

# Short Term Bond

## Products covered:

- Columbia Short Term Bond Fund

*Because we believe that the prospects for a modest economic recovery could push interest rates to the higher end of their current trading range, we are targeting a portfolio duration that is slightly shorter than the benchmark while maintaining a barbelled positioning.*

### Investment Risks

Bond investing poses special risks, including the credit quality of individual issuers, possible prepayments, market or economic developments, and yield and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop and vice versa.

## Sentiment and market conditions continued positive shift

Trends that were in place throughout the year continued into the fourth quarter of 2009, resulting in positive returns for the fixed-income markets. Capital market conditions continued to improve and liquidity increased for a wide range of issuers. The government's efforts to revive various sectors of the credit market continued to take hold, and yield spreads narrowed further. Agency mortgage-backed securities (MBS) have benefited from the government purchase program while asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) continued to benefit from their inclusion in the Term Asset-Backed Loan Facility (TALF) program. Corporate bond valuations rebounded strongly in 2009 after being punished in the last half of 2008.

With economic growth outweighing inflation as a concern, monetary policy remained unchanged. The Federal Reserve Board (the Fed) kept the federal funds target rate at between zero and 0.25%, where it has been since December 2008. Although the Fed made no change to short-term rates, longer-term interest rates rose during the fourth quarter and also for the year, as the large supply of Treasury issuance was absorbed by a market focused on the purchase of the non-Treasury sectors. This supply, along with a recovering economy, has caused the yield curve to steepen to very wide levels. In addition, government stimulus spending and borrowing have raised the possibility of higher inflation. However, we continue to believe that the Fed is unlikely to raise short-term rates until the pickup in growth is shown to be sustainable and that monetary policy will remain accommodative for an extended period of time, as the Fed's official commentary has stated. How long that "extended period" will last is an important question for the bond market, but the market appears to expect the Fed to remain "on hold" for at least the first half of 2010.

As market sentiment and technical factors continued to improve, lower-quality corporate bonds generally outperformed those of higher quality during the fourth quarter, as they have for the year. The Barclays Capital 1-3 Year Credit Index outperformed same-duration Treasuries by 1.26 percentage points. Short-duration AAA-rated CMBS and AAA auto ABS outperformed by 1.75 and 1.19 percentage points, respectively. Overweights in these securitized sectors helped the fund outperform its benchmark, the Barclays Capital 1-3 Year Government/Credit Bond Index.

## Overweights aided performance<sup>1</sup>

Both for the fourth quarter and for the year, all major non-Treasury sectors within the short-term bond market outperformed Treasuries. Overweights in the MBS, ABS and CMBS sectors, as well as an overweight in corporate securities, resulted in a return advantage for the fund. Within the corporate sector, exposure to finance, insurance and REIT subsectors was positive for performance, as these subsectors were among the top performers in the corporate market. With respect to credit quality, the Baa portion of the Barclays Capital 1-3 Year Credit Index performed best, generating 2.23% of excess return. However, as spreads tightened substantially over the year, the

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amount of alpha generated in each sector during the quarter declined from earlier in 2009.

During the quarter, we gradually shortened duration to be 0.2 years shorter than the duration of the benchmark, as we believe there is more room for short-term rates to move up than move down. Treasury yields rose during the month of December, with the two- to three-year Treasury yields up 47 and 57 basis points, respectively. Rising yields had a positive impact on performance relative to the benchmark. We continued to maintain a barbelled positioning to take advantage of a steeper-than-normal yield curve and better roll-down in the five-year part of the curve. Given the spread tightening we have seen in the ABS and Agency sectors, we have reduced exposure in these sectors as we increased our weights in the corporate and CMBS sectors and where we saw other opportunities to increase yield in the portfolios. This benefited performance as both corporate and CMBS sectors provided additional excess return over those of the ABS and Agency sectors.

### **High-quality bias detracted from returns**

The fund's bias toward higher-quality securities detracted from returns in the fourth quarter because lower-quality securities outperformed. However, the fund's high-quality focus served it better during the market turmoil of 2008. Approximately 10.0% to 13.0% of portfolio assets were invested in Treasuries during the period. During the quarter we made a gradual increase in the Treasury weight as the yield on the two-year Treasury hovered around the lower yields experienced earlier in 2009.

### **Market outlook**

We plan to proceed with caution as concerns about a growing supply of bonds and increased prospects for inflation in the medium to long term keep pressure on long-term rates, while continued macroeconomic weakness and accommodative Fed policy keep short-term rates low. However, we believe that the prospects for the economy to continue to recover over the next few quarters could push interest rates to the higher end of their current trading range. As a result, we are targeting a portfolio duration that is slightly shorter than the fund's benchmark while maintaining a barbelled positioning to take advantage of the steep yield curve and better roll-down in the five-year part of the curve.

In addition, the fund remains underweight in Treasuries, which we believe can continue to aid performance in the period ahead. Because corporate debt remains somewhat inexpensive by historical standards, we remain positive in our outlook for this sector. Within the corporate market, we favor financial paper from industries such as banking and insurance and utility paper with a focus on the natural gas pipeline sector. We continue to favor mortgage securities that are agency-guaranteed. Within ABS, we continue to target well-secured, very short AAA-rated auto securities. And, we remain invested in seasoned CMBS holdings that amortize fully without the need for borrowers to refinance balloon payments.

**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](http://www.columbiamanagement.com).**

The **Barclays Capital 1-3 Year Credit Index** measures the performance of investment grade corporate debt and sovereign, supranational, local authority and non-U.S. agency bonds that are U.S. dollar denominated. The Index includes investment grade U.S. credit securities that have a remaining maturity of greater than or equal to 1 year and less than 3 year and have more than \$250 million or more of outstanding face value.

The **Barclays Capital MBS Conventional 15 Year Index**, a subset of the Barclays Capital U.S. MBA Index which measures agency mortgage-backed passthrough securities (both fixed-rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC).

The **Barclays Capital ABS Auto AAA Index**, a subset of the Barclays Capital The U.S. Fixed-Rate Asset-Backed Securities (ABS) Index, covers fixed-rate ABS with the following collateral types: credit cards, autos, home equity loans and stranded-cost utility (rate reduction bonds). To be included in the index, an issue must have a fixed-rate coupon structure, have an average life greater than or equal to one year, and be part of a public offering.

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

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