

# BONDS — POTENTIAL STABILITY AMIDST VOLATILITY



*Despite the significant rise in stock prices since March 2009, many investors who fled stocks in the wake of the 2007 market meltdown remain cautious, especially in view of the recent uptick in volatility. For investors seeking shelter from the turbulence of stocks or for those looking to diversify their long-term portfolios, bonds remain a potentially compelling asset class that, over time, has offered low correlation to stocks, steady returns, and a degree of inflation protection.*

**One of bonds' key strengths is their potential to provide relative stability even as the stock market copes with bouts of widespread volatility.**

## **A RETURN TO STOCK MARKET VOLATILITY**

Volatility has returned to the U.S. equity markets and with it has come renewed anxiety among investors. The notable stability and upward momentum that dominated U.S. stocks in the first quarter of 2010 came to an abrupt halt in May. First there was the stunning “flash crash” on May 6 — a one-day event that resulted in a 9.6% intraday swing in a handful of U.S. stocks. By June 30, large-cap stocks, as measured by the S&P 500, had tumbled 15.3% from their peak on April 23. In addition, midcap and small-cap stocks, as measured by the S&P MidCap 400 and the S&P SmallCap 600 — although still up for the year — had each fallen by more than 16% since April 23.<sup>1</sup>

What is fueling investor jitters this time? The potential triggers are numerous: the European debt crisis and the declining euro; the crisis unfolding daily around the Gulf oil spill; and tensions brewing between North and South Korea. Perhaps the most unnerving factor is the uncertainty about how these issues might play out against the backdrop of a fragile economic recovery — both here in the United States and around the globe.

Regardless of the triggers, the result remains the same: Investors still wary of returning to stocks have parked their cash in money market funds and other low-yielding cash equivalents. According to the Investment Company Institute, \$2.84 trillion was being held in money, the money market assets were \$2.8 trillion as of June 30, 2010. That figure is down from the peak of \$3.92 trillion in January of 2009, yet with money market yields hovering well below the pace of inflation, holding assets in these market instruments is an improbable solution, especially when there are other options within easy reach of investors.

## **BONDS: POTENTIAL STABILITY AMIDST VOLATILITY**

While it is typically the world's stock markets that grab all the headlines, bonds have proven to be a versatile and essential element of a well-diversified investment portfolio.

Using recent market activity as an example, from the end of October 2007 — the beginning of the epic financial crisis — through June 30, 2010, stocks lost 29.2%, while bonds gained 18%.<sup>2</sup>

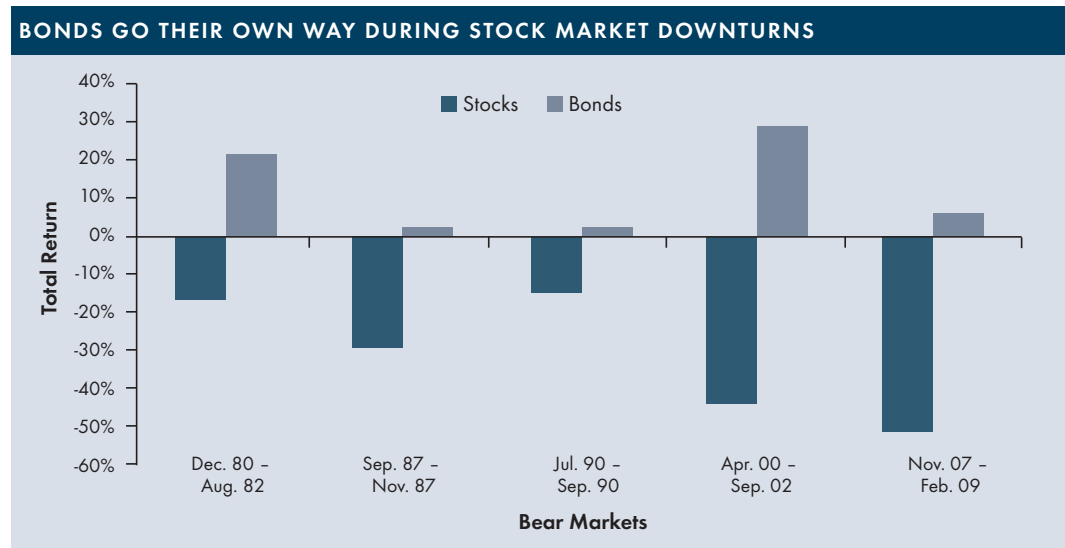
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Bonds' tendency to zig when the stock market zags — a feature technically referred to as low correlation — make bonds strong portfolio diversifiers that have the potential to compensate for the occasional declines in the value of stocks.

The argument for holding both stocks and bonds is supported by longer-term trends, too. As the chart below indicates, bonds have often performed differently from stocks during times of economic turmoil.



