CAPITAL INSIGHT

PERSPECTIVES FROM COLUMBIA MANAGEMENT | SUMMER 2009

Reexamining the Risk-Reward Equation

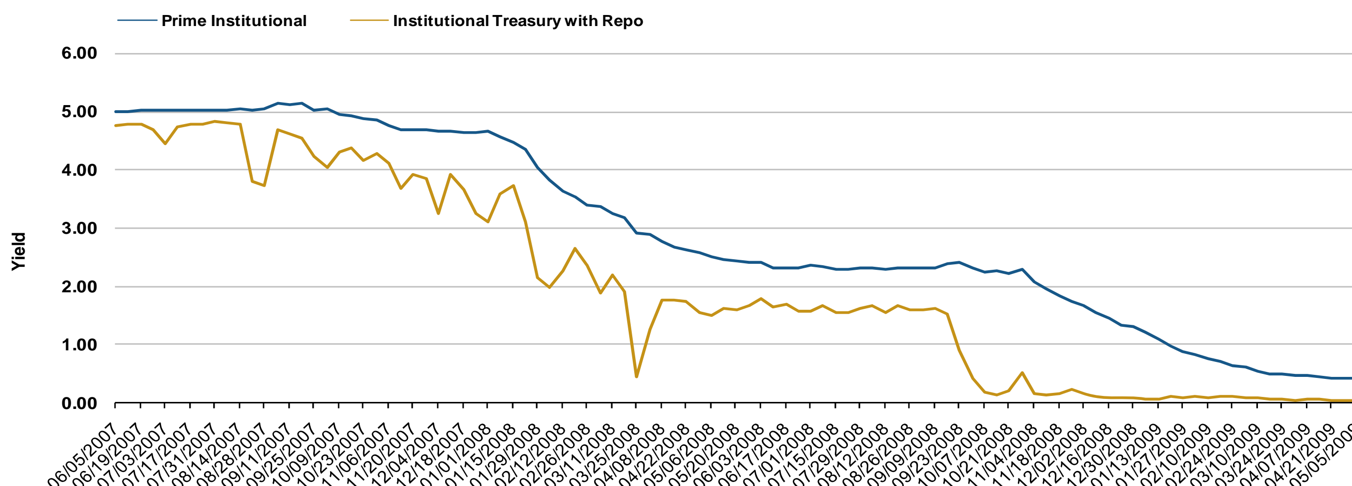
With the Short-Term Debt Markets Healing, Investors May No Longer Need to Sacrifice Yield for Stability

Once considered a safe haven during periods of market turbulence, money market mutual funds have proved no less vulnerable than any other investment to the ravages of the current financial crisis. In the wake of the Lehman Brothers bankruptcy on September 15 and the "breaking of the buck" at the Reserve Primary Fund a day later, panicked investors pulled more than $400 billion from prime money market funds. Hit with an onslaught of redemptions, fund managers were forced to liquidate commercial paper and other holdings just as demand for those assets was evaporating. Suddenly, an investment vehicle that had long served as a refuge from market volatility was at the vortex of the 2008 financial crisis.

Since the end of September 2008, the short-term debt markets have stabilized, due largely to the unprecedented actions of the federal government to guarantee money market funds' investments and inject liquidity into the short-term funding markets. Concerns about liquidity have since abated as evidenced by the increase in the weighted average maturities of many money market funds and the decision by many fund managers to reduce their allocations to cash. In this environment, it may be time for risk-averse cash investors who have shunned prime money market funds in favor of lower-yielding government funds to weigh the value of complete principal stability against the loss of return they accept when they limit themselves to funds invested solely in government obligations.

As the graph below reveals, that lost return is not insignificant. At the end of September 2008, investors who opted for a Treasury fund with exposure to repurchase agreements over a prime money market fund sacrificed nearly 300 basis points of yield. During the worst of the crisis last September, that might have seemed like a small price to pay for peace of mind. Since then, the short-term funding markets have steadied themselves. As such, we believe it is time for investors who chose to ride out the storm in government funds to consider shifting at least a portion of their cash into higher-yielding alternatives, such as prime money market funds.

Yield Differential: Prime and Treasury/Repo Funds



Source: iMoneyNet as of May 5, 2009

Past performance is no guarantee of future results.

Performance illustration is hypothetical and does not represent an investment in a specific security. The 30-day current yields are net of all fees and expenses and represent an annualization of dividends declared and payable to shareholders for the last 30 days of investment.

