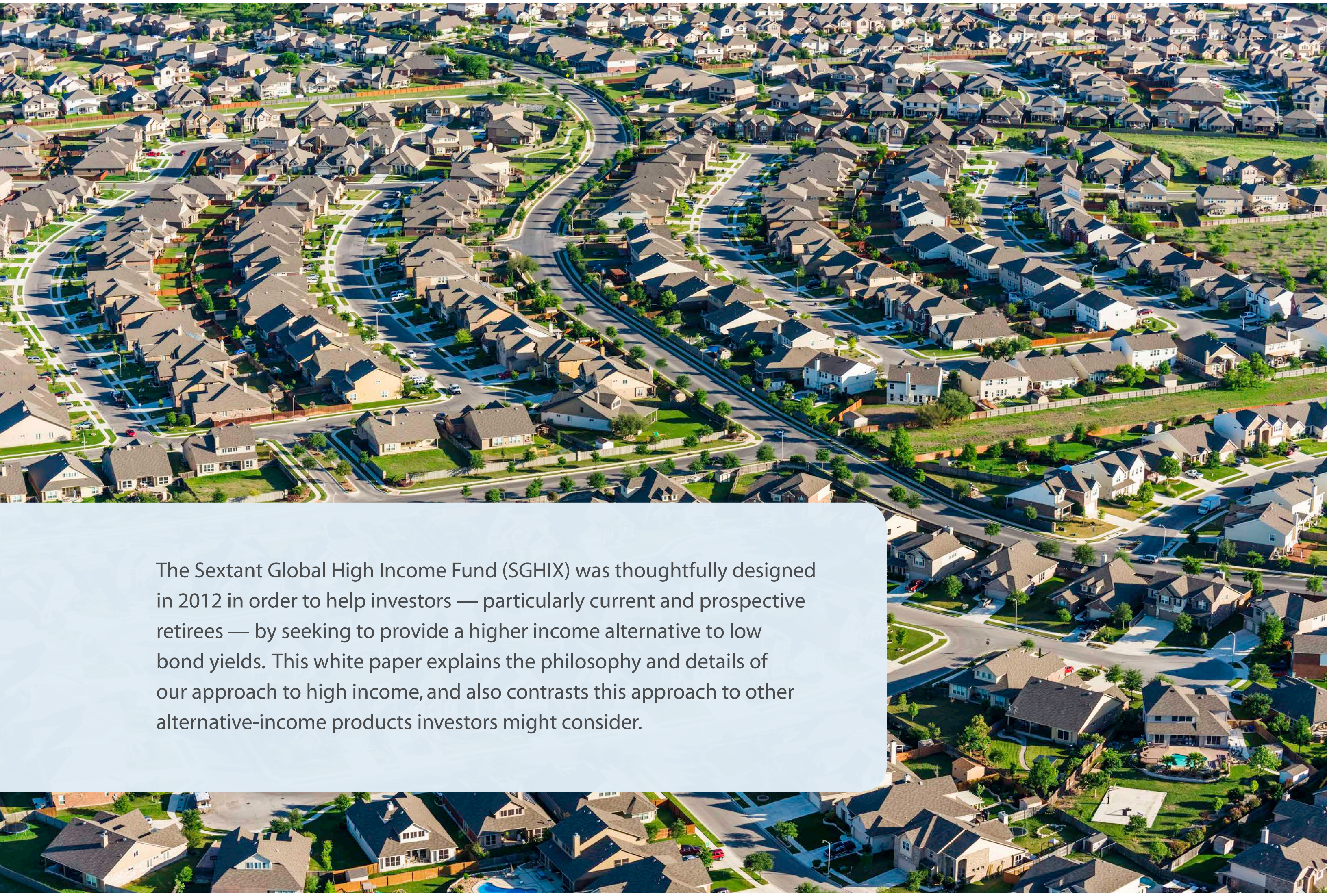
A Global, Asset Allocation Approach to High Income Investing



The Sextant Global High Income Fund (SGHIX) was thoughtfully designed in 2012 in order to help investors — particularly current and prospective retirees — by seeking to provide a higher income alternative to low bond yields. This white paper explains the philosophy and details of our approach to high income, and also contrasts this approach to other alternative-income products investors might consider.

