

Short Term Municipal Bond

Commentary

Products Covered:

- Columbia Short Term Municipal Bond Fund

Because we expect short-term rates to rise from their current record lows, we plan to maintain the fund's defensive positioning.

Investment Risks

When interest rates go up, bond prices generally drop and vice versa. Capital gains are not exempt from income taxes. Tax-exempt investing offers current tax-exempt income, but it also involves special risks. The value of the fund will be affected by interest rate changes and the creditworthiness of issues held in the fund. Interest income from certain tax-exempt bonds may be subject to certain state and local taxes and, if applicable, the alternative minimum tax. Any capital gains distributed are taxable to the investor.

Municipal yield curve steepened in fourth quarter

During the fourth quarter, the municipal yield curve steepened as yields fell on high-grade bonds with maturities of five years or less, and yields rose on bonds with maturities of more than five years. As a result, short-term municipal bonds outperformed Treasuries as Treasury yields moved higher and short-term municipal yields fell six to 13 basis points, depending on the maturity. The Fed's zero interest rate policy drove demand for short-term municipals, as investors pulled money out of tax-exempt municipal money market funds in search of returns higher than the five-to-ten basis points they offered. Some of this money flowed into short-term municipal bonds. While the economy is showing signs of a mild recovery, high unemployment rates and low levels of capacity utilization continue to provide the Fed with the ability to maintain a zero interest rate policy without any intermediate inflationary concerns.

Municipalities struggle to balance budgets

Credit concerns rose in the tax-exempt market as municipalities continued to struggle to balance their budgets. Many state and local governments will be forced to make substantial budget cuts as sources of revenue shrink. Many of the primary sources of revenue for general obligation bonds — income tax, sales tax and property tax — are suffering from a weak consumer and housing market. Even though we expect municipalities to weather this storm through spending cuts and tax increases, we continue to take a defensive position in managing the fund, with an emphasis on revenue bonds and high-quality general obligation bonds.

In this environment, credit spreads widened over the quarter, creating opportunities to add certain lower-quality credits in situations where we believe that investors have been overly bearish on a municipality's situation and where bonds are priced at yields sufficiently attractive to justify the additional risk.

The fund underperformed its benchmark, the Bank of America Merrill Lynch 1–3 Year U.S. Municipal Index, for the fourth quarter, but performed in line with the benchmark for the year. It performed in the top third of its Lipper peer group for the fourth quarter. Although one-year performance versus the peer group was disappointing, the fund's performance was less volatile through both the downturn and recovery. The fund's longer-term rankings are still high, placing it in the sixth percentile on a three-year basis and in the 14th percentile over five years.

Sector allocation, California positions aided performance¹

An overweight in revenue bonds and an underweight in pre-refunded bonds aided performance. Revenue bonds outperformed the overall market, while pre-refunded bonds underperformed the index. In particular, an allocation to electric revenue, hospital and lease-backed bonds generated excess returns. California issuers that were bought during the quarter were strong performers. At the end of October we purchased California Economic Recovery bonds that mature in 2014. Over the next

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two months, these bonds rallied, generating a total return of more than 3.0%. In November, we purchased California Prop 1A bonds that mature in 2013, and the price on these bonds rose, generating a return of more than 3.5%. We entered the quarter with an underweight in California paper versus the index, and remained underweight even with these purchases.

GO security selection, barbelled positioning hampered performance

General obligation bonds (GOs) generated positive returns, but the GOs in the portfolio underperformed the broader GO market in general. In addition, the portfolio's barbelled positioning hurt performance as the yield curve steepened and short-term rates fell while long-term rates rose. However, we continue to believe that this strategy will prove beneficial in dampening the impact of eventual Fed rate hikes, and we continue to position the portfolio defensively in today's low rate environment.

Looking ahead

While we believe that the Fed will remain on hold in the near term, we expect the federal funds rate to rise in 2010. We believe that hikes will most likely begin in the second half of the year. However, due to the mildness of the current recovery, we expect the Fed to move at a relatively gradual pace. Because we expect short-term rates to rise from their current record lows, we plan to maintain the fund's defensive positioning so that it is appropriately positioned when rates eventually rise. We expect the fund's barbelled strategy to benefit from steepness in the yield curve between three and five years. If inflation remains subdued, as we expect, and the yield curve flattens, the current strategy should prove beneficial to returns. We plan to keep duration shorter than the benchmark, in anticipation of higher short-term rates. Because some GO credits are likely to struggle in this environment, we will continue to use our credit team to help identify undervalued issues and, even more important, to reduce or eliminate exposure to any issuers that we feel could develop severe credit problems in the future.

Please read and consider the investment objectives, risks, charges and expenses for any fund carefully before investing. For a prospectus, which contains this and other important information about the fund, contact your Columbia Management representative or financial advisor or go to www.columbiamanagement.com.

The Bank of America Merrill Lynch 1-3 Year U.S. Municipal Index is an unmanaged index that tracks the performance of investment-grade U.S. tax-exempt bonds with remaining terms to final maturities of at least one year and less than three years. Unlike mutual funds, indices are not managed and do not incur fees or expenses. It is not possible to invest directly in an index. Securities in the fund may not match those in an index.

¹ Determinations of contributors and detractors are based on performance relative to the fund's benchmark.

Lipper Inc., a widely respected data provider in the industry, calculates an average total return (assuming reinvestment of distributions) for mutual funds with investment objectives similar to those of the fund. Lipper makes no adjustment for the effect of sales loads.

Since economic and market conditions change frequently, there can be no assurance that the trends described here will continue or that the forecasts will come to pass. The views and opinions expressed are those of the portfolio managers and analysts of the affiliated advisors of Columbia Management Group, are subject to change without notice at any time, may not come to pass and may differ from views expressed by other Columbia Management associates or other divisions of Bank of America. These materials are provided for informational purposes only and should not be used or construed as a recommendation of any security or sector.

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