

September 19, 2008

Columbia Management Market Analysis

The analysis presented below reflects the views of Columbia Management's senior investment executives: Colin Moore, chief investment officer; Robert McConnaughey, head of equity; Stephen Peacher, head of fixed income; and Paul Quistberg, head of cash investments. This information has been compiled from several conference calls with Columbia Management's clients and from other communications Columbia Management issued this week to keep our clients and business partners informed of important developments driving the markets.

Overview

- Over the past week, we have witnessed an unprecedented restructuring of the financial services industry. The venerable Lehman Brothers has sought bankruptcy protection; Merrill Lynch—the firm that brought Wall Street to Main Street—is to be acquired by Bank of America; and the giant American International Group (AIG) is now owned largely by the U.S. government.
- The category-5 storm buffeting the financial sector triggered a major sell-off in the equity markets that ultimately was reversed as news of the government's more comprehensive plan to shore up the capital markets emerged. But even before the announcements by the U.S. Treasury and Federal Reserve, the drop in equity values did not approach the 20% decline we saw in 1987 when there was far less systemic risk confronting investors.
- The relative equanimity shown by investors during the darkest hours reflects confidence that the federal government has the will and the wherewithal to contain the collateral damage from the credit crunch. It may also be that the steady ratcheting down of share prices over the course of the year amounted to a gradual release of pressure that forestalled the kind of massive plunge in values we saw 21 years ago.
- Looking to the future, no one can say with any certainty whether the worst of the credit crisis is behind us. The nation's financial institutions are well into the vital deleveraging process, but there is still a great deal of work to be done. For that reason, we should continue to expect strong market volatility in the weeks ahead. This will likely result in the continuation of the flight to quality we have witnessed across the major asset classes.
- Having said this, every market generates opportunity, and even the most conservative of investors will be sifting through the wreckage in search of value. The issue for many of them will be whether they can tolerate the short-term volatility they must assume to pursue the opportunities the equity and fixed-income markets continue to present.

Equity Markets

- Caution will be the watchword as investors wait for signs that the financial system is stabilizing before actively adding risk to their portfolios. As recently as July it appeared the appetite for risk was growing, but this week's developments have served to remind equity investors of the magnitude of the challenges facing Wall Street and of the attendant investment risk.
- We favor U.S. equities over international stocks for several reasons. For one, European economies are likely to weaken fairly significantly, in our view, because it appears the European Central

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Bank has been overly focused on containing inflation—to the detriment of economic growth. In addition, declining commodities prices may put pressure on emerging markets stocks.

- As grim as the U.S. economic outlook appears now, we must keep in mind that the U.S. economy softened first, which means the clouds will likely begin parting here as they darken elsewhere. Unlike Japan in the 1990s, the United States is taking the steps necessary to address imbalances in the financial system, which positions us for a shorter period of economic weakness and a more robust recovery when it comes.
- The timing of the U.S. economic recovery will likely parallel a rebound in the housing market. We expect housing prices nationwide to continue to decline in 2009, but we also see signs of hope in some of the housing data. Prices of homes in the hardest hit markets—California, Florida, Arizona and Nevada—have declined to 2004 levels, which means those areas have surrendered a good portion of the gains they enjoyed during the boom. In addition, transaction activity is up markedly across the nation, which inspires optimism. Admittedly, that increase is driven in part by banks selling foreclosed properties, but increased activity generally presages price gains down the road.
- As we survey the markets for opportunities, we will be focusing on sectors that have been tarred by the travails of high-profile companies within them. Financials come immediately to mind. We believe the financial sector will be a rich source of opportunity for equity investors in the months ahead. We will be paying particular attention to companies that stand to benefit from Wall Street’s casualties. These include well-capitalized U.S. and international insurance companies that we believe are well positioned to increase their market share and return on capital as AIG contracts.

Fixed Income and Cash Markets

- Fixed-income investors responded to the grim news from Wall Street by fleeing to the safety of government debt. At the beginning of the year, the yield on the 30-year Treasury was 4.4%; at one point last week it had fallen to 4%, a level not seen since the 1950s. Investors also found comfort in Agency debt, which has performed well since federal regulators intervened to prop up Fannie Mae and Freddie Mac.
- Conversely, spread product—corporate debt, municipals and emerging markets bonds, for example—has seen a dramatic increase in its yields. Once again this is a reflection of focus on quality and liquidity.
- The sell-off of spread product has created opportunities for investors who can tolerate the pain created by the recent market volatility. Many will find it difficult to muster the courage to increase their exposure to these securities, however, because spread product has underperformed Treasuries for some time now and because of continued anxiety about the health of the credit markets.
- For investors blessed with a strong tolerance for risk and a long-term investment horizon, the high-yield sector may offer promise. Spreads on high yield debt have increased on concern about rising default rates and lower recovery rates, but we believe there is money to be made in high yield at current prices.
- We also believe that municipals may be a solid option for investors. The decline in economic growth translates to lower tax revenues, which will no doubt lead to an increase in ratings downgrades. Municipal issuers have an advantage over issuers of other fixed-income securities, however, and that is their taxing authority. Assuming the fiscal condition of the state or municipality is sound, their general obligation debt may provide a safe harbor relative to other

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spread product while also offering yields that are more attractive than those provided by Treasuries.

- The recent “breaking of the buck” at the Reserve Primary Fund has reminded investors that there is no truly safe investment outside of federally insured accounts. Investors in money market funds are now focusing on counterparty risk and the finer points of repurchase agreements as they weigh their investment options. Many of those investors also are beginning to recognize that, in this environment, there are advantages to investing in money market funds sponsored by large, well-capitalized financial institutions.
- The managers of Columbia Management’s money market funds continue to emphasize high-quality securities with very short maturities. Repurchase agreements (repos) remain an important component of our effort to achieve safety, liquidity and attractive yields on behalf of our clients. Our credit analysts address the counterparty risk inherent in repurchase agreements through a multi-layered screening process, and our investors are further protected by high-quality collateral whose value exceeds the principal amounts of the repos themselves. Our funds have no exposure to Washington Mutual and minimal exposure to AIG and Lehman.

Conclusion

- Investors have had a front-row seat to history this week with some of the nation’s oldest and most storied financial firms effectively disappearing from the investment landscape. Little wonder those investors are questioning the underpinnings of our financial system – and investing accordingly.
- We are of the opinion that the anxiety currently gripping the markets will abate as even faint signs of healing on Wall Street emerge. In the meantime, one can find reason for optimism in the federal government’s coordinated and intelligent response to the momentous developments that have unfolded over the past year. Similarly, we are encouraged by the actions of Wall Street’s stronger players, who have bolstered our financial infrastructure through lending and through acquisition of their weaker competitors.
- There is little doubt that the excesses that generated the current crisis will be addressed by the next president and the Congress through regulatory reform. The regulatory changes will likely restrict the use of leverage and promote greater transparency. In the meantime, the painful process of deleveraging will continue, testing both our financial institutions and investors. We do not underestimate the challenges that lie ahead, but we believe the steps taken to date provide the foundation for a rejuvenated financial sector and better-functioning markets in the future.

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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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