

D RAMATIC REENACTMENT

THE BULL MARKET HAS BEEN FOLLOWING A FAMILIAR SCRIPT



“All the world’s a stage,” a famous playwright once told us.

Enter U.S. stocks, whose long-term rallies often unfold like three-act dramas.

“Each bull market is different because the economic environment is different,” says Matt Peron, director of equity research for Northern Trust. “The narrative changes. But there are enough similarities that investors can look to history for important clues about the leading characters.”

The opening scene for the bull market that started last year reads like it came straight from a writers’ workshop. After a 17-month mega-meltdown, stocks bottomed in March 2009 — a few months before the economy began to recover.

“Just as the economic textbooks would have predicted,” noted Peron.

And since history suggests this bull run could have staying power, it is worth getting to know the cast, in what is the usual order of appearance.

I ACT I: BETA MAX

Volatile stocks typically steal the spotlight during the first third of a bull market. The so-called high beta group is more linked to the economy, and includes small caps, non-dividend payers, growth stocks, companies with lots of debt and those whose credit is rated below investment-grade.

The bullish stampede that began in March 2009 was true to form, with small caps rebounding 97.21% during the next 12 months, followed by mid caps at 93.91% and large-company stocks at 71.98%.¹

High-yield bonds also took flight, gaining 63.13% during those 12 months.²

Among industry groups, basic materials, consumer discretionary and financial stocks almost always lead at this stage of the young bull’s life. The economically sensitive materials sector has beaten the S&P 500 during the first year of every bull market since 1975, while consumer discretionary and financials have outperformed more than 80% of the time.³

But since the economy is still reeling when most bulls are born, a rally in the riskiest and most growth-dependent companies might seem counterintuitive.

According to Peron, however, there’s actually method to the apparent madness. “These are the stocks that were beaten up the most during the bear phase,” he says.

Pummeled might more precisely describe the fate of the high-risk group during the global financial crisis that erupted in September 2008. By March 2009, low-quality stocks had fallen to the deepest discount relative to the overall market in at least 40 years.

Yet six months later, stocks of companies rated below investment grade had gained twice as much as their higher-quality cousins.⁴

“When investors see light on the economic horizon, they go bargain hunting,” Peron says.

Not that large caps or higher-quality companies usually get cheated. Since 1932, the S&P 500 averaged a 52.9% gain over the first year of a bull market.⁵ This is when the Federal Reserve is usually flooding the financial system with liquidity.

“A rising tide lifts all boats,” says Peron. “The smaller ones just get lifted a little higher.”

II ACT II: CHARACTER DEVELOPMENT

Second acts of three-part dramas present complications and reveal how the main characters respond to these problems.

In the middle act of a bull market, the current version of which may already be underway, investors might face similar difficulties.

“The easy money’s been made, and this is when companies are expected to deliver much better earnings,” says Peron. “Investors are trying to make sense out of the new macro-economic environment and identify the potential winners and losers.”

Although stocks continue rising in fits and starts, the middle third of a bull market typically produces the smallest gains. During the last century, the average return of the Dow industrials during Act II was 14.7%, compared to 31.1% during Act I.⁶

But as prices inch higher, so does volatility.

Assuming the Great Recession ended last summer, the American economy this

year will be in months six through 18 of the economic recovery. If history follows the usual script, there is a 77% chance that stock prices may fall 10% or more during that period.⁷ The brief pullback in the broad market earlier this year fell just short of that threshold.

Besides more modest gains and increased choppiness, other characteristics of the mid-life bull often remain remarkably similar to those in Act I. Most of the time, leadership continues to reside in smaller growth stocks within cyclical industries.

FULL CAST OF CHARACTERS

In a typical three-act bull market, all the leading characters usually get their moment in the spotlight. Growth and value stocks, as well as those from the small-, medium-, and large-capitalization sectors, take center stage for varying lengths of time. So do the permutations on each managerial style, like aggressive growth and growth at a reasonable price, or deep value and relative value.

