

TAKING TAX ADVANTAGE OF MUNICIPAL BONDS

THE TAX BENEFITS OF MUNICIPAL BONDS STILL MAKE SENSE

In today's risk-averse market environment, the advantages of municipal bonds are clearer than ever, especially for investors seeking safety but more attractive yields than offered by money market investments.

Investors who flocked to money market funds in the wake of the 2008 market routing have paid the price for quality: low yields that barely keep up with inflation. But there is another choice. Munis feature high quality and offer a possible refuge from the high volatility of stocks, with a standard deviation of 9.6% between January 1, 1980, and December 31, 2009, compared with 18.3% for stocks.¹ Of course past performance is not a guarantee of future performance, but consider the other type of shelter that munis may provide: Their income is exempt from federal taxes, making them an attractive alternative for investors looking to diversify their portfolios with less volatile assets.

HIGHER AFTER-TAX YIELD

For investors, one of the most important features of municipal bonds is that their income is exempt from federal income tax. This federal tax exemption benefits individuals who buy municipal bonds as well as the states and localities issuing them. Because of the federal tax exemption, municipal bond coupon yields often translate into higher after-tax returns for investors.

In fact, on an after-tax basis, munis have historically offered higher yields than Treasuries. Of course, the potential for higher yield comes with a nominal level of increased risk vs. U.S. Treasuries. On average, the yield of muni bonds from 1958 through December 2009 was 5.83%, compared with a 4.69% average tax-equivalent yield for 20-year U.S. Treasuries — a 114 basis point spread.² In 2009, this spread grew to more than 300 basis points as investors fled to the safety of Treasuries. More recently, spreads have returned to historical levels as investors again refocus on the tax advantages posed by munis.

SPREAD BETWEEN MUNI YIELDS AND TAX-EQUIVALENT 20-YEAR TREASURY YIELD 1958 TO 2009



Source: U.S. Treasury. For illustrative purposes only. For the period from January 1, 1958, through December 31, 2009.

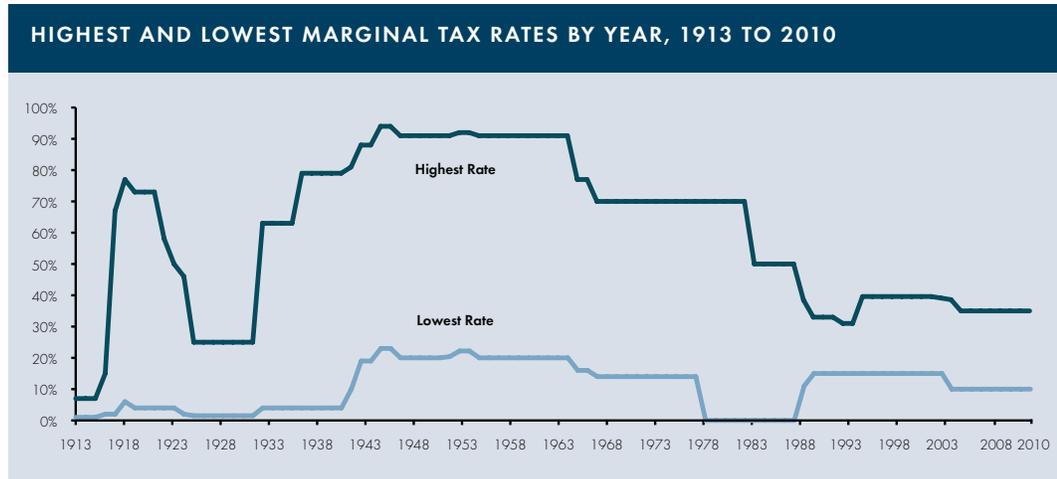
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HIGHER RATES AHEAD?

Currently, federal income tax rates on ordinary income range from 10% to 35%, depending upon income level and filing status. But these rates have changed significantly in the past — reflecting changing political and economic environments. Since 1913, when federal income taxes were first imposed, the maximum rate has varied from as high as 94% to as low as 7%. The average top rate during this period was 61%.³



Source: Tax Foundation. For illustrative purposes only.³

No one can be sure if tax rates will rise in the coming year. Certainly, mounting deficits in the face of a slowing economy and a massive bank bailout suggest higher tax rates might be possible. But history has shown that tax rate increases or decreases are more a matter of politics than economics, and it's anyone's guess as to when or what form they will take. One thing is certain: The after-tax yields of municipals versus taxable securities is compelling now and would potentially become even more attractive should tax rates increase. The table below shows tax equivalent yields for a variety of different tax rates — both current and higher-than-current tax brackets.

