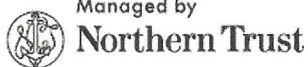


## Northern Funds Small-Cap Value Fund Profile





## Northern Funds Small Cap Value Fund

Well-diversified portfolio seeking to invest in higher-quality small companies at attractive prices

Robert Bergson, CFA, manages the Northern Funds Small Cap Value Fund (NOSGX) and is a Senior Vice President at Northern Trust Chicago. With a risk-sensitive investment perspective, Bergson seeks to access the strong potential of small companies through a long-term approach using quantitative research and analysis. With over 17 years of investment experience and over 10 years managing the Fund, Bergson believes that a prudent approach to bottom-up stock selection should focus on finding reasonably-priced, but profitable companies, while avoiding companies with signs of distress. As Bergson says, "I don't buy stocks whose prices seem to be either too good or too bad to be true. Avoiding companies that are less likely to perform is critical in a riskier market segment, like small capitalization stocks." He also relies heavily on diversification, taking small positions in over 500 companies and limiting concentration in any one sector. Working closely with the Quantitative Active Equity team at Northern Trust, Bergson accesses the robust equity research, portfolio management and trading teams of one of the largest investment organizations in the world.

Bergson points to a central tenet of his approach to managing small cap portfolios: *"Risk must be understood and managed, and effective steps must be taken to identify and control risk exposures that are unlikely to be adequately compensated with proportionate excess returns."* Focusing on delivering against his preferred measure of investment success, Bergson strives to provide a consistently strong information ratio (excess return divided by tracking error) and the Fund's historic performance demonstrates his success in accomplishing this goal. While accepting that risk is necessary for achieving excess returns, Bergson states that *"risk should be measured and managed. Most importantly, risk should be compensated appropriately in the form of excess returns."*

Working with members of the Active Quantitative Equity Team, Bergson invests in companies where the reward/risk tradeoff is identified as most favorable – profitable companies that are reasonably priced and don't demonstrate signs of fiscal distress. The fund's core philosophy, focused on identifying opportunity in market mispricing, integrates a number of ideas into its quantitative analysis of company fundamentals.

Foremost is the recognition that the market dislocates stock prices from their underlying company fundamentals in response to despair and euphoria. The market does this with sufficient frequency and magnitude to create exploitable investment opportunities. The quantitative research and disciplined decision-making used in the Small Cap Value Fund analyzes the complex trade-offs between risk, cost and potential return. Layered on top of disciplined, fundamentally-oriented investment decision-making, is an emphasis on risk control – to deal with the underlying volatility of the small cap market – and cost-sensitive trading implementation – to address potential liquidity issues. This Fund offers a highly-



disciplined process for determining company attractiveness, based on quantitative analysis of company fundamentals, unbiased by anecdotes or emotions.

The portfolio construction process balances return, risk and transaction costs. According to Bergson, "Our goal is to balance competing elements that are important to producing consistent return premiums in the small capitalization environment – where the challenging characteristics of high volatility and above-average transaction costs place additional road-blocks in the way of a fundamentally-focused investor." On an ongoing basis, the stock ranking system identifies potential changes in the portfolio – isolating stocks that look more or less attractive based on the wide range of criteria utilized by the quantitative model. Risk analysis evaluates changes, based on daily portfolio management performance reviews, stock and factor-level attribution analysis and realized volatility. Monthly risk analysis reviews performance results; factor, stock and style attribution; and adherence to client guidelines and investment policy.

Managing trading costs provides value-added by minimizing turnover, isolating trading strategies and managing transaction costs. Based on the long-term investment horizon and the broad diversification of the portfolio, costs usually associated with trading small capitalization stocks can be controlled and minimized. Due to the portfolio construction and stock selection process, Bergson and the trading desk can implement patiently, with Northern Trust a provider of liquidity. Some of the transaction cost management tools available to Bergson and his team include: a dedicated trading desk in Chicago, quantitative transaction analysis, principal/agency trading methods and electronic connection to multiple pools of liquidity.