Bolstering the short-term debt markets

When assessing investment risk in the short-term debt markets, it is important to take into account both the scope and the impact of the federal government's effort to stabilize those markets. Throughout the current crisis, Washington has demonstrated that it would take extraordinary measures to protect the financial markets, which is exactly what it did in the fall when it launched multiple initiatives that have eased the pressures on money market funds. These measures, most of which have been extended to October 30, 2009, include:

- The Temporary Guarantee Program for money market funds, through which the government guaranteed investor assets in 2a-7 funds up to the value of the assets as of September 19, the day the program was launched. Many large financial institutions, including Bank of America, signed up for the program, which succeeded in stemming the flood of redemptions that precipitated the program. This program has been extended to September 30, 2009.
- The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), which proved beneficial to money market funds by restoring liquidity to the short-term debt markets. Under the program, eligible borrowers may secure advances from AMLF to finance the purchase of eligible commercial paper from a money market mutual fund, making it easier for the funds to meet redemptions.
- The Commercial Paper Funding Facility, a credit facility established to enhance the liquidity of the U.S. commercial paper market by increasing the availability of term funding to issuers, as well as provide greater assurance that maturing paper will be rolled. The program creates a special-purpose vehicle that serves as a funding backstop to facilitate the issuance of term commercial paper by eligible issuers. Money market funds indirectly benefit from the program because it stimulates demand for these instruments and increases liquidity.
- The Money Market Investor Funding Facility, which provides funding to a series of special-purpose vehicles established by the private sector to purchase assets from money market funds (eligible assets include certificates of deposit, bank notes and commercial paper with maturities of 90 days or less). Like the corresponding program for asset-backed commercial paper, this initiative was developed to provide direct liquidity to money market funds.

Collectively, these measures helped restore liquidity to the short-term funding markets and, in doing so, eased concerns among money fund investors about the safety of their principal. We cannot know whether the government programs launched in September are sufficient to protect investors from future dislocations, but they do demonstrate that Washington is committed to safeguarding the markets. That alone should provide comfort to cash investors.

Reassessing risk – and the cost of avoiding it

The events of last September have highlighted the fact that cash is not a "no-risk" asset class. Investors, many of whom had viewed money market funds as a "safe" investment, should now reevaluate their approach to money fund investing to ensure they are comfortable with a given fund's approach to managing cash portfolios. Significant due diligence should be performed with a focus not just on a portfolio's holdings, but also on the manager's credit research capabilities, its compliance and risk management strategies, its philosophy on liquidity and shareholder concentration, as well as on its experience managing through the business cycle. Attention also should be paid to the fund's sponsor, for example, a bank or other financial institution, because the experience and resources of the sponsor can affect the fund.

A flight to quality is perfectly understandable during a crisis as profound as the current one. That said, investors must not abandon the practices underlying a sound investment program. For cash investors, this means looking at how the cash they are investing will be used because the intended use of the funds determines the need for liquidity. Once the investor's liquidity requirements have been established, he or she can assess the appropriateness of a given money market fund based on its investment objective, historical performance, holdings, manager experience, etc. Assuming adequate due diligence has been performed, cash investors should be comfortable investing in a variety of short-term instruments, including prime money market funds.

In our view, the fear that triggered the flight to quality among cash investors last September has subsided as a result of the federal government's actions. In the current environment, limiting oneself to government funds amounts to a costly flight from the enhanced yield prime funds can offer and that most investors need to meet their long-term investment objectives.

Money Market Liquidity Enhancement Programs

Asset-Backed Commercial Paper Money Market Liquidity Facility (AMLF)

Launch date: September 19, 2008 **Expiration date:** October 30, 2009

Purpose: To restore liquidity to the ABCP market by providing eligible investors with the option to sell ABCP through eligible borrowers to the Federal Reserve Bank of Boston.

Key terms and conditions: Eligible borrowers may secure advances from AMLF to finance the purchase of eligible CP from a money market mutual fund (MMMF). Eligible borrowers: All U.S. depository institutions, bank holding companies (parent companies or U.S. broker-dealer affiliates), or U.S. branches and agencies of foreign banks. Eligible investors: MMMFs organized under SEC Rule 2a-7. Eligible ABCP: Rated not lower than A1/F1/P1 by at least two major rating agencies and issued by an entity organized under the laws of the United States or a political subdivision thereof under a program that was in existence on September 18, 2008. An eligible borrower can only borrow against ABCP purchased from a MMMF on or after September 19, 2008.