SEXTANT
MUTUAL FUNDS

About Sextant Mutual Funds

Formed in 1995, the Sextant Funds provide basic elements to build a low-expense, balanced investment program emphasizing a value approach to investing.

The Growth Fund and International Fund invest primarily in stocks, the Short-Term Bond Fund and Bond Income Fund invest in bonds, the Core Fund invests in both stocks and bonds, and the Global High Income Fund invests in common stocks, preferred stocks, and bonds. All Sextant Funds seek tax-efficiency for their shareowners and reduced trading expenses by limiting portfolio trading.

Please consider an investment's objectives, risks, charges, and expenses carefully before investing. To obtain this and other important information about the Sextant Funds in a current prospectus or summary prospectus, please visit www.sextantfunds.com or call toll free 1-800-728-8762. Please read the prospectus or summary prospectus carefully before investing.

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A Few Words About Risk

The Growth Fund may invest in smaller companies, which involve higher investment risks in that they often have limited product lines, markets, and resources, or their securities may trade less frequently and have greater price fluctuation than those of larger companies.

The International Fund involves risks not typically associated with investing in US securities. These include fluctuations in currency exchange rates, less public information about securities, less governmental market supervision, and lack of uniform financial, social, and political standards.

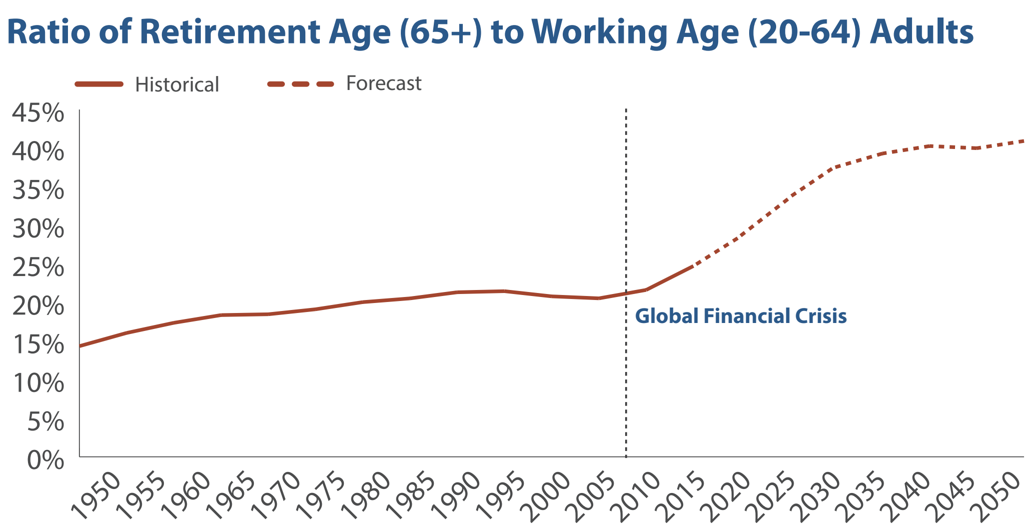
The Core Fund involves the risks of both equity and debt investing, although it seeks to mitigate these risks by maintaining a widely diversified portfolio that includes domestic stocks, foreign stocks, short and long-term bonds, and money market instruments.

Investment in the Global High Income Fund entails the risks of both equity and debt securities, although it seeks to mitigate these risks through a widely diversified portfolio that includes foreign and domestic stocks and bonds. Issuers of high-yield securities are generally not as strong financially as those issuing higher quality securities. Investments in high-yield securities can be speculative in nature. High-yield bonds may have low or no ratings, and may be considered "junk bonds."

