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Greek Austerity Bill Passed... But Many Challenges Ahead

In a controversial vote taken in the face of violent protests and civil unrest, Greek lawmakers passed by a wide margin the latest version of an austerity package demanded by European officials in return for a 130 billion euro bailout payment which will allow Greece to avoid defaulting on debts coming due in March. Unfortunately, this is just the first step in the ratification process. The €3.3 billion austerity package, which includes €300 million in pension cuts, a 22% cut in the minimum wage and 150,000 job cuts still has to be agreed to in writing by the leaders of each of the major Greek political parties to insure that the commitments will continue to be honored after national elections in April. Once these conditions have been met, finance ministers from the Euro area will convene on Wednesday to approve the payment of the bailout funds, as well as implement a bond swap with private holders of Greek government debt, representing a write-down of €100 billion out of the €350 billion currently owed by the Greek government. It is still unclear whether the European Central Bank (ECB) will be participating in the debt write-down to further ease the currently unsustainable debt load. The ECB cannot take a direct loss on their holdings as it would be perceived as directly financing government spending, which is prohibited by their charter. However, a proposed work-around would be the European Financial Stability Facility (EFSF), which is the region's bailout vehicle, potentially buying the bonds from the ECB at cost and then absorbing the write-down.

Even assuming all the required approvals are garnered, the bailout funding is paid and the debt write-down is imposed, it seems highly unlikely that the situation will have been resolved. The Greek economy is in freefall, and the forced austerity is likely to exacerbate that fact, making any debt/Gross Domestic Product targets unlikely to be reached. This agreement, if fulfilled, may buy a few weeks of peace, but it will be an uneasy peace at best, and unfortunately, not likely to be sustained. In fact, I would argue that the greatest window of vulnerability for a mutually agreed upon settlement will be between February 29, which is the day the ECB holds the second installment of its three year financing auction for European banks, which is expected to pump 500 billion to 1 trillion euros of cash into the banking system, and the days leading up to the March 20 Greek debt payment, prior to which the disbursement of bailout funds to Greece must be made. If there was ever a time that European officials would be likely to give up on the Greek tragedy that has been playing for over two years and let them face an official default on their own, it would be after a massive injection of cash into the banking system, making it as resilient to a default as it will ever be under the circumstances, and prior to paying out €130 billion which is on top of the €110 billion already committed and largely disbursed.

Investment Grade Corporate Bonds Off To A Strong Start in 2012

By Tom Murphy, Head of Investment Grade Credit and Kirk Moore, Head of Investment Grade Research

“Market participants and strategists are currently pointing to the shrinking of “new issue concessions” as a signal of robust demand in the market and a further reason to be bullish.”

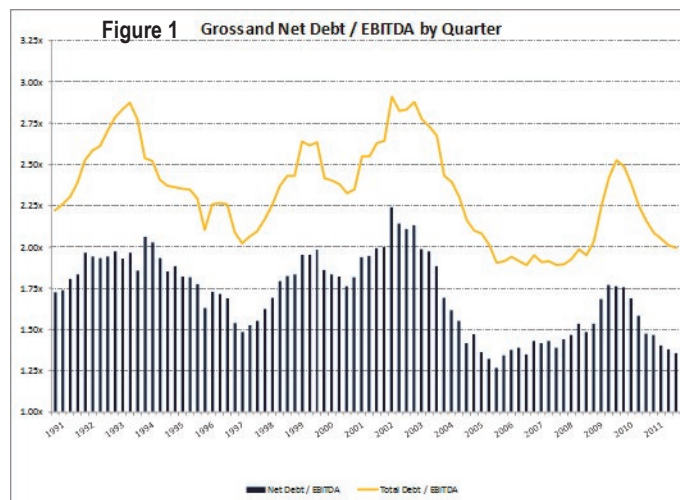
Past performance does not guarantee future results.

The investment grade corporate market is off to a strong start, performance-wise, in 2012. Through February 9, the Barclays U.S. Corporate Investment Grade Index has generated a Total Return of 1.95%, and an excess return above like-duration Treasuries of 2.77%. There are many reasons for the strong start to the year, including continued strong economic releases, 4Q11 corporate earnings that are coming in better than expected and a more emboldened investor class that is looking at the glass as “half-full” as opposed to the “three-quarters empty” siege mentality that seemed so pervasive throughout the second half of 2011.

