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Key Investment Themes for 2012: Short Term Credit

Hello, my name is Tom Murphy. I am a co-portfolio manager of the Columbia Limited Duration Credit Fund and have more than 20 years' experience managing corporate bond portfolios. I wanted to spend a few moments describing our current view on short term credit.

Why is short term credit a key investment theme for 2012?

We believe that short term credit represents a timely opportunity in the current market environment because it combines the positive tailwind of strong underlying corporate fundamentals with protection against rising U.S. Treasury rates afforded by shorter duration securities.

Unlike the well-documented issues with finances at the consumer and government entity level, many corporations currently possess solid credit fundamentals. By any number of measures we examine — leverage, coverage, margins, cash available for investment, recent earnings, etc. — many corporations are in as good a position as they have been over the last 20 years.

Corporations spent the better part of the decade leading up to the great recession improving their operational efficiency and right-sizing their debt burdens. This put them in a solid position to weather the credit crisis, and to further reap the benefits as the economy continues to improve.

The other attractive attribute of short term credit is the ability to minimize the impact of rising Treasury rates once the Federal Reserve commences its much-anticipated and -debated monetary tightening cycle. The price sensitivity to interest rates, as measured by duration, of a five-year corporate bond is one-third that of a 30-year corporate bond, making short term corporate bonds more attractive in that environment.

Why do you feel that short-term credit securities are a good investment choice?

I just laid out the case for strong credit fundamentals for corporate issuers and the reduced price sensitivity to interest rate changes that short term corporate bonds possess.

The other piece of the puzzle is valuations. A widely utilized index of short term corporate bonds — the Barclays 1-5 Year Corporate Bond Index — has a current spread over Treasuries that is nearly equal to its 20-year average. However, if you strip out the impact of the 2007-2009 credit crisis — which was more about negative sentiment and horrible market liquidity than it was about underlying credit fundamentals — this Index is currently trading at levels 20% wider than its long term average.

As I mentioned, corporate fundamentals are as good as they have been over that 20-year period, so we find strong value in these securities at these valuations.

Lastly, in a world where we just experienced record low yields in U.S. Treasuries back in the Fall of 2010, the relative spread compensation for accepting the credit risk of corporate bonds as opposed to merely owning U.S. Treasuries becomes more important.

Another way to look at valuations for this same Index of short corporate bonds is to measure the proportion of overall yield represented by the credit spread, with the remainder coming from the yield of an equivalent-duration U.S. Treasury. Currently, 50% of the overall yield for short corporate bonds comes from this credit spread compensation vs. a historical average closer to 20%. In fact, during more "normal" economic environments, this ratio can fall to 10% or lower.

In summary, short term corporate bonds have the support of solid credit fundamentals, reduced sensitivity to interest rate risk, and attractive absolute and relative valuation measures. This is why we see short term credit securities as a key investment theme for investors right now.

Thanks for listening. And for more investment insight, we encourage you to visit our web site: columbiamanagement.com.

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The Barclays Capital U.S. 1-5 Year Credit Index is an unmanaged index of dollar-denominated, nonconvertible U.S. corporate fixed income securities. The index also includes specified foreign fixed-income securities that meet its maturity, liquidity and quality requirements. Only publicly issued fixed-income securities with a remaining maturity from one to five years are included. The index reflects reinvestment of all distributions and changes in market prices.

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