But every bullish plot line is different and investors don’t get to see the script in advance. Besides, the most interesting part of the story might be in the subtle ways that the style-sector “characters” interact. That’s why Northern’s multi-manager mutual funds could make sense for many investors. The funds provide broad access to several major asset classes: small-, medium- and large-capitalization domestic stocks, international and emerging market equities, global real estate, and high-yield bonds. The multi-manager funds combine external managers, each with a different investment style, in ways that seek to optimize risk-adjusted performance.



Here is Northern’s multi-manager funds line up:

- Northern Multi-Manager Small Cap Fund
- Northern Multi-Manager Mid Cap Fund
- Northern Multi-Manager Large Cap Fund
- Northern Multi-Manager International Equity Fund
- Northern Multi-Manager Emerging Markets Equity Fund
- Northern Multi-Manager Global Real Estate Fund
- Northern Multi-Manager High-Yield Opportunity Fund

For more information on how Northern Trust’s multi-manager mutual funds can work for you, please contact your financial advisor or visit northernfunds.com.

Mutual fund investing involves risk, including loss of principal.



“WHEN THERE’S
NOTHING LEFT TO
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JEREMY BASKIN,
MANAGING DIRECTOR — ACTIVE EQUITY GROUP,
NORTHERN TRUST

Peron sees that storyline playing out again.

“There are signs that the economy is building momentum toward a self-sustaining recovery,” he says. “Industrial orders have picked up, and business investment typically surges at this stage as well.”

In addition to normal cyclical factors, the need to boost productivity in a slow-growth world could bode well for technology stocks.

“A lot of tech hardware is old and should be replaced,” Peron says. “So far, businesses have held back on making needed upgrades, but that could change as the recovery gathers momentum. Tech has been a star performer in recent months, yet we think it may still have farther to run.”

Which is what you would expect during Act II of a bull market, when cyclical companies and sectors typically are still occupying center stage.

“Right on cue,” says Peron.

III ACT III: GETTING DEFENSIVE

By the third and final stage of a bull market, most investors have overcome their doubts about the rally’s longevity. And even though they may have arrived late, there usually is still plenty of money to be made before the curtain falls.

During the 34 bull markets since 1907, the Dow industrials gained an average of 20.4% in the final stage.⁸

“Once investors see a self-sustaining recovery taking hold, money starts cascading into equities,” says Peron, who notes that money market and fixed-income funds have been the main beneficiaries of deep public skepticism about the economy. “Increased demand for stocks causes valuations to expand, which hasn’t happened to the normal degree so far considering the extremely low-rate environment.”

Eventually, though, the number of stocks enjoying strong up-trends starts to

wane, even as the broad-market averages climb to new highs.

The seeming contradiction in this less-is-more environment is due to the fact that the indices garnering most of the media attention — the Dow Jones industrials and S&P 500 — are comprised of large-cap stocks.

“This final stage of the bull market is usually when big companies shine,” says Jeremy Baskin, managing director of Northern Trust’s active equity group. “Investors are looking for stability and sustainable growth.”

Baskin notes that taking quantitative factors, such as momentum, into account is especially important as economic risks to the bull market creep higher.

Meanwhile, the small- and mid-cap sectors often lag at this stage. Relative strength also shifts from cyclical stocks toward defensive sectors like utilities, health care and consumer staples.

“Even as growth moderates, people still

buy toothpaste,” says Peron. “And with the market’s advance slowing, dividend-paying stocks look more attractive.

GREAT WALL OF WORRY

Peron thinks the current bull market is somewhere in its middle phase. He acknowledges that economic concerns are piled high, but cautions that all bull markets climb the proverbial wall of worry.

Potential problems include the possibility that households might keep cutting back on their spending, even if the job market stabilizes or improves. If that happens, a double-dip recession could follow, though Peron thinks that scenario is unlikely.