Market participants and strategists are currently pointing to the shrinking of “new issue concessions” as a signal of robust demand in the market and a further reason to be bullish. Whenever an issuer, working with their Wall Street syndicate managers, arranges a new debt offering in the marketplace, the process of deciding where to offer the new bonds to institutional investors is much more art than science. Sector, ratings, market tone, other competing issuers, amount of current debt outstanding for this issuer, etc., are all inputs that affect how much “cheaper” (wider spread) the new issue will be offered to entice investors to want to own this new security versus already existing debt of the same issuer or others in the market. There are 4,000+ securities in the Barclays U.S. Corporate Investment Grade Index, which is essentially the investable universe for investment grade

credit investors, so the way to “get noticed” and generate demand for an offering (akin to an equity market IPO) is to price it cheap to outstanding debt of the same issuer with similar characteristics (same place in the capital structure, similar indenture/covenant language, maturity, price, etc.). With the strong tone and robust demand this week, the market actually got to a point where new issues were pricing at negative new issue concessions — i.e., TIGHTER than outstanding paper. While this is definitely a bullish sign, there is more to it in our view. We have written previously (“The Future of Corporate Bond Market Liquidity,” Columbia Management 2012 Perspectives) about how the reduced inventories at primary dealers lead to greater spread volatility. In addition, this lack of available inventory also leads to lower price

transparency — with fewer bonds owned in inventory and subdued secondary trading, the quoted levels on outstanding bonds can become stale and quite suspect. As a market with this backdrop transitions quickly from “risk-off” to “risk-on,” the secondary market can have a hard time “keeping up” with the improved sentiment that is being expressed in the primary (new issue) market. As a result, while market participants might infer that new issues are coming rich to secondaries, we would argue that secondary spreads were most likely artificially being quoted too wide. Either way, investors have seemingly entered 2012 with lots of cash built up and a willingness to invest in corporate bonds and other risk as-



Source: Bloomberg, Barclays Capital US Corporate Index

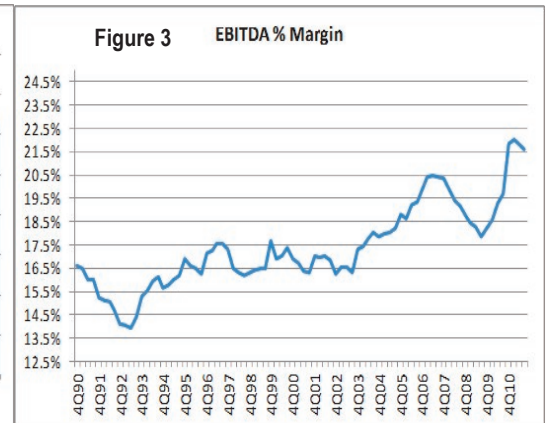
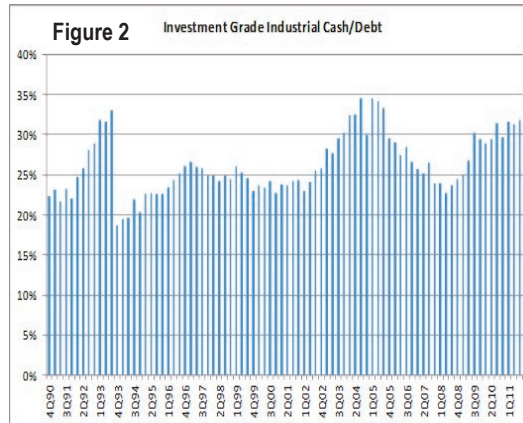
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sets — unless/until Greece and the rest of the eurozone saga pushes its way back into the market’s psyche.

Looked at from an issuer’s perspective, it should come as no surprise that the new issue

Average gross leverage, as measured by debt/EBITDA (earnings before interest, taxes, depreciation, and amortization) is at 2.0x, while net debt leverage is a very comfortable 1.4x (Figure 1). It should also be noted that the 0.6x spread in gross less net leverage is near the all time wides, highlighting that investment grade

“A primary reason why we still see value in investment grade corporate bonds is the continuing strong credit fundamentals. Balance sheets remain in very good condition, as leverage, liquidity and asset quality remain solid.”



