

Short Term Municipal Bond

Commentary

Products Covered:

- Columbia Short Term Municipal Bond Fund

By employing the efforts of our analyst team, we believe that we can find instances where it makes sense to add some credit risk, focusing on credits that have the potential for rating upgrades while seeking to maintain a high overall credit rating for the fund.

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. When interest rates go up, bond prices generally drop and vice versa. 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 rally stumbled, then continued into third quarter

The municipal market rallied in the early part of the quarter, as July reinvestment money (from coupon payments and maturities) hit the market and investors went hunting for incremental yield available in short-term securities. As a result, two- to five-year yields fell 28 to 40 basis points, with five-year rates dropping the most. One-year paper remained relatively unchanged. While spreads tightened moderately, the rally was particularly evident in high-grade bonds. By mid-August rates had fallen too far too fast, and municipal securities became expensive versus taxable securities, which resulted in a mild sell-off. Three-year maturities were hit the hardest, with those yields rising by 17 basis points. The sell-off was relatively short lived, and September brought an even stronger rally that took short municipal yields to multi-decade lows. This final rally left high-grade municipal rates 30 to 50 basis points lower on two- to five-year securities when compared to June 30. At quarter end, yields were 0.37%, 0.64%, 0.98% and 1.57% on one-, two-, three- and five-year high-grade rates, respectively. This September rally also extended to lower-rated securities, where spreads tightened by 50 to 55 basis points on A-rated paper and by 100 to 135 basis points on BBB-rated paper. By the end of the quarter, short-term municipals again looked expensive relative to the taxable markets.

In this environment, the fund's Class A shares came close to matching the return of their benchmark, the Merrill Lynch 1 – 3 Year U.S. Municipal Index, for the third quarter. For the year to date, the fund remained ahead of its benchmark.

For two primary reasons, the fund underperformed the average fund in its peer group, the Lipper Short Municipal Debt Funds Classification, for the quarter and for the year to date. First, the peer group includes some short-intermediate funds, which have longer durations by mandate, and they have benefited more from the decline in rates. Second, some competing funds focus on lower-rated securities, which have had very strong performance in this most recent rally. We took advantage of the market conditions by adding A- and BBB-rated securities to the fund. However, we did not stray from the fund's style, which is to focus on higher-quality short-term securities. Although the fund's high-quality focus resulted in a shortfall in relative performance, we believe that it is more important to stay with our conservative style, which we believe has the potential to provide more stable long-term returns than riskier strategies. In this regard, it is worth noting that the fund has beaten its peers over one-, three-, five- and 10-year time periods.

Sector weights and duration aided performance¹

The fund's sector weights and their duration helped performance relative to the benchmark. The fund was underweight in pre-refunded bonds and overweight in revenue bonds. In particular, electric revenue bonds, hospital bonds and state and local appropriation debt aided performance. Even though the fund was underweight in pre-refunded bonds, those that it did own outperformed the pre-refunded portion of the index.

Security selection also played a positive role in the fund's performance versus the benchmark. Earlier this year, we added kicker bonds, which tend to be defensive in a low-rate environment. Kickers are bonds with slightly longer maturities (four to seven years) with high coupons, which cause them to be priced to the call. This is a way to add the yield a longer bond might offer but still maintain duration risk similar to a shorter-term security. Most of the securities we focused on had calls in the two- to three-year range. During the period, these securities rallied versus the overall market.

NOT FDIC INSURED	May Lose Value
NOT BANK ISSUED	No Bank Guarantee

In addition, one of the Pennsylvania general obligation (GO) positions that we bought in June was pre-refunded in August, raising its price because it is no longer callable and raising its quality because it is now backed by an escrow of government securities. In addition, we added California GO bonds during the state's budget crisis and by the end of the quarter, this paper had also rallied and outperformed the market.

Duration, defensive positioning hampered performance¹

We have positioned the fund defensively because of our concerns that the current low-rate environment may not last. As a result, we have shortened duration relative to the fund's benchmark. While this had a negative impact on fund performance during the third quarter, we believe this positioning is prudent going forward. In another effort to keep the portfolio defensively positioned, we structured the fund to cushion the impact of rising rates by barbellizing the portfolio, using variable-rate demand notes (VRDNs) and short-term notes for our short end positions and five-year maturities for our longer positions. A VRDN is a debt instrument that represents borrowed funds that are payable on demand and accrue interest based on a prevailing money market rate, such as the prime rate. The interest rate applicable to the borrowed funds is specified from the outset of the debt and is typically equal to the specified money market rate plus an extra margin.

The longer side of the barbell posted very strong returns. However, as the markets recovered, yields on VRDNs dropped, and they became a slight drag on performance since their yields were less than the index. We avoided the riskiest VRDN securities, which are the ones that still provide the highest yield; however, they also carry the most risk because they are backed by weaker financial institutions or by structures that could cause liquidity to disappear. We feel it is prudent to maintain the fund's conservative philosophy going forward.

Market outlook

We do not think that the fed funds rate will rise from its current low until the middle to second half of next year. However, we believe that securities in the two- to three-year maturity range will sell off before the Fed actually raises the federal funds rate. An added risk to short-duration portfolios is the overall low level of rates because income is one of the major drivers of return. Today's low yields provide less of a cushion than we have historically seen in the past. As a result, we are taking a very conservative approach and keeping the fund's duration short versus the benchmark to lessen the impact when rates do eventually rise. We have adjusted the duration range so that if the market sells off, we might move to neutral versus the benchmark. However, a long-duration stance seems imprudent in light of our knowledge that rates will eventually trend higher.

In our opinion, today's ultra low rates also make it unattractive to invest in very low-rated short-term securities. Although they might offer some incremental yield, it is not sufficient to take on the added risk, particularly when you look at the "all-in yield." However, by employing the efforts of our analyst team, we believe that we can still find instances where it makes sense to add some credit risk. We would focus on

Performance data quoted represents past performance, and current performance may be lower or higher. Past performance is no guarantee of future results.

Columbia Management Group, LLC ("Columbia Management") is the investment management division of Bank of America Corporation. Columbia Management entities furnish investment management services and products for institutional and individual investors. Columbia Funds are distributed by Columbia Management Distributors, Inc., member FINRA and SIPC. Columbia Management Distributors, Inc. is part of Columbia Management and an affiliate of Bank of America Corporation.

credits that have the potential for rating upgrades. Even so, the fund's overall focus on quality in this conservative short-duration fund would generally eliminate consideration of the lowest-rated securities.

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 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.

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.

There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. It should not be assumed that any securities transactions or holdings discussed were or will prove to be profitable, or that the investment recommendations or decisions made in the future will be profitable or will equal the investment performance of the securities discussed herein.