The risks inherent in the Short-Term Bond and Bond Income Funds depend primarily on the terms and quality of the obligations in their portfolios, as well as on bond market conditions. When interest rates rise, bond prices fall. When interest rates fall, bond prices go up. Bonds with longer maturities (such as those held by the Bond Income Fund) usually are more sensitive to interest rate changes than bonds with shorter maturities (such as those held by the Short-Term Bond Fund). The Funds entail credit risk, which is the possibility that a bond will not be able to pay interest or principal when due. If the credit quality of a bond is perceived to decline, investors will demand a higher yield, which means a lower price on that bond to compensate for the higher level of risk.

The Global Financial Crisis of 2008 arrived at an inopportune time for the baby boom generation nearing retirement age. First, the large decline in equity markets (albeit temporary in hindsight) forced workers on the cusp of retirement to scale-back goals and/or reconsider their timing. It also may have caused them to make investment decisions they would come to regret, like selling some or all of their portfolio equities. Second, the prolonged decline in interest rates in the aftermath of the crisis added insult to injury with the paltry income streams available from bonds — the very income retirees might need to replace their wages.

Figure 1: The ratio of retirement age to working age adults shows how rapidly the ranks of retirees began to swell around 2010, in the aftermath of the GFC.



Source: United Nations, Department of Economic and Social Affairs, Population Division (2015). World Population Prospects: The 2015 Revision, custom data acquired via website.

SATURNA CAPITAL'S APPROACH TO HIGH INCOME INVESTING

The Sextant Global High Income Fund offers a unique approach to high income investing, beginning with an asset allocation strategy rather than adhering to a specific asset class or "style box" from which to select high income investments. This asset allocation strategy entails a set of constraints designed to allow flexibility in management of the fund's asset allocation within minimum and maximum thresholds, consistent with the high income investment objective.

Within these thresholds, the portfolio managers have ample latitude to select attractively valued securities by country or economic sector. Compared to single asset class funds, which we will talk more about later, we believe our asset allocation approach should provide superior risk-adjusted returns over a full investment cycle.

Allocation Constraints	Impact
No more than 50% in common stocks	Limits the impact of equity volatility
No more than 50% in securities of US issuers	Maintains global diversification
No more than 50% in bonds rated A3 or higher	Puts a ceiling on credit quality in order to limit portfolio managers' ability to "hide out" in low-yielding, higher quality bonds
No more than 33% in securities of emerging markets issuers	Limits the concentration of foreign investment risk that tends to be magnified in emerging markets

The other important aspect of our approach to high income investing complements our asset allocation strategy and its constraints, and that is our philosophy of, and attitude toward diversification and fundamental valuation.

We believe diversification comes not only in the form of asset class, geographic, or sectoral diversity, but in diversity of quality, cyclicality, value, and growth factors.

For example, it seems self-evident to mention that so-called "junk bonds" tend to be issued by lower-quality companies. However, higher-quality enterprises with stable revenues and earnings, but minimal growth, such as regulated utilities and pipelines, also tend to command higher yields for their common stocks. Likewise, cyclical factors can lead to widely varying yields available among various sectors and countries. We believe that diversification along the continua of quality, cyclicality, and value can add an important dimension to diversification along traditional lines.

Saturna Capital has a heritage of investing based on fundamental values, so we also favor securities we believe to be attractively valued, and we structure the portfolio to underline our convictions across the range of diversification dimensions we discussed previously. We emphasize three aspects of fundamental value in selecting securities and their weights for this fund:

MEAN REVERSION:

How far is a security's value from our appraisal of its long-term equilibrium value?

CONTRARIANISM:

Are there reasons to believe that securities prices have been influenced by excessive optimism or pessimism, and can we justify a contrary point of view?

TIME-HORIZON ARBITRAGE:

If securities prices reflect myopic overreaction to recent events or trends, do we expect these short-term issues to eventually become outweighed by longer-term trends working in our favor?