Sources: Bloomberg, Barclays Capital US Corporate Index

calendar remains robust. The yield of the Barclays U.S. Corporate Investment Grade Index currently stands at 3.40%. This is essentially the lowest level on record (index data back to 1973) and almost two standard deviations lower than the average yield over that time frame. The public debt markets are providing very attractive financing for corporations. While the spread of the Barclays U.S. Corporate Investment Grade Index has tightened 43 basis points YTD, we still find value in certain names and sectors, and from a valuation perspective, we prefer the yields of corporate bonds relative to U.S. Treasuries.

A primary reason why we still see value in investment grade corporate bonds is the continuing strong credit fundamentals. Balance sheets remain in very good condition, as leverage, liquidity and asset quality remain solid (See “Investment-Grade Corporate Credit Quality – Still Strong But Less Improvement Ahead,” Columbia Management 2011 Mid-Year Perspectives). For industrials, many metrics are at or near the strongest levels seen in two decades.

corporations continue to maintain a notable amount of cash on the balance sheet. Despite the headlines surrounding dividend and share buyback announcements during 2011, cash/debt remains robust at 32% (Figure 2). The ability to generate cash remains solid, as demonstrated by average EBITDA margins near recent highs at 21.6% (Figure 3). And while we have seen an increase in debt issuance to start 2012, as highlighted above, it is our belief that management teams are being cost-of-debt opportunistic, as corporate actions, as well as discussion with our credit analysts, highlight a continuing concern about managing term structures. Most management teams have not forgotten the complete shutdown of the capital markets during periods of 2008 and 2009 and prefer to maintain a capital term structure that fits within their free cash flow generation.

Q1 Asset Allocation Update



By Anwiti Bahuguna
Senior Portfolio Manager
Asset Allocation

“Although U.S. economic growth remains below long-term trend, economic data is showing some signs of improvement after the recession scare last fall. However, we expect financial markets to remain volatile as news of tentative improvements in the economic landscape is met with headlines from Europe of potential flare ups in the debt crisis.”

In a shift from our asset allocation position last quarter, we have added to equities and are now positioned neutral to portfolio benchmark weights. Market sentiment has improved as U.S. economic data — particularly labor and manufacturing — are showing some signs of improvement and the housing market appears to be stabilizing. Worries remain that uncertainty surrounding an agreement on extending payroll tax relief and other unemployment benefits could be a drag on economic growth in 2012.

The Federal Reserve continues to expect modest growth and has announced their intention not to raise rates until 2014. Fears of a euro-debt crisis have abated somewhat. Europeans have made demonstrable progress on two key fronts. First, European Central Bank’s (ECB) long term refinancing program (LTRO) has removed the funding shortages impacting the European financial system last year. ECB’s unlimited LTRO does not solve the sovereign debt crisis and the related solvency issues, but does buy crucial time for the participating banks to repair their balance sheets and be in a better state to weather downgrades to their sovereign debt holdings. Second, broad agreement on a new fiscal pact by most countries in the European Union with the notable exception of U.K and the Czech Republic is a step in the right direction towards greater fiscal consolidation. U.S. equity market valuations are not stretched and after the price to earnings (PE) multiple contraction in 2011, valuations appear attractive.

Although U.S. economic growth remains below long-term trend, economic data is showing some signs of improvement after the recession scare last fall. However, we expect financial markets to remain volatile as news of tentative improvements in the economic landscape is met with headlines from Europe of potential flare ups in the debt crisis.

While we have added to equities, we continue to favor defensive lower beta, large-cap dividend-paying companies and are staying below benchmark weights in higher beta, riskier small- and mid-cap stocks. From a global allocation perspective, we continue to favor U.S. and emerging market equities over other developed market equities. About 80% of economic growth this year is expected to come from emerging or developing market economies and we continue to favor emerging market equities.

Within fixed income, we continue to favor high-yield bonds despite some spread tightening since last October. The majority of high yield returns going forward will likely come from the interest paid on bonds or the coupon and additionally there could be incremental gains from modest spread tightening, if the economic environment were to continue to strengthen. Therefore, the risk-return characteristics of high yield bonds remain attractive. Balance sheets of U.S. corporations are strong and we continue to favor investment-grade bonds as a balance to riskier holdings in the portfolio. Emerging market bonds are also attractive as we believe policymakers are less likely to tighten monetary policy with some signs of slow-down in inflation. We are underweight Treasuries as they appear overvalued after the flight to safety last year and we expect rates to inch up marginally if the economy continues to recover. We have reduced cash allocations held during the volatility of last quarter to fund additions to equity weights.

There are risks associated with fixed income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is more pronounced for longer-term securities.

