Investing in ultra-short-term bond strategies? Consider this:

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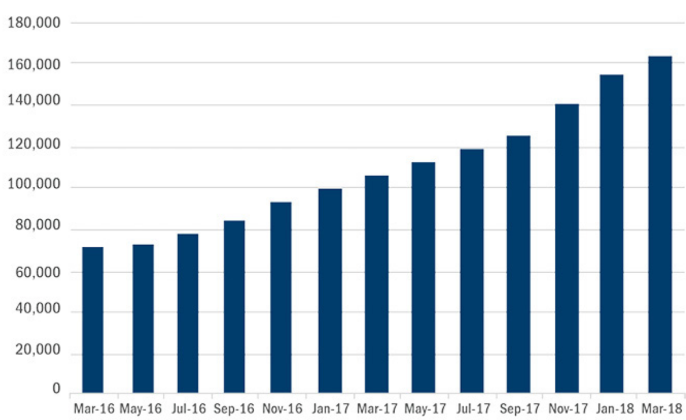
Columbia Threadneedle Investment Team

Ultra-short-term bond strategies have been particularly attractive in the past couple of years. But investors need to understand the varying levels of risk.

Ultra-short-term bond strategies can help provide competitive yield and total return by investing in a diversified portfolio of short duration bonds — generally with an average effective duration of less than one year. At the same time, these strategies can provide capital preservation. Ultra-short-term bonds have been one of the largest asset-gathering categories recently; investors put more than $8 billion into ultra-short-term bond mutual funds in the first quarter of 2019, boosting the AUM to $162 billion as of March 31, according to Morningstar. Net inflows were more than $41 billion in 2018.

Rising rates boosted the appeal of ultra-short-term bond funds

Morningstar ultra-short-term bond category assets under management ($ millions)

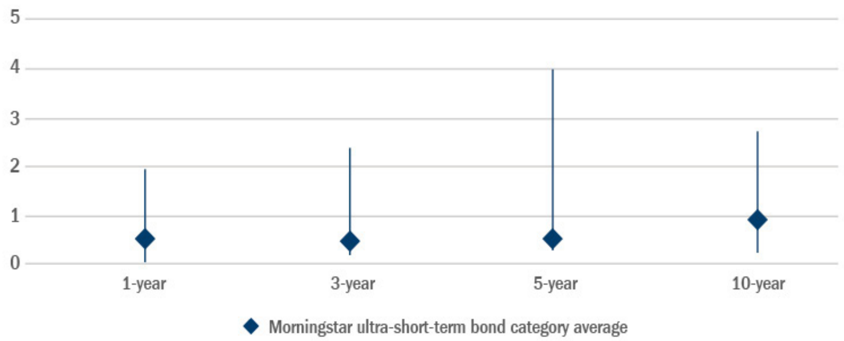


Source: SIMFUND. Data as of 03/31/19.

Ultra-short-term bond strategies may be appropriate for investors who want liquid assets. They've been particularly attractive since the SEC money market reforms were finalized in 2016, coupled with three years of increases in the fed funds rate (the upper range increased from 0.25% to 2.50%). The inflows may temper now that the Federal Reserve has stepped back from future planned rate increases, and inversion in the yield curve will likely keep investors focused on the short end of the yield curve until the curve normalizes. While ultra-short-term bond strategies have historically offered lower volatility relative to the longer duration options, it's important to remember that they are not money market funds and will present additional risks. It's critical for investors and their advisors to take a look under the hood and understand how much risk their ultra-short-term bond manager is taking because every strategy will vary in its investment approach.

There may be wide variation in the level of risk of ultra-short-term strategies

Morningstar ultra-short-term bond category standard deviation (high/low/average)



Source: Morningstar. Data as of 03/31/19. Standard deviation is a statistical measure of the degree to which an individual value in a probability distribution tends to vary from the mean of the distribution.

The category is well-known for encompassing a wide variety of approaches and risk levels, and it varies in several key ways:

- **Credit quality:** Credit risk is less of a factor for funds that principally invest in government securities. Funds that invest in bonds of companies with lower credit ratings, derivative securities or certain mortgage-backed securities, may be subject to higher risk levels. Taking credit risk has rewarded investors for the past several years, but that could change if a slower economy results in wider credit spreads.

- **Duration:** While the Fed has declared that it does not intend to raise rates over the balance of 2019, understanding the sensitivity to interest-rate changes in an ultra short-term fund is an important consideration for investors. Funds with a higher duration may be especially vulnerable to losses in a volatile rate environment.

- **Liquidity:** Rising interest rates and liquidity are a particular concern to ultra-short-term bond investors, particularly those making an active decision to keep a portion of their assets somewhat liquid, whether it be for planned or unexpected expenses. Ultra-short-term bond strategies that invest in more than investment-grade, U.S. dollar-denominated debt may be investing in securities that could become less liquid in certain environments. A fund's historical NAV volatility is worth considering if an investor is primarily concerned with capital preservation.

Bottom line

A decision to allocate to an ultra-short-term bond fund should always be deliberate. Not all options are the same, and investors should understand the risks that may be embedded in varying portfolios.

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