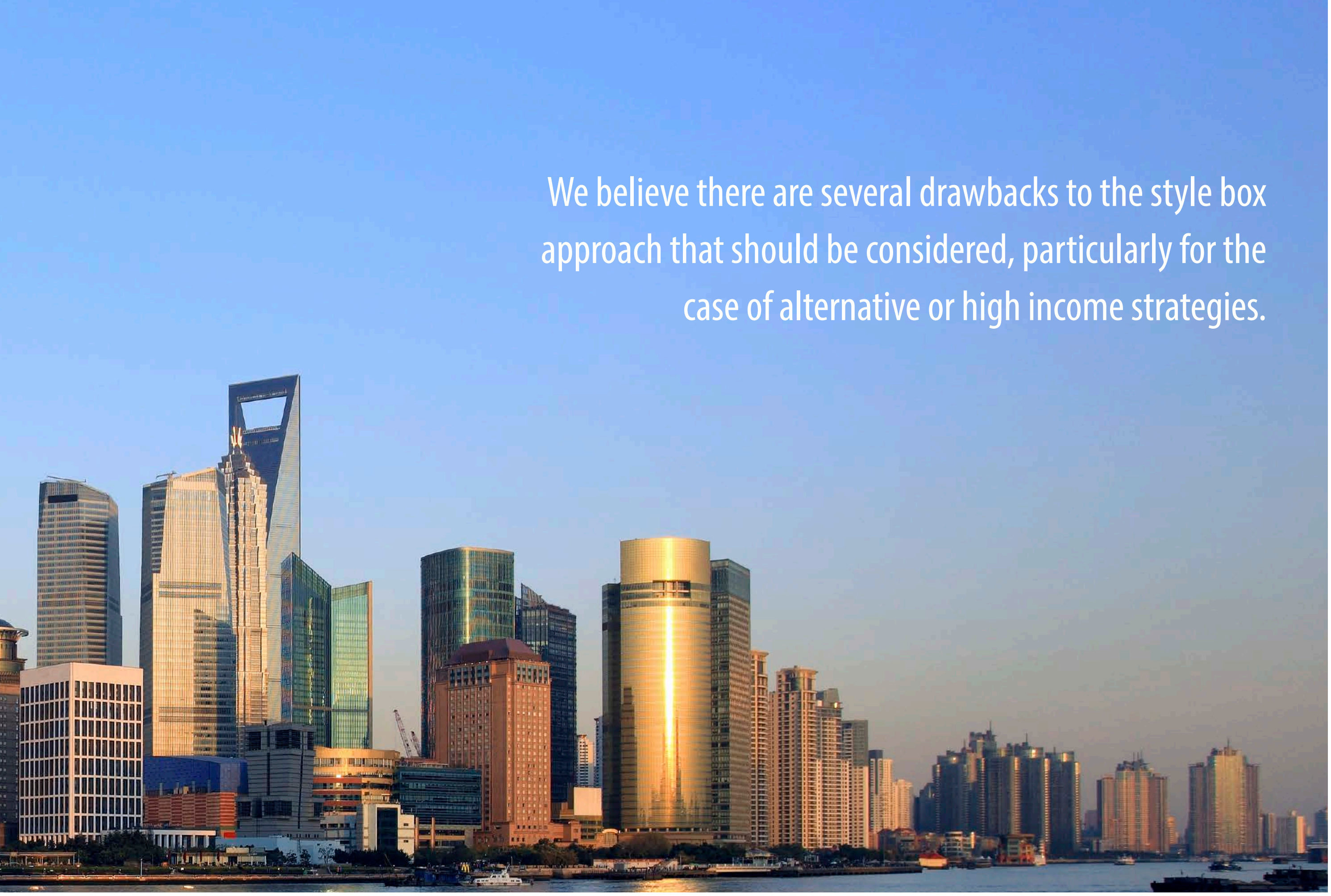
In summary, we believe our asset allocation strategy supports our objective of high income with wide diversification across multiple dimensions. And by not confining our investment selection to a single asset class or geographic region, we can better align our high-level views on relative valuation to construct our portfolios.