Federal Income Tax Bracket	MUNICIPAL BOND YIELD				
	3%	4%	5%	6%	7%
	Taxable Bond Yield Required to Match After-Tax Muni Yield				
10%	3.33%	4.44%	5.56%	6.67%	7.78%
15%	3.53%	4.71%	5.88%	7.06%	8.24%
25%	4.00%	5.33%	6.67%	8.00%	9.33%
28%	4.17%	5.56%	6.94%	8.33%	9.72%
33%	4.48%	5.97%	7.46%	8.96%	10.45%
35%	4.62%	6.15%	7.69%	9.23%	10.77%
40%	5.00%	6.67%	8.33%	10.00%	11.67%
45%	5.45%	7.27%	9.09%	10.91%	12.73%
50%	6.00%	8.00%	10.00%	12.00%	14.00%

Rates apply to ordinary income, not capital gains. Does not take into consideration state or local taxes, or rates under the alternative minimum tax. For illustrative purposes only. This is not meant to predict any future tax rates.

OTHER TAX MATTERS

Certain municipal bonds and municipal bond funds can also offer exemption from state and local taxes as well — if investors live in the state, county, and city issuing the municipal bonds. In such a case, the issue is considered triple tax-exempt. This contrasts with income from U.S. Treasury securities, which is exempt from state tax, but is subject to federal tax.

It's important to keep in mind that capital gains on municipal bonds, like gains from other bonds or securities, are currently taxed at a 15% maximum rate. This rate is scheduled to increase to 20% in 2011, unless Congress elects to modify the current rate. Additionally, interest income received from some types of municipal bonds may be subject to the alternative minimum tax (AMT). The alternative minimum tax is an additional tax that individuals in high income tax brackets with large deductions may have to pay. The AMT is designed to ensure that individuals in high income tax brackets who may not be subject to regular federal income taxes (due to large deductions) will be required to pay some federal taxes.

THE MUNICIPAL BOND ADVANTAGE

Whether or not tax rates change, municipal bonds clearly offer an attractive alternative to Treasuries and taxable bonds. Their comparatively low volatility, historically high credit ratings — and above all their tax advantage — make them an alternative worth considering for risk-averse investors.

For additional insights about tax-exempt investing, contact Northern's Advisor Consulting Group at 877-867-1259 or visit us at northerntrustinvestments.com.

¹Sources: Barclays Capital; Standard & Poor's. For the period from January 1, 1980, through December 31, 2009, the standard deviation of 12-month returns was 11.61% for long-term U.S. government bonds, 9.61% for long-term municipal bonds, and 18.30% for U.S. stocks, as represented by the S&P 500. Standard deviation is a statistical measurement that depicts how widely returns vary over a given period of time. The measurement is generally used to understand the range of returns that are most likely for a given investment. Generally, a higher standard deviation indicates a more risky investment.

²Source: U.S. Treasury. For the period from January 31, 1958, to December 31, 2009. Treasury after-tax yields assume a married couple filing jointly, with \$100,000 of taxable income in 2009. The taxable income is adjusted for 4% annual inflation in years prior to 2009. From 1958 to 2009, the highest marginal rate for this hypothetical investor was 39% and the lowest was 25%. Municipal bond yields are represented by the U.S. Treasury, state, and local government bond series, which includes general obligation bonds with maturities of at least 20 years. From January 1987 to September 1993, the 20-year Treasury bond yield is represented by the U.S. Treasury Long-Term Composite (maturities of 10 years or more), as the Treasury temporarily discontinued the 20-year bond. The chart does not consider the potential impact of the alternative minimum tax or state or local taxes.

³Source: Tax Foundation. Reflects the highest and lowest marginal tax rates on income, inclusive of surcharges. Does not include the effects of the maximum effective rate limitations used in the 1940s. The "highest" rate is the highest marginal rate applied to any tax bracket, although from 1988 to 1990, the marginal rate was lower than the highest rate for the top income bracket.

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.

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.

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

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