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Team Managed and Diversified

In the fixed-income market, maintaining a liquid portfolio is the key to capitalizing on market opportunities, whenever they arise. Brad Camden, co-manager of the Northern Trust Core Bond Fund, gives high priority to liquidity and diversification across the investment grade spectrum, combining disciplined macroeconomic views with proprietary credit research in an effort to provide downside protection and steady returns.

What is the history of the company and the fund? Could you give us some background information?

The Core Bond Fund is managed by Northern Trust Asset Management, a bank-owned asset manager with about $875 billion in assets at the end of 2015.

The fund's inception date is 2001; at year-end 2015 it had $237 million of assets under management. Recent asset growth has been steady on the back of consistent performance results. The fund is benchmarked to the broad Barclays U.S. Aggregate Bond Index.

What is the investment philosophy behind the Core Bond Fund?

We like to say that it takes an artful blend of investment insight and process discipline to consistently produce the predictable returns favored by investment-grade bond investors.

Our goal is to build a high-quality, well-diversified and highly liquid portfolio that generates strong and steady risk-adjusted returns. Typically used in multi-asset class applications, the Core Bond Fund seeks to provide diversification, liquidity, capital preservation, income and total return. When other asset classes are suffering, Core Bond should always act as a stabilizer.

What type of securities do you invest in?

The fund invests in investment-grade debt securities in the following sectors: U.S. Treasuries, agencies, mortgage-backed securities, credit, asset-backed securities, and commercial mortgaged-backed securities. It invests primarily in cash-only dollar-denominated issues. Occasionally, we use Treasury futures to manage duration and adjust yield curve positioning.

What differentiates you from your peers?

Our investment process and four key attributes.

First is our client mix, ranging from high net worth individuals to sophisticated institutions. Nearly all of them view fixed income as a core strategic holding. Because of this we are able to manage the fund using an extended time horizon and calibrate our investment process to consider longer-themed opportunities.

Second, we use a team approach. We don't believe in the "star manager" model. Instead, we incubate a strong bench of talent that collaborates on all our investment and portfolio decisions. Our sector portfolio management teams (e.g. rates, credit, securitized product) average 19 years of experience. As Director of Fixed Income Strategy, I serve as co-manager of the fund with Dan Personette, our Director Interest Rate Strategy. Together, we act as facilitators between the sector specialists.

Bradley Camden, CFA
Portfolio Manager

Bradley Camden, Senior Vice President of Northern Trust, is a member of the active long duration strategy team and responsible for research and implementation of several quantitative fixed income strategies. He currently co-manages the Northern Core Bond Fund, Northern Fixed Income Fund and Northern Short Bond Fund.

Prior to joining Northern Trust in 2005, Mr. Camden was a member of Northern Trust's Global Opportunities Leadership Development (GOLD) program where he completed rotations in Tax Advantage Equity Indexing, Equity Research and Fixed Income.

Mr. Camden holds a B.A. in economics from DePauw University. He is an active CFA® charterholder and a member of the CFA Institute and the CFA Society Chicago.

"When other asset classes suffer, the investment grade bond portion of the portfolio should always act as a stabilizer."

Third, we don't have a separate dedicated trading desk. Our sector portfolio managers also act as traders across their strategies. We find that combining these roles lets us extract important information that leads to better investment decisions. This is especially the case given today's challenging market-making dynamic.

Fourth, our investment decision-making is integrated across Northern Trust's broad range of fixed income strategies, be they active, passive or ETF. The fixed income team's experience and expertise runs the gamut from legacy passive beta to our next-generation ETFs.

Viewing asset flows and opportunities across this span regularly provides us with unique perspectives on market and credit trends that benefit all our investors. For example, proprietary quantitative tools are used to evaluate and inform our determinations of fundamental credit quality and trading liquidity.

How would you describe your investment process?

The goal of our investment process is to construct a well-diversified, high-quality, and liquid portfolio that generates consistent strong risk adjusted returns in any market environment.

We employ a disciplined top-down/bottom-up investment process. Our macro views are developed by a team of senior investment professionals from fixed income and other asset classes who meet regularly (weekly, monthly or annually, depending on purpose) to develop and refine "house views" on growth and inflation and on monetary, fiscal and regulatory policies.

The top-down output from this macro process is shared with the fixed-income portfolio managers and sector specialists. They in turn meet weekly to consider and reconcile the macro outputs with their own bottom-up perspectives. It is important to note that the portfolio managers are not required to follow the house views.

The weekly Portfolio Strategy forum has two purposes: affirm or identify high-conviction, non-consensus investment outlooks, and, decide how best to position the portfolios using duration/curve, sector allocation and security selection levers. Evaluating current portfolio constructions against evolving in-house macro and credit research outputs is an essential element of our portfolio management process.

For example, in January 2016 the portfolio strategy group spent considerable time analyzing why credit spreads had unexpectedly widened. Ultimately, this group determined that the spread widening was driven by technical considerations more than fundamental factors. This led us to increase allocations to credit at the expense of Treasuries benefiting performance.

How is research and decision-making organized? What are the most important factors behind the macro scenario?

Proprietary credit research is a key component of our investment process. We employ 13 research analysts, divided between Financials and Industrials, averaging 14 years of experience.

The research process begins with analysts screening the credit universe for names that fit the portfolio objectives. We analyze credit fundamentals, market liquidity, industry and relative-value considerations in an attempt to identify worthy credits. Next, analysts dive deeper into the credit fundamentals and make recommendations to the portfolio management team. The research team maintains a list of 500–700 approved issuers and provides an internal rating on each security.

