

Taking the Pulse of the Money Markets

The Short-Term Debt Markets Are Healing, but Caution Is Still Warranted



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Less than one year ago, the bankruptcy of Lehman Brothers nearly resulted in the collapse of the global credit markets. In the wake of Lehman's dissolution, even money market funds failed to provide sanctuary from the storm as some prominent fund complexes either failed to maintain their \$1 NAVs or teetered on the edge of "breaking the buck." Washington responded with extraordinary measures to inject liquidity into the debt markets in general and to restore confidence in money market funds specifically. In the Q&A below, Pat Ford, head of money market portfolio management at Columbia Management, discusses both the current health of the money markets and developments that will change the way money funds are managed in the future. With more than 25 years of experience managing money market funds through various market cycles, Ford is able to provide valuable perspective on both topics.

Q. How would you describe the current health of the short-term debt markets?

A. The short-term markets have definitely improved in 2009, and we believe they will continue to recover on the basis of certain market indicators. For example, we have seen a narrowing of the TED spread¹ – the difference between Treasury yields and the yield on the London Interbank Offered Rate or LIBOR². More specifically, the three-month LIBOR has fallen from approximately 142 basis points in early January to roughly 44 basis points as of August 13, 2009. We are also seeing less reliance on government initiatives that were designed to inject liquidity into the system and restore confidence in money market funds. For example, the outstanding debt in the Commercial Paper Funding Facility has dropped from \$350 billion in mid-January to \$54 billion in early August. Washington also has restricted access to the

Asset-Backed Commercial Paper Money Market Fund Liquidity Facility by setting redemption thresholds. The facility now can be accessed only by a fund whose investors redeem 5% of the fund's assets in a single day or 10% of its assets over five business days.

In addition, the U.S. Treasury recently indicated that it will let its money market fund insurance guarantee expire on September 18, 2009. Clearly government officials believe the short-term debt markets are now strong enough for them to begin winding down their support programs. We believe the spread narrowing and the changes in the government support programs are signs that the short-term debt markets are well on their way to recovery.

Q. The government may believe it can reduce its profile with regard to supporting the short-term debt markets, but do you believe the markets are stable enough to function without that government support?

A. We believe the expiration of the federal government's money market support programs should be a non-event for money market funds. As we mentioned previously, issuers of short-term securities are now less reliant on the government's programs, which is good because Washington wants to wind down those facilities and insurance programs and because we believe it signals that liquidity has returned to the market. While we don't foresee any problems due to the withdrawal of that governmental support, we are taking a prudent approach by building cash balances in anticipation of the expiration of the insurance guarantee. This is in keeping with our emphasis on preserving principal and maintaining liquidity.

Q. Could you speak to the potential impact of proposals by the government and a key industry group to change the way money market funds are managed? Are there any funds that will be especially affected, e.g., prime funds?

A. Both the Securities and Exchange Commission (SEC) and the Investment Company Institute (ICI) have issued recommendations that collectively should increase confidence in money market funds. As we know, that confidence was badly shaken a year ago when the credit markets froze and a major fund complex broke the buck. In the case of the SEC, the changes would be initiated through amendments to Rule 2a-7 of the Investment Company Act of 1940. The proposed

¹ TED spread — The price difference between three-month futures contracts for U.S. Treasuries and three-month contracts for eurodollars having identical expiration months.

² LIBOR — The interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market.

rule change, which likely will take effect in 2010, will enhance the money market fund regulatory, oversight and disclosure processes and should strengthen portfolio liquidity, credit quality and overall resiliency.

The SEC and ICI proposals are designed to increase liquidity and reduce investment risk by requiring advisors to better measure and manage long-term credit and interest rate exposures. Both the SEC and ICI have recommended daily and weekly liquidity requirements to increase funds' ability to meet unexpected and large redemptions.

They have also suggested implementing shorter weighted-average maturities or WAMs, introducing the concept of "spread WAM" and prohibiting investments in second-tier, i.e., more risky, securities. These steps together should help to better measure and manage a fund's long-term credit and interest rate exposure to floating-rate notes, which played a big role in destabilizing some money funds last fall.

As for funds that may be especially affected, it is our view that prime funds will likely be most impacted by the proposed SEC and ICI guidelines, especially in the areas of liquidity and credit quality. Regarding liquidity, prime funds will likely hold more overnight repo and short-dated credit exposure in addition to likely including a higher balance of U.S. government Agency and Treasury debt. Regarding credit quality, prime funds will likely no longer be able to hold tier-2 securities and also have more limited appetite for long-dated tier-1 corporate floating-rate debt. The combination of more government debt and much less lower-quality and longer-dated corporate debt will certainly enhance the liquidity and stability of all prime funds.

Q. How will these recommendations impact Columbia Management's money market offering?

A. We do not feel there will be a significant impact on the Columbia Funds because we have already adopted a more conservative investment approach that emphasizes the maintenance of liquidity and preservation of capital. Actually, as of the date of this article, all of our funds already comply with the ICI's investment-related proposals, and we feel confident that we would be able to comply with the final SEC rule changes shortly after they are implemented and with little impact.

Q. You mentioned taking a more conservative approach, can you give us a few examples?

A. In the beginning of the fourth quarter of 2007, we elected to not purchase floating-rate notes due to our concerns about the liquidity and pricing uncertainty associated with those securities. We have since begun to reenter that market but only with Agency floaters, as their price volatility is generally more limited; they are more liquid than corporate floating-rate notes; and, in our view, they don't carry the same credit risk as their corporate equivalents. We have also moved to a more traditional laddered portfolio structure with the majority of our holdings invested in maturities of three months or less. These decisions enable us to better protect our funds from the price deterioration associated with interest rate increases as well as help mitigate credit and liquidity risk.

Of course, our focus on risk does not mean we aren't seeking to deliver the best yields possible, but our primary emphasis is on liquidity and principal stability. This has put us at a bit of a disadvantage relative to fund complexes that continue to pursue a more aggressive management style, but we believe our approach is the correct one because the top priorities of our clients are access to their funds and protection from loss of principal. As the SEC and ICI proposals are implemented, the money market fund industry as a whole will likely pursue a similarly conservative approach.

Q. In the current environment, what should investors look for when assessing money market funds – and what should they seek to avoid?

A. The events of last September 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. They should perform significant due diligence by focusing not just on a portfolio's holdings, but also on the manager's credit research capabilities; its compliance and risk management structures; its philosophy on liquidity and issuer concentration; and, of course, its experience managing through the business cycle. As with so many things in life, there is no substitute for experience and the insights it brings.

To read more about the ICI and SEC proposals, please visit the ICI money market fund resource center at www.ici.org/mmfs.

Money Market Liquidity Enhancement Programs

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

Launch date: September 19, 2008

Expiration date: February 1, 2010

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 commercial paper (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 an MMMF on or after September 19, 2008. A MMMF must experience 5% redemption in one day or 10% over a five-day period.

Commercial Paper Funding Facility (CPFF)

Launch date: October 27, 2008

Expiration date: February 1, 2010

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 New York (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 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 18, 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 September 19, 2008 or the current amount, whichever is less. Portfolio holdings are subject to change periodically and may not be representative of current holdings. Current and future holdings are subject to risk, including, but not limited to, market and credit risk.

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 three 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.

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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NOT BANK ISSUED	No Bank Guarantee