OTHER APPROACHES IN THE MARKET

Investors and their advisors, eager to find sources of high income, have flocked to a number of alternative income product types:

- High-yield Bond Funds
- Leveraged Loan Funds
- Equity Income Stock Funds
- Total Return Bond Funds
- Unconstrained Bond Funds

As should be evident from their descriptions, these products almost exclusively confine their investments to a single asset class, or in some cases — such as high-yield bonds and leveraged loans — to niches within these asset classes. This is typical of the traditional style box approach to building products and comparing fund managers. The general idea is that investors and advisors want to be able to evaluate and compare similar funds. In theory, it also allows them to tailor their allocations to asset classes, or even niches within asset classes.



Apples to oranges

Even within some of these product types, such as total return bond funds and unconstrained bond funds, there may be significant differences in the investment strategies employed, strategies which may include the use of leverage, derivatives, and short-selling, that make comparison of competing funds and the sources of their returns a challenge, if not meaningless. Total return funds also attempt to profit from forecasting changes in interest rates, with a secondary focus on providing income.

Plowing through dicey conditions

We also strongly believe that conditions in the high-yield bond and leveraged loan markets can make them plainly unattractive from time to time. However, fund managers faced with heavy inflows may have no choice other than to plow ahead and purchase dicey new issues. And those very inflows also suggest a lack of awareness about the prevailing market conditions among investors and their advisors.

Beginners beware

Results achieved by investors and their advisors in allocating to these markets may depend, to a significant degree, on their timing. It may make more sense for investors who wish to invest in high income securities to outsource their investment allocations to professionals who specialize in these markets and can make informed appraisals of relative value across asset classes.

Low liquidity masks risk

We believe the less liquid types of fixed income assets, such as high-yield bonds and levered loans, may present an illusion of low risk because of their low day-to-day or week-to-week volatility.

By comparison, the Sextant Global High Income Fund does not permit the use of leverage, derivatives, or short selling. Our asset allocation approach limits the extent to which we become "forced buyers" of plainly unattractive issues, since there are usually pockets within the wide net we cast where we can find attractively valued securities.

CONCERNS FOR HIGH INCOME INVESTORS

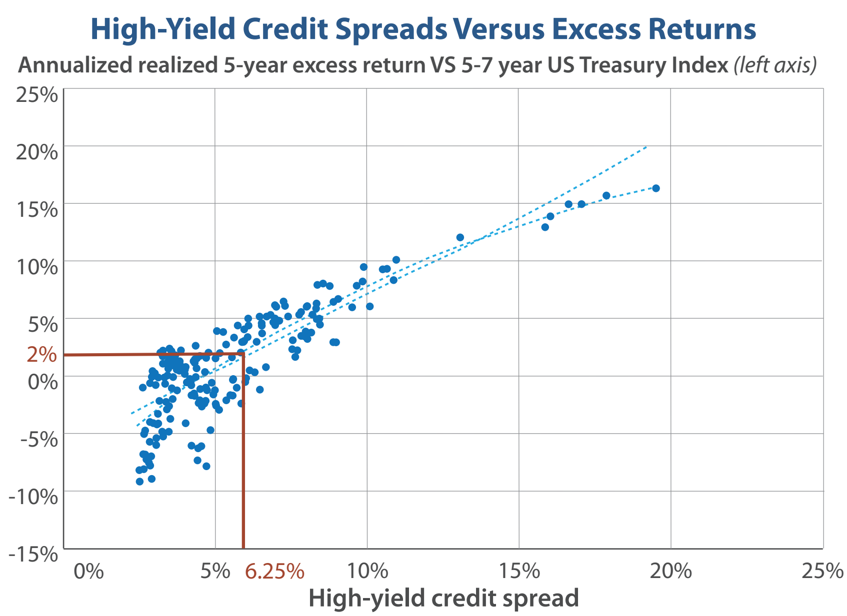
Some Risks of High-Yield Bond Funds

We believe the high-yield bond market entails risks similar to equities but that it behaves in a way that is especially procyclical, moving in line with the economy. By this we mean the market is prone to virtuous and vicious cycles. It may be possible to avoid the worst of the vicious cycles by scrutinizing fundamental attributes such as credit spreads,[1] aggregate issue quality, market structure, and investment flows in and out of high-yield funds.

