The costly downside of moving to cash

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Low rates for the foreseeable future are a great reason to consider a more active approach to your cash position.

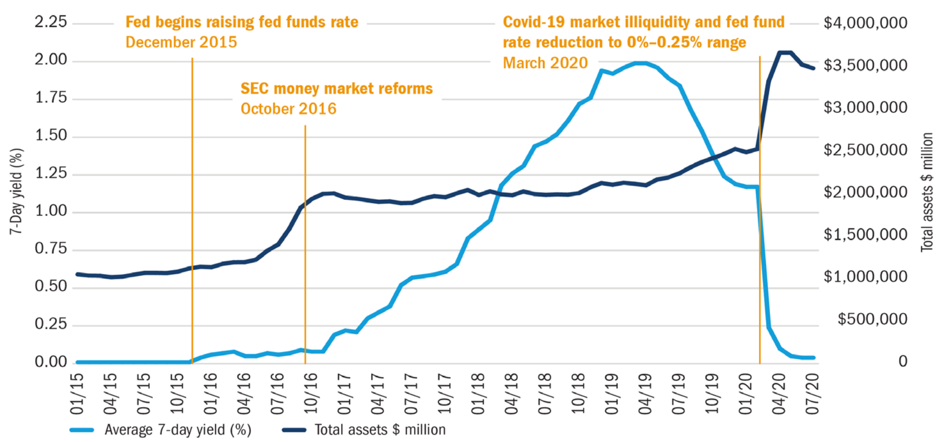
Even when investors try to be logical, it's challenging to keep emotions at bay when markets are in free fall. And when faced with capital losses, many well-planned investment strategies can be quickly forgotten in the hope of preserving wealth. Investors sometimes opt to move to cash, which may provide a short-term sense of relief. But in the long run, this knee-jerk reaction can significantly erode their wealth.

Timing rarely works in investors' favor

We recently saw an influx into cash in response to the COVID-19 pandemic. The Morningstar Money Market - Taxable category gained significant cash flows in April and May when market volatility surged. Investors who allocated to cash thinking they would find safer ground, plus a small yield, got less than they bargained for — yields fell close to zero in less than two months.

Market volatility in 2020 drove investors to cash — but yields fell rapidly

Morningstar Money Market — Taxable Funds Assets vs. 7-Day Yield



Source: Morningstar; Columbia Threadneedle

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While a move to cash may have seemed the right thing to do at the time, selling in volatile markets often means taking losses. And many investors who shifted assets to cash missed the rebound markets once the Federal Reserve (Fed) and Treasury relief programs were announced.

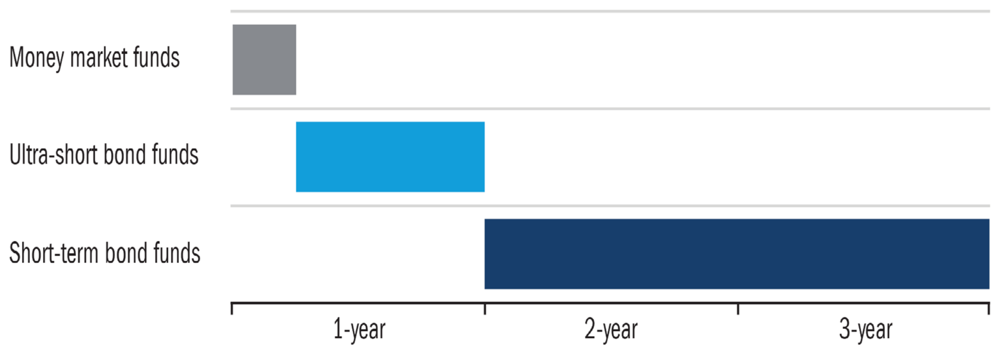
More options for managing volatility

In the eight years following the global financial crisis, many cash indices returned less than 0.25% annualized. They were safe, liquid — and the worst performing asset class during that period. Recent Fed policy, our internal analysis and the economic environment all suggest that cash returns going forward will follow a similar pattern as we continue this recovery.

For people who are still concerned about volatility (either from the pandemic or the election), short-term and ultra-short-term bond funds may be a smart choice. As the names indicate, these funds are typically shorter maturity, lower volatility funds that can use a broader array of securities than money market funds. And, compared to our forecast for cash returns, may offer attractive yields and total returns. Investors need to be willing to take more risk relative to a money market fund, but for many people, these funds can be part of a long-term solution or a temporary investment to bridge the gap while an investor redefines their future goals.

