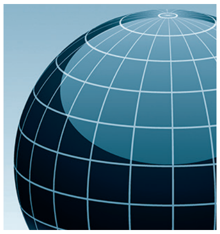
ADDING VALUE WITH ULTRA-SHORT FIXED INCOME



Ultra-short fixed income strategies can be an attractive option for any investor looking to improve returns while still seeking to limit principal volatility, even during rising interest rate environments. The ultra-short strategy covers the yield curve from one day to three years for fixed-rate securities, thus providing some of the stability and liquidity of money market funds and the higher return potential of short duration (one to five years) bond portfolios. Investors willing to increase risk exposure moderately and extend the investment horizon to 12 months or longer (reducing daily liquidity) can realize higher current yields and the potential for higher total returns with ultra-short strategies.

RETHINKING CASH STRATEGIES IN TODAY'S ENVIRONMENT

Money market funds, the traditional short-term vehicle of choice for conservative investors, face a number of constraints in the current investing environment. These constraints are keeping money market returns extremely low, and limiting their usefulness to investors who are interested in seeking incremental return in addition to limited volatility.

- **Near-zero interest rates** – Since 2008, global central banks have flooded the financial markets with liquidity in an effort to restore financial stability and set the stage for economic recovery. With interest rates near historic lows, investors seeking greater incremental returns will need to look elsewhere.
- **Money market fund reform** – The money market fund industry is going through a period of great change working to comply with the SEC's new reforms. With a need to hold high levels of overnight liquidity at rates close to zero, the opportunity cost has remained high for investors who have an investment horizon beyond a few weeks.
- **Liquidity and fixed income supply and demand** – Increased regulatory constraints on the financial services industry continue to affect not only the liquidity within the fixed income markets but also the supply and demand for securities. With recent record issuance in investment grade securities, ultra-short portfolios allow for a broader range of eligible supply and for increased diversification across broader asset classes.

MOVING BEYOND THE FINANCIAL SECTOR

Historically, investment options in an ultra-short strategy leaned heavily toward the financial sector because of the dominance of bank instruments between one- and three-year maturities. For example, between 2000 and 2007, financial institutions accounted for approximately 67% of new investment grade issuance. A shift has occurred since the global financial crisis toward increased issuance by nonfinancial issuers, led by investor demand for industrial and utility credits. Between 2008 and the end of 2014, issuance by financial institutions was down to 42% of the total. Since 2008, investors have demanded greater diversification, and those investing in an ultra-short strategy have benefited from this greater set of investment opportunities.

Source: Bank of America Merrill Lynch

ULTRA-SHORT FIXED INCOME OFFERS AN ALTERNATIVE OPTION

Typically, the primary investment objectives for short-term cash are capital preservation, liquidity and periodic income. As such, money market funds offering a stable net asset value (NAV) and full daily liquidity have appealed to cash investors. In light of the environmental challenges facing money market funds today, investors who have longer-term investment horizons or are managing to long-duration liabilities may want to consider an ultra-short strategy for a portion of their cash allocation — in other words, funds representing their second or third lines of liquidity with greater than a one-year investment horizon. Ultra-short portfolios are actively managed strategies with the goal of generating higher total returns (income plus appreciation), while still seeking to limit the risk to principal.

While ultra-short solutions vary somewhat by investment manager, the investment objectives are similar: outperform money market funds on a total return basis by taking modest interest rate, credit and liquidity risk. Whereas money market funds operate with interest rate duration of up to two months, ultra-short strategies, as shown in Table 1, tend to have durations of six months to one and a half years.

TABLE 1: CASH TO SHORT DURATION CONTINUUM

Cash	Ultra-Short Duration	Short Duration
$1 net asset value (NAV) funds comprised of high quality securities structured to preserve principal, generate income and provide daily liquidity. Money market reform coming in 2016	Total return portfolio invested in high quality instruments overnight to two or three years for fixed rate securities and out to five years for floating rate securities	Total return portfolio focusing on sector allocation, security selection and yield curve management across universe of investment grade securities generally concentrated on one to five years. Opportunities to include below-investment grade up to an allowed percentage
WEIGHTED AVERAGE MATURITY 0- to 60-day maximum	**DURATION** .5 to 1.5 years	**DURATION** 1.75 to 2.25 years
TARGET AVERAGE QUALITY Top-tier short-term	**TARGET AVERAGE QUALITY** "A" or better	**TARGET AVERAGE QUALITY** "BBB" or better

Ultra-short strategies also invest in securities outside the traditional money fund opportunity set. Securities include longer-term fixed and floating rate agencies, corporate bonds, and prime asset-backed securities. Managers limit holdings to securities rated A (or BBB) or better, and the average portfolio quality typically is AA or A, depending on the specific mandate, as demonstrated in Table 1. Ultra-short strategies also can offer the option to cross over between taxable securities and tax free municipal bonds based on a "best net after-tax" basis. This flexibility, particularly valuable to taxable investors, is not generally available in money market funds.

By constructing high quality portfolios through an investment process that emphasizes thorough credit research, broad diversification across sectors and risk management, managers of ultra-short strategies target total net returns of 25 to 50 basis points over money market funds across a market cycle.

PROTECTION WHEN INTEREST RATES RISE AGAIN

With interest rates at historic lows, investors are bracing themselves for when interest rates rise. Investors who think money market funds are safer in a rising rate environment should look at the long-term historical record of ultra-short strategies. In past rising rate environments, cash (money market) strategies have outperformed slightly longer strategies (ultra-short and short-duration) only for brief periods.