Credit Spreads

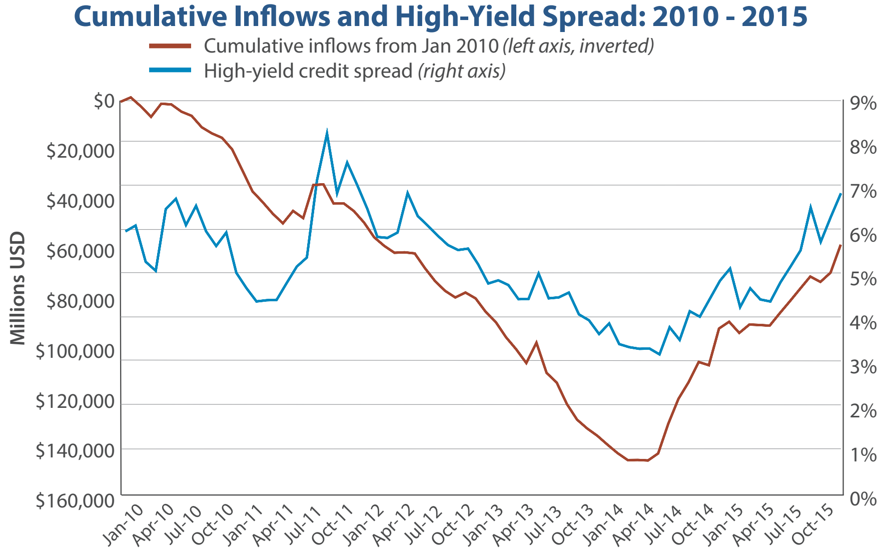
The longest running index of high-yield bonds may be the Bank of America Merrill Lynch High Yield Master II Index, which has return data going back 30 years to 1986. Over the past 30 years, the monthly returns of this high-yield index have exceeded those of the comparable 5 to 7-year US Treasury index by an average of roughly 2%, annualized. However, if we use the benefit of hindsight to analyze the relationship between the realized 5-year excess return of the high-yield index and the credit spread, we can see there has been an approximately linear relationship between credit spread and realized returns.[2] Based on the best-fit line in Figure 2, investors should require a high-yield spread of 6.25% over US Treasurys to earn a 2% excess return, on average. Where has the remaining 4.25% of yield gone? Evidently it has been given up to default losses and changes in relative valuation. Figure 2 also shows that accepting high-yield credit spreads near the low end of the historical valuation range was perilous, as excess returns dropped most steeply into negative territory there. Conversely, some flattening evident in the upper right hand portion of the chart suggests there was relatively less to gain in return for demanding a historically high credit spread as compared to the best-fit line.

Figure 2: The historical relationship between realized 5-year excess returns of high-yield bonds and the high-yield credit spread required a 6.25% spread over US Treasurys, on average, to achieve the 2% historical excess annualized return.



Source: Bank of America Merrill Lynch, via Bloomberg

Figure 3: As investors poured new money into high-yield bond funds, the yield spread dropped commensurately.



Sources: Bank of America Merrill Lynch, Investment Company Institute

We believe another important fundamental indicator for investing in high-yield bonds is aggregate credit quality. According to the Investment Company Institute, investors poured almost $150 billion (net of outflows) into high-yield bond funds between 2010 and mid-2014. As they did so, high-yield credit spreads fell commensurately.

What this data demonstrates is that the yield premium available to investors in high-yield bonds is in part dependent upon the aggregate behavior of mutual fund investors.