Short- and ultra-short-term funds have longer duration, but higher yields

Representative short-term bond fund duration



Source: Securities and Exchange Commission; Morningstar; Columbia Threadneedle Investments. For illustrative purposes only.

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Ultra-short-term bond funds

Just past money market funds on the risk spectrum, ultra-short-term bond funds tend to prioritize capital preservation over yield and will maintain a duration of one year or less. For investors who want to lower day-to-day NAV volatility, ultra-short-term bond funds may make sense. But the profile of these funds in the category can vary widely.

In general, funds that offer the highest yields tend to also experience higher NAV volatility, which is why you may see some funds in the Ultrashort Bond Morningstar category gravitate more towards one goal, not both. In order to obtain a yield greater than the 3-month Treasury bill "risk-free" rate, funds must increase risk in some portion of the fund. It's the management of risk that will differentiate funds. Yield-enhancing strategies include:

Sector concentration

Some funds are more heavily focused on a specific sector, such as the corporate market. They use fixed- and floating-rate bonds and commercial paper, while keeping average portfolio maturities similar to those of money market funds to reduce NAV volatility.

Expanding the universe

Some funds may invest in securities other than short-duration, U.S. dollar-denominated, investment-grade bonds. These may include high-yield, non-U.S. dollar-denominated debt, (floating rate) bank loans and derivatives.

Extending maturity/duration

While ultra-short-term bond funds can have less volatility than short-term bond funds, many still have longer duration (or the measure of a bond's price sensitivity to changes in interest rates) than money market funds and can have some duration risk. Investors who are concerned about risk from duration exposure should determine a baseline comfort level (compared to money market funds, for example).

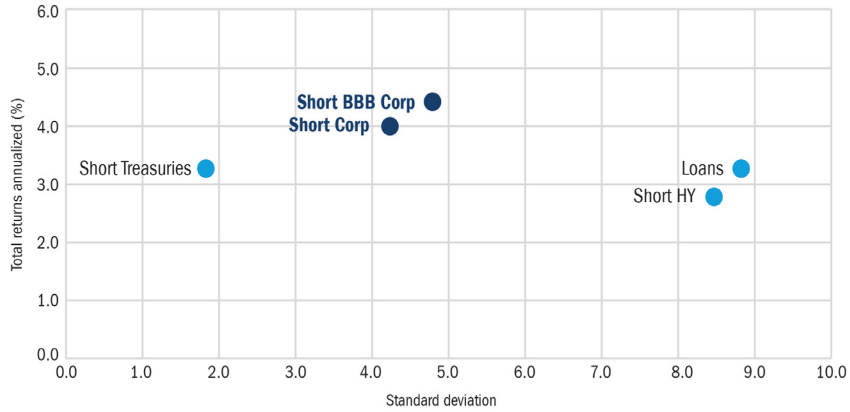
These same strategies apply to short-term bond funds, which may have a wider latitude to increase risk and return. The duration range will typically fall between one year and three and half years.

Short-term bond funds

Short-term bond funds will typically invest farther out on the yield curve and in a broader array of security types, introducing a higher risk profile. Certain money market funds may invest in short-term securities, such as commercial paper issued by corporations. But they're unable to invest in longer maturity corporate bonds, which are an integral part of many short-term and ultra-short-term bond fund investment strategies. Given the significant support for investment-grade corporate debt currently provided by Federal Reserve programs, investors continue to find the risk/reward premium offered by corporate debt attractive. In today's market, BBB-rated bonds in the Bloomberg Barclays 1 -5 Year Corporate Index offer investors an additional 110 bps (or 1.1%) of yield on average versus similar duration Treasury bonds (source: Bloomberg as of 09/30/20). But this additional compensation does not come without risk, including the prospect of downgrades or, in very rare cases, defaults.