Before a credit idea becomes a holding, it must pass the credit screening process and be reconciled with the portfolio management team's investment outlook. It also will be assigned a specific role in the portfolio. Possible roles include diversifier, income generator or total return play. Ultimately, the portfolio manager has the final say about whether an issuer is added or removed from the portfolio.

Every aspect of our investment process is important. However, at different times in the economic cycle or credit cycle an input may increase or decrease in importance. One element we pay very close attention to is investment horizon. Examples include understanding when and if monetary policy might change or how the political or regulatory timeline might influence future GDP.

In our experience, the fixed-income market usually provides only one or two opportunities a year to make a significant bet against consensus expectations. The goal of our investment process is to identify these opportunities at an early date and provide the conviction to act on the insight. Without a strong investment process and understanding of the investment time line, it would be difficult to generate strong performance.

How has your process evolved over time? What are the key changes since the onset of the financial crisis of 2008–2011?

Prior to the financial crisis, our portfolios held more concentrated positions and thus bore more idiosyncratic risk.

The crisis forced us to take a fresh look at our investment process. We spent considerable time discussing how an anticipated environment of below-trend growth and disinflation with record low nominal and real interest rates might impact active fixed income management. Part of our review included a deep dive into the drivers of fixed income portfolio returns.

We determined that the new "lower for longer" interest rate backdrop had re-ordered these drivers. Specifically, security selection had become the least influential driver and duration/curve positioning and sector allocation had become more dominant.

These insights directly impacted our portfolio construction process, leading us to put greater emphasis on duration/curve and sector allocation decisions while actively diversifying our credit holdings. Our portfolios contain about 325 credit securities today compared to 150 pre-crisis.

New technology has helped us manage this change. Better portfolio management tools with integrated risk management systems provide operational improvements that make it easy and efficient to hold more securities. In addition, the rise of electronic trading platforms gives us instant access to over 45 dealers with a click of a button.

Also, as sell-side balance sheet space becomes scarcer due to crisis-induced regulatory changes we have found it advantageous to trade in smaller block sizes. More diversification results in greater portfolio flexibility. Holding liquid securities allows us to quickly respond to market opportunities whenever they arise. Overall, the changes we've made to our investment process have resulted in better returns with reduced risk.

Could you provide some examples of current or historical holdings? How does the macro view affect holdings?

Sector allocation takes precedence over security selection in managing our portfolios. Once we choose to invest in a sector, we then have to decide how much risk we want to take in that specific sector and select the best combination of issuers. For example, we recently decided to add more exposure to the energy and commodity space.

However, given percolating concerns about downgrade risk it was important to select the right issuer mix. Working with credit research we focused on adding multiple high quality industry leading names. By adding numerous issuers to the portfolio versus buying one or two concentrated positions we expect over time to generate stronger risk adjusted returns.

Macro "house views" are important elements in fixed income's overall investment process but are not considerations in the credit analyses conducted by our research team. Typically, these proprietary opinions are framed by either the analyst's own outlook or the consensus expectation.

For example, a topic much discussed by our macro group over the past 18 months had been whether or not the decline in petroleum prices would boost domestic consumption and the broader U.S. economy. The macro group's conclusions leaned constructive.

However, we analyzed the situation differently. After dissecting payroll data, wages, drivers of inflation, retail sales, and listening to our analysts' opinions on the consumer and energy spaces, we were unable to find a scenario over our investment horizon that looked constructive for economically sensitive issues. Therefore, we sold our cyclical names and moved to more defensive credits.

What is your portfolio construction process?

Our weekly Portfolio Strategy committee meeting starts with a review of any updates to the macro views after which the sector specialists discuss and challenge these views. The specialists also vet any macro changes against their own quantitative and qualitative analyses to recommend/affirm either a buy or sell of their sector. The meeting's objective is to make sure we correctly assess the big positioning decisions while taking the smallest risk needed to meet the portfolio's objective.

Once the portfolio targets are set, the sector specialists implement the strategy. As co-manager of the Core Bond fund, my role is to coordinate and monitor the individual sector teams and to make sure that as we rotate sectors and buy or sell individual securities everything comes together in a cohesive package.

Northern Funds Core Bond Fund

Company	Northern Trust
Symbol	NOCBX
Address	50 South La Salle Street Chicago, IL 60603
Phone	800-595-9111
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Source: Company Documents

Typically, our duration ranges from +/-20% of the benchmark and historically we've allocated about 30–35% of our portfolio to corporate bonds, 20% to Treasuries, 25–30% to agency mortgages, and a combination of 20% in high quality commercial mortgage-backed and asset-backed securities.

Security selection is delegated to the sector specialists who work closely with research analysts to identify the optimal securities to implement our big decisions. As directed, these teams actively diversify positions across issuers, maturities and ratings quality.

How do you define and manage risk?

Risk management plays an integral role in our daily decision making—standalone risk management and compliance teams are embedded in our investment process.

From the onboarding of investment guidelines, these experts are involved and have full access to our portfolios. Compliance guidelines are coded and entrenched in the portfolio management system and are monitored in real time by Compliance to make sure no guidelines or internal limits are breached.

Separate from Compliance is a team of dedicated risk management professionals who understand our business and investment process and help us manage risk. We regularly meet with both Compliance and Risk Management to review portfolio holdings, performance, and guideline restrictions.

At the portfolio manager level, we view risk on both a relative and standalone basis. We monitor our tracking error versus the benchmark, monitor sector and issuer exposures, and control our duration and curve positioning. T

There can be no guarantee the investment strategy will be successful.

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.

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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