A more insidious impact of the volumes of money flooding in and out of high-yield mutual funds is the impact on aggregate credit quality. Mutual fund managers faced with large inflows often need to go to the new issues market for supply. Interested in securing a minimum yield to maintain a competitive fund-level yield, they may be willing to negotiate covenant details with issuers. The aggregate impact of these negotiations has led to a proliferation of so-called "covenant-lite" bonds in the high-yield market. Thus, a survey of the credit spread alone tells only part of the story, and today's spreads are probably wider than they would be if adjusted for the lack of credit protection provided by the standard suite of bond covenants.

Finally, issues in the high-yield market tend to trade infrequently, so bond valuations are typically based on observed trades of similar bonds and the general movements in interest rates. Even if the subject bond has a trade, it may only be one component of its valuation that day. Implicit within these statistical valuation techniques is some degree of averaging that smooths returns compared with securities that are priced based on their own trading,

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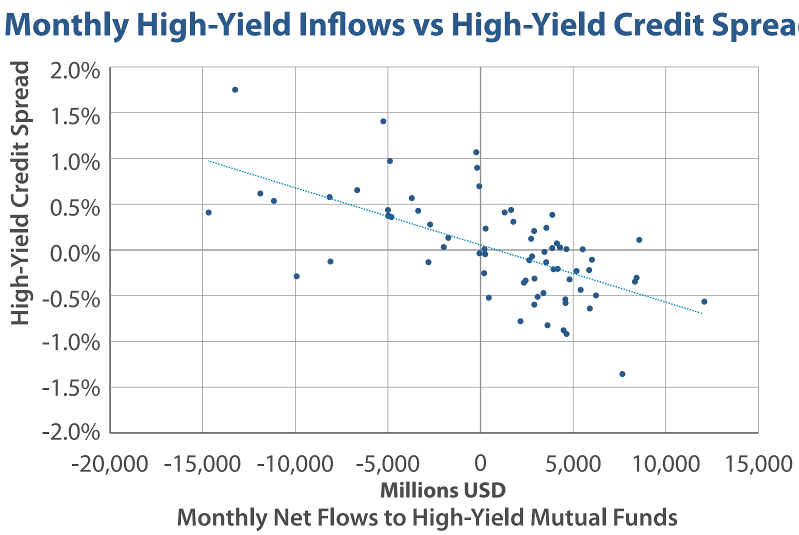
Figure 4: The monthly change in credit spread also demonstrated a decent negative correlation to the monthly high-yield fund flows, which suggests the relationship in Figure 3 above was not spurious.



Sources: Bank of America Merrill Lynch, Investment Company Institute

like equities. This smoothed valuation effect is partly responsible for the lower volatility observed in high-yield bonds when compared to equity volatility. However, the low observed volatility during benign market conditions is likely to significantly underestimate the underlying risks of these bonds, and when market conditions deteriorate, these bonds may experience sudden and large swings in value that are more commensurate with the bonds' actual level of risk.

Leveraged Loan Funds

Our concerns about the procyclicality of the high-yield bond market are amplified by the nature of the leveraged loan market. The secondary market for leveraged loans has traditionally been very thin, and the arrival of mutual funds that invest in these securities threatens to become the proverbial bull in the china shop. Even setting aside liquidity concerns faced by funds that are supposed to be able to provide their investors with daily liquidity, a flood of new cash into these markets incentivizes investment banking underwriters to scour for borrowers in places they probably shouldn't look.

About The Author

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Bryce R. Fegley, Tactician, Investment Analyst and Portfolio Manager, joined Saturna Capital in 2001.

Beginning in 2010, he spent two years as President of our Malaysian subsidiary, Saturna Sdn Bhd, directing its research and fund management operations. In 2012 he returned to Saturna Capital headquarters.

He holds a BA in English Literature from University of Colorado at Boulder and a Certification in Computational Finance and Risk Management from the University of Washington. He is a Chartered Financial Analyst® (CFA®) charterholder and holds a Certificate in Investment Performance Measurement (CIPM®).

Footnotes

[1] The credit spread is the difference in yield between the high-yield security and a low-risk government security of the same maturity.

[2] The yield and spread data we have is truncated to between March 1995 and August 2011, but it captures the last two major high-yield credit cycles.

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