alpha through fundamental credit analysis, security selection and sector allocation. We do not employ equities, leverage or derivatives in portfolio construction. Our investment process is designed to preserve capital and manage risk by constructing well-diversified investment portfolios that reflect our views on the economy, fiscal and monetary policy, and market valuations.

As has been noted throughout the year, the Fund has been cautious in its investments in the energy and metals/mining spaces, and our caution there remains. Both sectors were hit hard this year as commodities prices have continued to decline. From a quality perspective, the Fund this year has been more risk-averse and its quality has been higher than it has been in several years. We believe these factors are helping to keep the Fund's performance competitive in the midst of a very risk-off environment.

This year seems to be an inflection point versus what we've seen in the post-2008 crisis period. As a result of Federal Reserve's intervention, risk assets traded in a correlated manner, either up or down, starting in 2009. This phenomenon started to decouple last year. Starting with the energy sector, which peaked in June 2014, risk has been revalued across the entire market. What started with energy has bled into other commodities, basic materials, telecom, retail, pharmaceuticals and healthcare to some extent.

The Barclays U.S. Corporate High Yield 2% Issuer Capped Index currently has approximately an 8.70% yield-to-worst. The spread between the highest-quality securities and B/CCC names is at its widest in several years as investors flock to safer investments. BB-rated investments have held in well and now yield about 6.30%, but CCCs have been punished severely and now yield approximately 15.75%. The October default reading on the high-yield market was 2.8% and it's expected to finish the year at 3.3%. The majority of new defaults are expected to be in the energy sector, but we think we may see a few in the retail sector as well. A material change in the default outlook isn't expected at this time.

There have been large redemptions in the high-yield market recently. The market has seen investor outflows in four of the last five weeks for a total of approximately $6.7 billion. Despite the increase in redemptions, there continues to be liquidity in the market. Managers, including Northern Trust, have been actively trading in size during the past week without any impact on pricing and execution in the market. While passively managed ETFs seemed to be sellers in order to meet redemptions last week, we did see orderly interest from actively managed high yield funds using the weakness as a buying opportunity.

Past performance is no guarantee of future results.

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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.

Credit Quality Ratings: are a grade assigned to bonds by ratings agencies that indicate the bonds' ability to pay principal and interest in a timely fashion. As expressed in Standard & Poor's nomenclature, they range from AAA (extremely strong capacity to meet its financial commitment) to D (in default). These ratings represent the rating agencies' opinions of the quality of the securities they rate. Ratings are relative and subjective and are not absolute standards of quality.

Yield-to-Worst: The lowest potential bond yield received without the issuer defaulting, it assumes the worst-case scenario, or earliest redemption possible under terms of the bond.

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.

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