COLUMBIA THREADNEEDLE INVESTMENTS

Look under the hood of your ultra-short-term bond fund

June 27, 2019

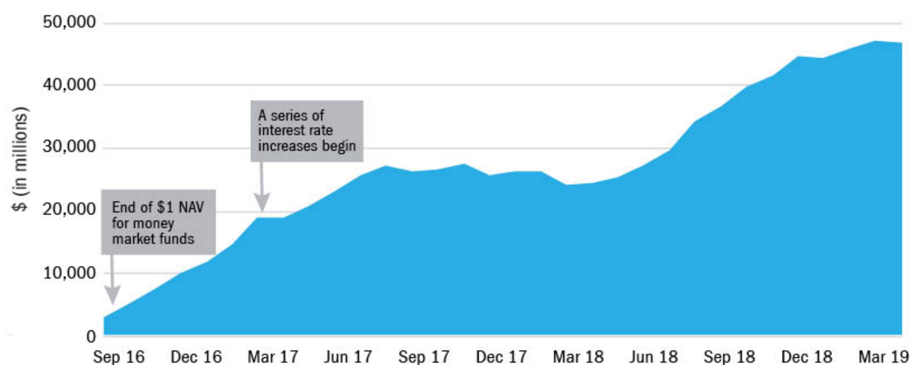
Ultra-short-term bond funds, which bridge the gap between money market funds and short-term bond funds, have soared in popularity. But there's a wide variation in how these funds invest, and investors should understand the associated risks and rewards.

A few years ago, if you wanted a place to park your money to keep it accessible and get a better return than a savings account, a money market fund would have been the obvious choice. But in 2016, the SEC revised longstanding regulations. The changes eliminated the steady $1 net asset value (NAV) per share that prime money market investors had long enjoyed, removing a key distinction between money market funds and ultra-short-term bond funds.

Investments into the ultra-short category significantly increased starting in September 2016, just before the floating NAV took effect. Higher market volatility driven by global macro issues and three years of increases in the upper Fed Fund target rate (from 0.25% to 2.50%) have continued to drive the flow of investments into ultra-short-term bond funds.

Columbia Threadneedle Investment Team

Ultra-short-term bond funds continue to attract investors



12 months net new flows into the Morningstar Ultrashort Bond category. Source: Morningstar, Columbia Threadneedle Investments
As of June 2019

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Choosing the right ultra-short-term bond fund

As the flow of investments into the category demonstrates, many investors want to have at least some assets in liquid investments that emphasize capital preservation. But within this broad goal, the ultra-short-term bond category offers a range of choices. In general, funds that offer the highest yields tend to also experience higher day-to-day NAV volatility, so investors need to think about the goal of the fund they are selecting: higher yields or lower volatility.

In order to obtain a yield greater than the 3-month Treasury bill "risk-free" rate, funds must increase risk in some portion of their portfolio. Here are three common yield-enhancing strategies:

1. Sector concentration: Some funds are more heavily focused in the corporate sector — using fixed- and floating-rate bonds and commercial paper — while keeping average portfolio maturities similar to those of money market funds to reduce NAV volatility. But it could be challenging to overcome the lack of diversification if the markets turn and spreads widen significantly in the corporate sector.

2. Expanding the universe: With corporations reducing issuance and yield spreads being compressed, some funds may invest in securities other than short, U.S. dollar-denominated investment-grade bonds. These may include high-yield bonds, non-U.S. dollar-denominated debt, floating-rate loans and derivatives. It's important for investors to understand the risks associated with each of these types of securities.

3. Extending maturity/duration: Duration is a measure of how sensitive the price of an investment is to changes in interest rates. It's expressed in the number of years — greater duration means greater interest-rate risk. A money market fund may have a duration of just a couple of months, but in the ultra-short-term bond fund category, it typically ranges from three months (expressed as a duration of 0.25) to 9 months (0.75). Investors who are concerned about risk from duration exposure should determine their baseline comfort level compared with money market funds and find a fund with a duration range that would be acceptable.

Bottom line

Ultra-short-term bond funds are a worthwhile consideration for investors who are looking for liquidity and mitigation of risk, but they entail greater risk than a money market fund. It's important to remember that not all funds within the ultra-short-term bond category are alike, and investors should understand the risks and potential rewards of strategies used to boost yield.

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CTBPH546 (06/19) 2604228