Investments in foreign securities involve certain risks not associated with investments in U.S. companies, due to political, regulatory, economic, social and other conditions or events occurring in the country, as well as fluctuations in currency and the risks associated with less developed custody and settlement practices. Risks are particularly significant in emerging markets.

Investments in small- and mid-capitalization companies involve greater risks and volatility than investments in larger, more established companies.

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Weekly Market Summary as of 02/10/12

	Last	Week Ago		Month Ago		YTD		Year Ago	
	Yield	Yield	Chg	Yield	Chg	Yield	Chg	Yield	Chg
Bonds									
U.S. 2-year	0.27	0.23	0.04	0.24	0.03	0.24	0.03	0.83	-0.56
U.S. 10-year	1.99	1.92	0.06	1.97	0.02	1.88	0.11	3.69	-1.71
Barclays Capital U.S. Aggregate	2.10	2.11	-0.01	2.22	-0.12	2.24	-0.14	3.29	-1.19
Barclays Capital U.S. Agg Corporate	3.37	3.43	-0.06	3.72	-0.35	3.74	-0.37	4.22	-0.85
BofAML High Yield Index	7.78	7.84	-0.06	8.34	-0.56	8.54	-0.76	7.40	0.38
AAA Muni 10-year	2.24	2.21	0.03	2.21	0.03	2.28	-0.04	3.48	-1.24
Equity Indices	Price	Price	TR Chg	Price	TR Chg	Price	TR Chg	Price	TR Chg
S&P 500 Index	1,342.6	1,344.9	-0.1%	1,292.1	4.1%	1,257.6	7.0%	1,321.9	3.7%
Russell 1000 Growth Index	630.6	630.5	0.1%	596.3	5.9%	580.9	8.7%	607.1	5.5%
Russell 1000 Value Index	664.0	666.6	-0.4%	645.1	3.1%	626.1	6.3%	669.9	1.6%
Russell 2000 Growth Index	470.2	479.4	-1.9%	439.0	7.2%	425.0	10.7%	459.8	2.9%
Russell 2000 Value Index	1,066.5	1,092.3	-2.3%	1,010.0	5.7%	979.3	9.0%	1,089.8	-0.1%
MSCI EAFE Index	1,525.0	1,529.5	-0.3%	1,429.0	6.8%	1,412.6	8.0%	1,725.6	-8.7%
MSCI EM Index	1,042.2	1,048.4	-0.6%	948.8	9.9%	916.4	13.8%	1,089.3	-1.9%
Commodities	Price	Price	%Chg	Price	%Chg	Price	%Chg	Price	%Chg
Gold	1,722.0	1,726.3	-0.2%	1,632.4	5.5%	1,563.7	10.1%	1,363.8	26.3%
Crude Oil	98.7	97.8	0.8%	102.2	-3.5%	98.8	-0.2%	86.7	13.8%
USD Index	79.1	78.9	0.2%	80.8	-2.1%	80.2	-1.3%	78.3	1.1%

Source: Columbia Management Investment Advisers, LLC

Past performance is no guarantee of future results.

DESCRIPTION OF INDICES

The Barclays Capital Aggregate Bond Index is a market value-weighted index that tracks the daily price, coupon, pay-downs, and total return performance of fixed-rate, publicly placed, dollar-denominated, and non-convertible investment grade debt issues with at least \$250 million par amount outstanding and with at least one year to final maturity.

The Barclays Capital Corporate Investment Grade Index is an unmanaged index consisting of publicly issued U.S. Corporate and specified foreign debentures and secured notes that are rated investment grade (Baa3/BBB- or higher) by at least two ratings agencies, have at least one year to final maturity and have at least \$250 million par amount outstanding. To qualify, bonds must be SEC-registered

The BofA Merrill Lynch High-Yield Bond Master II Index is an unmanaged index that tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

The Russell 1000 Growth Index measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 1000 Value Index measures the performance of those Russell 1000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The Russell 2000 Growth Index measures the performance of those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 2000 Value Index tracks the performance of those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The Morgan Stanley Capital International Europe, Australia, Far East (MSCI EAFE) Index is a capitalization-weighted index that tracks the total return of common stocks in 21 developed-market countries within Europe, Australia and the Far East.

The Morgan Stanley Capital International Emerging Markets Index (MSCI EMI) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of June 2006, the MSCI Emerging Markets Index consisted of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey.

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