“There is no way to accurately predict how 300 million people will respond to the new economic circumstances,” says Peron. “Will Americans return to the high levels of personal savings that were common a generation ago, or will they spend freely again once the job market recovers? The answer lies in mass psychology, which is not something that anyone can know with certainty.”

The negative mindset of a largely jobless recovery also could continue to restrain flows into stock mutual funds, which generally remain tepid despite the torrid gains in equities during the last year.

Peron also cites uncertainty over the

impact of recently enacted healthcare legislation, worries over sovereign debt, and the possibility that monetary or fiscal policy might be tightened too soon as issues that could shorten the lifespan of the maturing bull market.

Yet ironically, what investors should perhaps fear most is the absence of fear.

“If there weren’t concerns, stock prices already would be higher,” Baskin says. “When there’s nothing left to worry about, we’re probably near a top.”

A LONG-LIVED BREED

So assuming you missed Act I of the bull market drama, is there still time to enjoy the show?

Past is not necessarily prologue, but investors can take comfort from the fact that one-act bull markets are rare.

During the last six decades, no bull market has ever failed to celebrate a second birthday.⁹ Going back to the Great Depression, bull markets have survived an average of slightly more than four years, according to Standard & Poor’s.¹⁰

Even though the economic context is different this time, the storyline has been playing out in a fairly typical manner. Certainly, the early reviews have been positive.

“The first six months of the rally were the strongest since 1933,” Peron noted.

Yet bull markets don’t conform to any

timetable. Investors don’t get a program and the house lights don’t flash when a new act is about to begin.

“There are subtle clues that professional managers monitor, and these clues can be very helpful in positioning portfolios to grab the bulk of the relative strength,” Peron says. “But the transitions often are only clear in hindsight.”

Just as you’d expect from a good drama. ■

Past performance is no guarantee of future results.

It is not possible to invest directly in an index.

¹ Northern Trust.

² Northern Trust.

³ Ned Davis Research, Inc. “S&P 500 Sector Leadership After Recession End, 1975-2002; Standard & Poor’s. “Global Equity Strategy: U.S. Sector Watch.” March 5, 2010.

⁴ Northern Trust. “Investment Strategy Commentary.” September 2009.

⁵ Northern Trust, from Bloomberg terminal.

⁶ Ned Davis Research, Inc. “Chart of the Day.” September 9, 2009.

⁷ Ned Davis Research, Inc. “Investment Strategy.” January 2010.

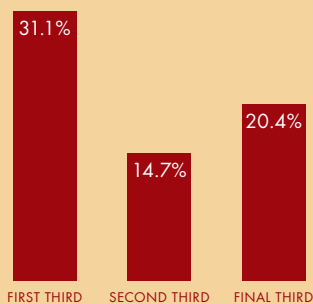
⁸ Ned Davis Research, Inc. “Chart of the Day.” September 9, 2009.

⁹ Standard & Poor’s. “Global Equity Strategy: U.S. Sector Watch.” March 5, 2010.

¹⁰ Standard & Poor’s. “Global Equity Strategy: U.S. Sector Watch.” March 5, 2010.

ACTING UP...

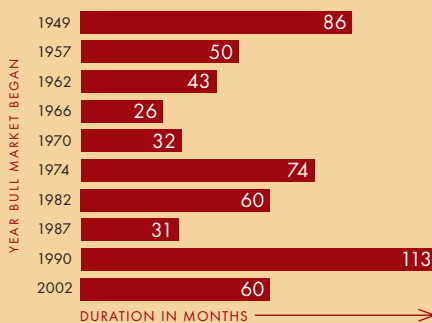
Average return of Dow Jones Industrial Average during three stages of bull markets; 1907–2007



Source: Ned Davis Research, Inc.

...HANGING AROUND

Length of bull markets, in months



Source: Standard & Poor’s



Before investing, you should carefully read the prospectus and consider the investment objectives, risks, charges and expenses of Northern Funds. A prospectus with this and other information may be obtained at **800-595-9111** or northernfunds.com.

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