Commercial Paper Funding Facility (CPFF)

Launch date: October 27, 2008 **Expiration date:** October 30, 2009

Purpose: To enhance the liquidity of the USCP market by increasing the availability of term funding to issuers and also provide greater assurance that maturing CP will be rolled.

Key terms and conditions: Established by the Federal Reserve Bank of NY (FRBNY), the CPFF is a credit facility provided to a special purpose vehicle (SPV) that will serve as a funding backstop to facilitate the issuance of term commercial paper (CP) by eligible issuers. Eligible USCP: 3-month USCP and ABCP purchased through the FRBNY's primary dealers issued by U.S.-based issuers (including those with a foreign parent) rated at least A-1/P-1/F1 by a major NRSRO and, if rated by multiple major NRSROs, at least A-1/P-1/F1 by two or more.

Money Market Investor Funding Facility (MMIFF)

Launch date: Week of October 27, 2008 **Expiration date:** October 30, 2009

Purpose: To restore liquidity to the U.S. money markets.

Key terms and conditions: Under the MMIFF, the FRBNY will provide senior secured funding to a series of private special purpose vehicles (PSPVs) to facilitate an industry supported private sector initiative to finance the purchase of eligible assets from eligible investors. Eligible assets: U.S. dollar-denominated certificates of deposit, bank notes and CP issued by financial institutions. Each financial institution must be rated at least A-1/P-1/F1 from two or more NRSROs with a maturity of 90 days or fewer. Eligible financial institutions will be disclosed. Eligible investors: U.S.-money market mutual funds organized under SEC Rule 2a-7 (and others as determined by the FRBNY).

Temporary Guarantee Program for Money Market Mutual Funds

Launch date: September 19, 2008 **Expiration date:** September 30, 2009

Purpose: To improve investor confidence in both retail and institutional money market mutual funds.

Key terms and conditions: Established by the U.S. Treasury Department, this program provides coverage to MMMF shareholders for amounts held in participating funds as of the close of business on September 19, 2008. Any increase in the number of shares held in a specific fund after the close of business on September 19, 2008 will not be guaranteed or if a customer closes his or her account with a fund or broker-dealer, any future investment in the fund will not be guaranteed. Eligible funds: Taxable and tax-exempt money market mutual funds organized under SEC Rule 2a-7. These funds must apply for and pay a fee to participate in the program. If the number of shares an investor holds fluctuates over the time period, the investor will be covered for the number of shares held as of the close of business 9/19/08 or the current amount, whichever is less.

Temporary Liquidity Guarantee Program

Launch date: October 14, 2008 **Expiration date:** October 30, 2009

Purpose: To strengthen confidence and encourage liquidity in the banking system by guaranteeing newly issued senior unsecured debt and non-interest bearing deposit accounts.

Key terms and conditions: This program is intended to allow the FDIC to provide a 100% guarantee for newly issued senior unsecured debt and non-interest bearing transaction deposit accounts at FDIC-insured institutions. Eligible institutions: FDIC-insured depository institutions; U.S. bank holding companies; U.S. financial holding companies; U.S. savings and loan holding companies. Eligible liabilities: All newly issued senior unsecured debt issued by eligible institutions on or before June 30, 2009, including promissory notes, USCP, interbank funding, and any unsecured portion of secured debt. For eligible debt issued on or before June 30, 2009, coverage would be provided for 3 years beyond that date; Funds in non-interest-bearing transaction deposit accounts held by FDIC insured banks until December 31, 2009.

Source: Banc of America Securities LLC; For complete descriptions, please refer to the Web sites of the sponsoring entities.

An investment in money market mutual funds is not a bank deposit, and is not insured or guaranteed by Bank of America, N.A. or any of its affiliates or by the Federal Deposit Insurance Corporation or any other government agency. Although money market mutual funds seek to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in money market mutual funds. Please see the prospectuses for a complete discussion of the risks of investing in money market mutual funds.

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.

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iMoneyNet (formerly IBC Financial Data Inc.) is an independent mutual fund performance monitor. The iMoneyNet averages are not intended to represent past or future performance of the funds, and do not represent the past performance of funds managed in a similar manner and having similar investment objectives and policies.

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