Short-duration corporate bonds offer attractive risk/reward

Representative short-term index: Three-year annualized risk/return



As of 09/30/20, based on rolling 3-year data. Source: Bloomberg Barclays; Columbia Threadneedle Investments. 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. Asset Class/Indexes are: Short BBB Corporates = ICE BofA 1-5 Yr. BBB US Corp. index, a subset of the ICE BofA US Corporate Master Index tracking the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market; Short Corporates = Bloomberg Barclays Corp. 1-5 Yr. index, which measures the investment grade, fixed-rate, taxable corporate bond market with 1-5 year maturities.; Short High Yield = Bloomberg Barclays US High Yield 1-5 Yr. index, which measures USD-denominated, HY, fixed-rate corporate debt with maturities of 1 to 4.99 years; Leveraged Loans = Credit Suisse Leveraged Loan index, designed to mirror the investable universe of the USD-denominated leveraged loan market; Short Treasuries = Bloomberg Barclays 1-5 Yr. Treasury index, which measures Treasury issues with 1-5 year maturities. It is not possible to invest directly in an index.

Exhaustive credit research is a good way to try to mitigate these risks, and it's a big undertaking because the investable universe is massive. Understanding different industries and knowing each company's management team can be a key differentiator in providing attractive long-term performance. Active managers can see through short-term market "noise" and volatility without reacting emotionally, focusing instead on company fundamentals and understanding how management teams intend to adjust to challenging markets.

Bottom line: Look beyond cash

Investors who are concerned about safety and liquidity, but don't have an immediate need for cash, should consider an ultra-short- or short-term bond fund. But investors need to be aware that not all funds within a certain category are alike. It's always important to consider each person's investment time horizon when allocating portfolio assets to avoid forced selling when markets may be down.

Disclosures

Market risk may affect a single issuer, sector of the economy, industry or the market as a whole. **Mortgage- and asset-backed securities** are affected by interest rates, financial health of issuers/originators, creditworthiness of entities providing credit enhancements and the value of underlying assets. Fixed-income securities present **issuer default** risk. A rise in **interest rates** may result in a price decline of fixed-income instruments held by the fund, negatively impacting its performance and NAV. Falling rates may result in the fund investing in lower yielding debt instruments, lowering the fund's income and yield. These risks may be heightened for longer maturity and duration securities. **Prepayment and extension** risk exists because the timing of payments on a loan, bond or other investment may accelerate when interest rates fall or decelerate when interest rates rise which may reduce investment opportunities and potential returns. Investing in **derivatives** is a specialized activity involves special risks, which may result in significant losses. Market or other (e.g., interest rate) environments may adversely affect the **liquidity** of fund investments, negatively impacting their price. Generally, the less liquid the market at the time the fund sells a holding, the greater the risk of loss or decline of value to the fund.

FTSE 1-Month U.S. T-Bill - The FTSE 3 Month US T Bill Index Series is intended to track the daily performance of 3-month US Treasury bills.

Bloomberg Barclays Short-Term Govt/Corp - The Index represents securities that have fallen out of the U.S. Government/Corporate Index because of the standard minimum one year to maturity constraint.

Bloomberg Barclays 1-3 Year Govt/Credit - The Index measures the performance of investment grade, US dollar-denominated, fixed-rate, taxable corporate and government-related debt with 1 to 2.99 years to maturity.

Bloomberg Barclays 1-5 Year Corporate - The Index measures the investment grade, fixed-rate, taxable corporate bond market with 1-5 year maturities.

Bloomberg Barclays 1-5 Year Treasury - The Index measures Treasury issues with 1-5 year maturities.

Bloomberg Barclays US High Yield 1-5 Yr. index – The index measures USD-denominated, HY, fixed-rate corporate debt with maturities of 1 to 4.99 years.

Bloomberg Barclays Corporate Investment Grade – The Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

Bloomberg Barclays CMBS Investment Grade index - The Index measures the investment grade collateralized mortgage bond index.

Bloomberg Barclays US Aggregate Bond index – The Index is is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

ICE BofA Cash Pay High Yield Constrained - tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. To qualify for inclusion in the index, securities must have a below investment grade rating (based on an average of Moody's, S&P, and Fitch) and an investment grade rated country of risk (based on an average of Moody's, S&P, and Fitch foreign currency long term sovereign debt ratings).

ICE BofA BBB US Corporate Index - a subset of the ICE BofA US Corporate Master Index tracking the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market. This subset includes all securities with a given investment grade rating BBB.

Credit Suisse Leveraged Loan Index - Is designed to mirror the investable universe of the USD-denominated leveraged loan market.

S&P 500 – Is a market capitalization-weighted index that includes 500 leading U.S. companies.

It is not possible to invest directly in an index.

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