Columbia Tax-Exempt Fund

Fund performance

- Columbia Tax-Exempt Fund Institutional Class shares returned -0.20% for the three months ending September 30, 2018. For monthly performance information, check online at columbiathreadneedle.com.

- The fund’s benchmark, the Bloomberg Barclays Municipal Bond Index, returned -0.15% for the same period.

- The fund’s performance was driven mainly by credit quality allocation, specifically bonds rated BBB and below investment grade. In addition, security selection in the twenty-year maturity space was additive.

Market overview

The municipal market declined 0.15% in the third quarter, based on the Bloomberg Barclays Municipal Bond Index. The three-month loss for tax-exempt issues occurred as the U.S. Federal Reserve once again raised rates at the end of September, and Treasury yields increased across the curve. Munis slightly underperformed Treasuries on the long end, and the muni curve steepened, as short rates saw smaller increases than longer rates. Expectations for additional rate hikes appear to be mostly priced into the market at this point. Munis continued to be supported by positive fundamentals driven by strong economic activity, all of which contributed to higher income, property and sales tax revenues at state and local levels. While returns were negative for the quarter, the market benefited from a favorable technical environment of continued low new-issue supply and strong demand for tax-exempt income, which helped mitigate negative performance.

The muni market delivered positive returns in July and August, as yields were relatively stable. However, as rates jumped higher across the curve, the 0.65% decline in September overwhelmed the positive returns from the prior two months, resulting in a negative return for the period. In addition to higher rates, continued lack of participation from corporate buyers due to tax reform was felt in the longer end of the muni curve, causing longer

Average annual total returns (%) for period ending September 30, 2018

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maturity bonds to underperformed their shorter counterparts. Higher yielding, lower rated bonds continued to outpace their higher quality counterparts. While most investment-grade sectors turned in negative performance, most high-yield muni sectors delivered positive performance, led by Puerto Rico’s 8.68% return. Longer maturity munis remain attractive vs. Treasuries, as the 30-year muni/Treasury yield ratio ended the quarter at 100%. In addition, the slope of the muni curve steepened further, indicating muni investors are being rewarded for extending out the curve.

Contributors and detractors

The fund performed in line with the Bloomberg Barclays Municipal Bond Index in the quarter. The fund’s main performance driver was quality allocation, specifically exposure to bonds rated BBB and below investment grade. Security selection in the 20-year maturity space was additive. In addition, a position in 10-year U.S. Treasury futures contracts, which reduced the fund’s duration and sensitivity to rising interest rates, also supported performance. (Duration is a measure of a bond’s sensitivity to changes in interest rates.)

During the quarter, shorter maturity municipal bonds outperformed long bonds with the strongest index returns coming from the 10–15 year maturity range and the weakest returns from the 20–25 year space. The fund’s curve allocation, in particular an overweight to 15-year and longer maturities and an underweight under 10 years, detracted from performance. In addition, security selection in the fund’s 20- to 25-year and over 30-year areas also detracted slightly. However, security selection in maturities of 20 years and shorter supported performance.
The fund’s exposure to the resource recovery, local general obligation (driven by a rally in Chicago credits) and education sectors added to performance, while relative performance was held back by its allocation to pre-paid gas, housing and hospital bonds.

The fund’s credit quality allocation helped returns, as exposure to bonds rated BBB and below investment grade were major contributors. Below-investment-grade bonds, which returned better than 1.0%, were the top-performing quality category in the fund. The fund’s BBB holdings returned 0.04%, while its single A exposure declined 0.41%. Returns in these categories were hampered by exposure to longer duration and 4% coupon bonds, which underperformed. The fund’s AAA and AA bonds were negative contributors, declining 0.58% and 0.36%, respectively.

Portfolio activity
We found attractive opportunities to add to the fund’s AA, A and BBB exposure. Purchases were focused on bonds in the 20-year and longer maturity range, which we believe offered an attractive level of income and good relative value. We invested in several sectors including transportation, housing, state general obligation and hospitals, based on our relative value assessment.

Outlook
Although interest rate volatility has picked up in recent months, we believe rates are likely to remain somewhat rangebound and lower than historical averages. The outlook for future federal budget deficits, an increasingly hawkish Fed stance and potential trade war implications would be supportive of higher rates. Nevertheless, inflation remains subdued despite somewhat stronger growth and tighter labor market conditions. Given this backdrop of rangebound rates and stable credit conditions, we will continue to focus on bonds with strong relative value. We believe that investment-grade bonds, particularly in the A and BBB categories, are attractive for their income stream. We expect to maintain the fund’s exposure to longer duration (15+ year) securities. While late in the economic cycle, we believe the economy is supportive of these higher yielding, investment-grade securities and that spreads are unlikely to widen significantly over the next six months. Where necessary, we will use Treasury short positions to reduce the fund’s sensitivity to changes in interest rates.

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Investment Risks

Fixed-income securities present issuer default risk. The fund invests substantially in municipal securities and will be affected by tax, legislative, regulatory, demographic or political changes, as well as changes impacting a state’s financial, economic or other conditions. A relatively small number of tax-exempt issuers may necessitate the fund investing more heavily in a single issuer and, therefore, be more exposed to the risk of loss than a fund that invests more broadly. 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. Non-investment-grade (high-yield or junk) securities present greater price volatility and more risk to principal and income than higher rated securities. Market risk may affect a single issuer, sector of the economy, industry or the market as a whole. 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. Federal and state tax rules apply to capital gain distributions and any gains or losses on sales. Income may be subject to state, local or alternative minimum taxes. Liquidity risk is associated with the difficulty of selling underlying investments at a desirable time or price. Investing in derivatives is a specialized activity that involves special risks, which may result in significant losses.

Investors should consider the investment objectives, risks, charges and expenses of a mutual fund carefully before investing. For a free prospectus or a summary prospectus, which contains this and other important information about the funds, visit columbiathreadneedle.com. Read the prospectus carefully before investing.

Columbia Threadneedle Investments (Columbia Threadneedle) is the global brand name of the Columbia and Threadneedle group of companies.

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Additional performance information: All results shown assume reinvestment of distributions and do not reflect the deduction of taxes that a shareholder would pay on fund distributions or the redemption of fund shares.

Expense ratios are generally based on the fund's most recently completed fiscal year and are not adjusted for current asset levels or other changes. In general, expense ratios increase as net assets decrease. See the fund's prospectus for additional details.

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The Bloomberg Barclays Municipal Bond Index is an unmanaged index considered representative of the broad market for investment-grade, tax-exempt bonds with maturities of at least one year. Indices shown are unmanaged and do not reflect the impact of fees. It is not possible to invest directly in an index.