The Fund evaluates companies using two stock selection models. The first model uses several dimensions; valuation, momentum and earnings. Within each dimension, stock selection factors are designed specifically for the small cap value universe of companies: within valuation, stocks priced at extremes relative to fundamentals are avoided, while momentum is used to help avoid stocks where price has gotten ahead of reported fundamentals. Finally, earnings (both trailing and forecast,) are used to identify companies with higher levels of profitability. A second, independently-run, model seeks to avoid companies in distress; those exhibiting low earnings quality, liquidity characteristics suggesting greater demands for outside capital (versus organic sources) and low, or declining, sales and operating margins. As of the end of June, the fund remains fully invested, using futures to ensure adequate daily liquidity and, in most cases, with sector weightings closely aligned with the benchmark and slight overweighting in industrials and health care, and a modest underweighting in energy. The portfolio attempts to minimize return differences from sector mis-weights, although the stock selection models do result in weight differences among sectors, as valuation, or quality, may result in fewer stocks ranking within the highest "Buy" ranking category.

"We believe the consistency of the fund over time supports the validity of our approach. But the fund tends to underperform in "junk" markets," notes Bergson. Driven by weakening economic data, fears about Europe's debt and banking-sector woes, stocks tumbled in the second quarter. Despite a shift to



more-defensive sectors, quality and low valuation were not clear predictors of performance during the quarter. Lower-quality and the highest price/book and price/earnings stocks generally outperformed. Despite atypical second quarter market behavior, the Fund continues to unemotionally seek reasonably priced, yet profitable, small-company stocks while avoiding stocks of companies with signs of distress – in pursuit of strong risk-adjusted excess returns over the long-term. According to Bergson, “We’re going to stay focused – tightly-focused on value and small capitalization.”



## Fund Facts: Northern Small Cap Value Fund

|                     |   |
|---------------------|---|
| Trading Symbol:     | NOSGX   |
| Objective:          | The Fund seeks long-term capital appreciation. Any income received is incidental to this objective.   |
| Principal Strategy: | In seeking long-term capital appreciation, the Fund will invest, under normal circumstances, at least 80% of its net assets in equity securities of small capitalization (cap) companies. Small cap companies generally are considered to be those whose market cap is, at the time the Fund makes an investment, within the range of the market cap of companies in the Russell 2000 Value Index (benchmark). Companies whose capitalization no longer meets this definition after purchase may continue to be considered small capitalization companies. As of May 31, 2012, the market cap of the companies in the benchmark was between \$1.4 million and \$2.8 billion. The size of companies in the benchmark changes with market conditions. In addition, changes to the composition of the benchmark can change the market cap range of companies in the benchmark. The Fund is not limited to the stocks included in the benchmark and may invest in other stocks that meet the Investment Adviser's criteria discussed in the prospectus. |
| Minimum Investment: | \$2,500   |
| Load:               | None  |
| Net Expense Ratio:  | 1.01% (as of 6/30/12)   |

*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 contain this and other information about the funds.*

**Past performance is no guarantee of future results.**

**Diversification does not reduce risk**

**Equity Risk:** Equity securities (stocks) are more volatile and carry more risk than other forms of investments, including investments in high-grade fixed income securities. The net asset value per share of this Fund will fluctuate as the value of the securities in the portfolio changes.

**Small Cap Risk:** Small-capitalization funds typically carry additional risks since smaller companies generally have a higher risk of failure. Their stocks are subject to a greater degree of volatility, trade in lower volume and may be less liquid.

**Value Risk:** Value-based investments are subject to the risk that the broad market may not recognize their intrinsic value.

**Russell 2000® Value Index** is an unmanaged index measuring the performance of those companies included in the Russell 2000 Index having lower price-to-book ratios and lower forecasted growth values. It is not possible to invest directly in an index.

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