Sources: Standard & Poor's; Barclays Capital. Past performance does not guarantee future results.

**BONDS HAVE HISTORICALLY YIELDED MORE THAN MONEY MARKETS**

Another reason to consider bonds is their ability to deliver higher yields than money market funds and other cash equivalents not only in the current environment, but also over longer time periods (see table below). Of course, investing in bonds entails more risk than a money fund investment.

**THE BONDS HAVE IT: YIELDS OF MONEY MARKETS VS. INVESTMENT-GRADE BONDS**

Type of Investment	Current Yield	10-Year Average	30-Year Average
3-Month T-Bills	0.12%	2.56%	5.29%
6-Month CDs	0.79%	3.41%	6.07%
Investment-Grade Bonds	3.17%	4.91%	7.44%

Sources: The Federal Reserve; Barclays Capital. Past performance does not guarantee future results.

## DIFFERENT BONDS, DIFFERENT BENEFITS

In addition to combining stocks and bonds, there may be incentives to hold a diversified mix of bond investments. The major segments of the bond market — government, corporate, and municipal — often perform differently, reacting in their own way to economic developments.

Other reasons to consider holding different types of bonds in a portfolio include:

- **High quality/low risk** — Though no investment is without risk, U.S. government bonds are generally considered to be among the highest-quality income investments.
- **Tax-free income** — Municipal bonds, or “munis,” are bonds that are issued by state or local municipalities. Generally, the interest earned on municipal bonds is exempt from federal taxes and sometimes state and local taxes.<sup>3</sup> The tax-exempt component of munis makes them valuable to investors in higher-income tax brackets — even more so at a time when tax increases have the potential to occur.

Another important tax development with regard to munis: Tucked inside the 2009 stimulus legislation is a provision that exempts private activity municipal bonds issued in 2009 or 2010 from the alternative minimum tax. This provision further enhances the tax savings available to higher-income investors.

- **Higher return potential** — Corporate bonds may offer greater returns than other fixed-income securities in exchange for greater risk. For example, high-yield, or “junk,” bonds (with lower credit ratings) may provide higher returns than other types of bonds. In fact, high-yield bonds may act similarly to stocks, offering higher return potential when the economy is expanding and struggling during turbulent times.<sup>4</sup>

## CONCLUSION

As the events of the past few years have reminded us, maintaining a well-diversified portfolio is perhaps the best defense against volatility and uncertainty in the markets. Now may be an ideal time to review your portfolio holdings and — keeping your investment horizon and goals in mind — consider whether increasing your allocation to fixed income is an appropriate choice for you.

For additional insights about tax-exempt investing, contact Northern’s Advisor Consulting Group at 877-867-1259 or visit us at [northerntrustinvestments.com](http://northerntrustinvestments.com).

<sup>1</sup>Source: Standard & Poor's, The Outlook, May 26, 2010.

<sup>2</sup>Sources: Standard & Poor's; Barclays Capital. Stocks are represented by the S&P 500, an unmanaged index that is representative of the broad U.S. stock market. Bonds are represented by Barclays Aggregate Bond Index, an unmanaged index that is representative of the broad U.S. bond market. Performance is based on total returns. Investors cannot invest directly in an index. Past performance does not guarantee future results.

<sup>3</sup>Any capital gains are taxable for federal and, in most cases, state purposes. Please consult your tax advisor before making any tax-related investment decisions.

<sup>4</sup>High-yield bonds are subject to greater risks, including the risk of default, compared with higher-rated bonds.

**Past performance is not a guarantee of future results.** U.S. Treasury Bonds are backed by the U.S. government, while municipal bonds are backed by state and local governments and agencies and may not carry AAA or equivalent rating. Each person's tax situation is unique, so the tax rates used in the examples may not apply to all investors. Be sure to speak with your financial and tax advisors about your specific situation. This material does not constitute tax, legal, or accounting advice.

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**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.

**Tax-Free/AMT Risk:** Tax-exempt funds' income may be subject to certain state and local taxes and, depending on your tax status, the federal alternative minimum tax.

**Money Market Risk:** An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in a money market fund.

**There are risks involved in investing including possible loss of principal. There is no guarantee that the investment objectives of any fund or strategy will be met. Risk controls and models do not promise any level of performance or guarantee against loss of principal.**

**BEFORE INVESTING YOU SHOULD CAREFULLY CONSIDER THE FUND'S INVESTMENT OBJECTIVES, RISKS, CHARGES AND EXPENSES. THIS AND OTHER INFORMATION IS IN THE PROSPECTUS AND SUMMARY PROSPECTUS, COPIES OF WHICH MAY BE OBTAINED BY CALLING 877-867-1259. PLEASE READ THE PROSPECTUS AND SUMMARY PROSPECTUS CAREFULLY BEFORE YOU INVEST.**

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