The most recent period offering meaningful insight into the effect of rising interest rates on an ultra-short portfolio is 2004 through 2006, when investors experienced 425 basis points of short-term rate increases in the United States. As noted in Table 2, performance remained positive in each of these years across a universe of ultra-short fixed income managers. The return and risk analysis of the primary benchmarks in this spectrum are shown in Table 3, demonstrating the infrequency of negative returns in the short duration space across one-year periods. For shorter investment horizons (e.g., rolling three-month performance), negative returns may occur, highlighting the importance of considering your investment horizon when choosing a strategy. While ultra-short strategies may experience short-term underperformance when rates rise, investors can attain principal preservation over these strategies' targeted durations.

TABLE 2: HISTORICAL PERFORMANCE IN CHANGING INTEREST-RATE ENVIRONMENTS

	Change in Fed Funds Target Rate	Top Quartile Enhanced Cash Manager	Median Enhanced Cash Manager
2002	– 0.50%	4.13	3.30
2003	– 0.25%	2.22	1.84
2004	1.25%	1.86	1.50
2005	2.00%	3.34	3.11
2006	1.00%	5.26	5.07
2007	– 1.00%	5.66	5.36
2008	– 4.25%	3.93	2.90
2009	0.00%	5.78	3.53
2010	0.00%	2.55	1.38
2011	0.00%	1.22	0.77
2012	0.00%	2.08	1.41
2013	0.00%	0.90	0.60
2014	0.00%	0.91	0.62

Source: Federal Reserve, eVestment

CREDIT RISK AND ULTRA-SHORT DURATION STRATEGIES

Investors in an ultra-short strategy also need to consider credit risk. Looking at the historical data as provided by Moody's, an investor can analyze the incremental risk associated with buying corporate credits with lower ratings. For example, between 1920 and 2014, the average annual issuer-weighted default rate for an AA-rated credit was 0.061%. Moving down in credit to A-rated and Baa-rated corporates increases the default rates marginally to 0.096% and 0.266% respectively. Investors can mitigate these risks by investing with an ultra-short manager that maintains a diversified portfolio and carefully manages those risks.

TABLE 3: INDEX RETURN AND RISK ANALYSIS (AS OF 6/30/15)

	3-Month T-Bill	Ultra-Short Duration Strategy	Short-Duration Strategy
Duration	0.25	1.08	1.91
PERFORMANCE			
1-Year	0.03	0.48	0.93
3-Year	0.08	0.51	0.94
5-Year	0.55	0.63	1.16
STANDARD DEVIATION			
10-Year	0.59	0.79	1.26
FREQUENCY OF A LOSS (Rolling 12 month periods – observed)			
No. of Negative Periods	4	0	1
Maximum Return	8.21	9.93	12.05
Minimum Return	0.00	0.23	– 0.17

Sources: Barclays Capital and Northern Trust

Data period: January 1990 – June 2015

In addition, ultra-short strategies can offer some back-end protection with floating rate securities in a volatile and rising interest rate environment. Corporate issuers historically have issued debt in both fixed and floating rate formats. Between 2000 and 2014, approximately 25%* of investment grade issuance was in floating rate format. These corporate floating rate notes typically reset every three months and respond favorably to rising rates, thereby protecting a portfolio against interest rate risk.

**Source: SG Americas*

A SLIGHTLY HIGHER RISK PROFILE

Employing an ultra-short strategy does not require a significant adjustment to your risk tolerance. One reason ultra-short strategies have a slightly higher risk profile than money market funds is the strategy's active nature. Most ultra-short managers actively manage their duration and yield curve position based on the prevailing and anticipated interest rate environment. Also, many managers use a barbell approach to construct portfolios; that is, holding a sizable allocation to securities maturing within 90 days as well as longer-dated bonds maturing from two to five years out.

Active ultra-short managers rely on a breadth and depth of risk management resources. Requirements include a continuous dialogue with an experienced credit research team that independently validates (or contradicts) rating agencies' baseline evaluations. Evaluation of market conditions, including liquidity and marked-to-market pricing, also are critical to risk management. Additionally, sophisticated analytical tools to measure and assess various credit and interest rate scenarios help underscore the pricing impact of a changing investment environment. A strong risk management process includes the following elements:

- Exposure controls at the security, portfolio and organizational level;
- Pre- and post-trade compliance checks against guidelines; and
- Periodic peer and independent reviews to ensure consistency and quality of process.

Careful adherence to prudent risk management based on thorough credit research can help alleviate risk.

IMPLEMENTING AN EFFECTIVE SHORT-DURATION STRATEGY

Combining money market funds, ultra-short and other short-duration solutions can lead to an overall portfolio design that meets liquidity needs, but also provides the opportunity for meaningful return without undue risk. Investors should examine and segregate those balances that require immediate liquidity versus those that are available for a longer investment horizon. Ultra-short strategies typically require horizons of at least 12 months to fully generate the benefits that justify the additional risk. Although many investors are happy to accept a lower return for the peace of mind that comes with a money market fund, other investors with a longer investment time horizon may find the opportunity for significant incremental returns well worth the modest exposure to interest rate risk and credit risk from an ultra-short strategy, even during periods of rising short-term rates.

LEARN MORE

If you would like to learn more about how ultra-short fixed income might fit into your overall portfolio strategy, or for information about Northern Trust's Ultra-Short Fixed Income Funds, please contact your relationship manager at one of our regional locations or visit us at northerntrust.com/fixed-income.

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Q 50770 (7/15)