

Portfolio Manager Commentary

## Overview, Strategy, and Outlook, as of September 30, 2010

*While the rest of the nation began to turn its focus to the upcoming elections in November, much of the attention of the money markets was on the Fed and other regulatory and supervisory bodies.*

### Money Market Overview by Dave Sylvester

In the statement it released after its September 21 meeting, the Federal Open Market Committee (FOMC, or Fed) made a curious reference to inflation rates being "... currently at levels somewhat below those the Committee judges most consistent ... with its mandate to promote maximum employment and price stability." To market observers, who have been conditioned to see central banks as inflation fighters, the words "inflation" and "too low" didn't seem to go together. Was the Fed signaling that it wanted to promote inflation and, if so, what would the Fed do about it? Well, not much for now, according to its statement. In addition to language contained in prior releases that "inflation is expected to remain subdued for some time," the Fed added, "... before rising to levels the Committee considers consistent with its mandate." What would cause this to occur was left unsaid.

The statement disappointed some market participants in that it did not formally announce a new wave of asset purchases. Presumably, these participants owned long Treasuries and hoped that the Fed would be an aggressive buyer in the markets, after having enjoyed the price appreciation that accompanied the Fed's August announcement that principal payments from agency debt and mortgage-backed securities would be reinvested in longer-term U.S. Treasury securities. Alas, all the Fed gave them was the assurance that it was "... prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate."

News articles published near month-end revealed additional details on the Fed's plans for what is being called "QE2." QE2 is no longer a reference to a luxury cruise ship but is market shorthand for another round of quantitative easing by the Fed; in other words, the Fed will be buying bonds. By purchasing bonds in the markets, the Fed hopes to lower interest rates and further spur the anemic economic recovery. In March 2009, the Fed announced a

massive round of easing with the purchase of \$1.7 trillion in government and mortgage-backed securities. In contrast, QE2 is envisioned as an open-ended program of smaller purchases. Of course, "smaller" is a relative term, and to the Fed, "small" is not that small. One regional Fed president said that purchases over \$1 trillion per year would give him "pause," since that is the total amount of net new borrowing expected by the Treasury in the coming year!

This is a big change from just a few months ago, when the Fed was talking about how to go about reducing the size of its portfolio and would seem to indicate that the Fed's own outlook for the economy has deteriorated considerably. Indications are that, at this point, the discussions within the Fed around QE2 are not if they will ease, but how they will ease. New reports point to an inclination to review the program at each FOMC meeting, making the program dependent on the latest economic data and subject to the potential pitfalls of fine-tuning the economy.

In another—though perhaps not unrelated—announcement, the Federal Reserve Bank of New York (FRBNY) expanded the criteria for reverse repurchase (RRP) agreements with a second wave of money market funds. Essentially, the minimum asset size for eligible money market funds was dropped from \$20 billion to \$10 billion. This change could significantly expand the number of funds that are potentially eligible to execute reverse repos with the FRBNY. In addition to the 26 funds that were approved on August 18, these expanded criteria have the potential to add another 35 or so funds, and potentially increase the assets represented by these funds from \$1.1 trillion to \$1.7 trillion. We have no insight into the timing of the RRP agreement program, but we continue to believe that the FRBNY's direct involvement in the repo markets will introduce much-needed collateral into what is an extremely important but shrinking market sector. A link to the FRBNY's announcement is below.

[http://www.newyorkfed.org/markets/rrp\\_criteria\\_II.html](http://www.newyorkfed.org/markets/rrp_criteria_II.html)

The potential for additional repo collateral is welcome news, especially in light of proposed regulatory action that might have the effect of further shrinking that market. The total net size of the repo market has already contracted substantially as the financial sector continues its process of reducing leverage. After peaking at nearly \$5 trillion in the spring of 2008, total net repo outstanding is now probably in the \$2.5 trillion to \$3 trillion range. Because repo balances tended to be “hot” during the liquidity crunch, regulators have wanted to get a better handle on this market. This month, the Securities and Exchange Commission (SEC) proposed new regulations that would require more detailed disclosure of companies’ short-term borrowings in an effort to curtail the “window dressing” of financial statements. Under the proposed new rules, financial companies would be required

to report not only period-end borrowings but also average daily and peak balances. Money market participants are familiar with the month-end and quarter-end decline in repo availability, as firms lower their leverage ratios in anticipation of publishing their financial statements. The new rules propose that firms provide an explanation of the differences between peak and period-end balances. Given the challenges of putting the current motivations for these changes into a form that might pass muster, we’d expect firms to instead reduce their intra-month borrowings in this market, further crimping supply. While this might lead to lower rates in this short, short sector, the hope is that this would be relieved by the introduction of additional collateral from the FRBNY’s RRP program.

#### RATES FOR SAMPLE INVESTMENT INSTRUMENTS (%)

*Current Month-End (September 2010)*

SECTOR	1 Day	1 Week	1 Month	3 Month	6 Month	12 Month
Government Repurchase Agreements	0.35	0.18				
U.S. Treasury Bills			0.13	0.13	0.16	
Agency Discount Notes	0.02	0.04	0.10	0.17	0.21	0.28
LIBOR	0.23	0.25	0.26	0.29	0.46	0.78
Asset-Backed Commercial Paper–First Tier		0.30	0.32	0.38		
Dealer Commercial Paper–First Tier		0.22	0.25	0.37		
Municipals/Variable-Rate Demand Notes/ Commercial Paper/Notes–“AA”	0.28	0.27	0.28	0.30	0.30	0.30

*Month-End (August 2010)*

SECTOR	1 Day	1 Week	1 Month	3 Month	6 Month	12 Month
Government Repurchase Agreements	0.24	0.23				
U.S. Treasury Bills			0.15	0.13	0.16	
Agency Discount Notes	0.12	0.13	0.14	0.17	0.19	0.30
LIBOR	0.23	0.25	0.26	0.30	0.50	0.84
Asset-Backed Commercial Paper–First Tier		0.35	0.33	0.39		
Dealer Commercial Paper–First Tier		0.20	0.19	0.32		
Municipals/Variable-Rate Demand Notes/ Commercial Paper/Notes–“AA”	0.26	0.30	0.28	0.30	0.30	0.25

*Change in Basis Points (M/M)*

SECTOR	1 Day	1 Week	1 Month	3 Month	6 Month	12 Month
Government Repurchase Agreements	0.11	-0.05				
U.S. Treasury Bills			-0.02	0.00	0.00	
Agency Discount Notes	-0.10	-0.09	-0.04	0.00	0.02	-0.02
LIBOR	0.00	0.00	0.00	-0.01	-0.03	-0.07
Asset-Backed Commercial Paper–First Tier		-0.05	-0.01	-0.01		
Dealer Commercial Paper–First Tier		0.02	0.06	0.05		
Municipals/Variable-Rate Demand Notes/ Commercial Paper/Notes–“AA”	0.02	-0.03	0.00	0.00	0.00	0.05

Source: Bloomberg, LP

## Credit Landscape by Mike Shinnors and Karen Hessing

On September 19, the oversight body of the Basel Committee on Banking and Supervision (BCBS) announced and fully endorsed changes to bank capital requirements and introduced global liquidity standards. Collectively, these changes are commonly referred to as Basel III and are scheduled to be presented for approval by the G-20 at its November meeting in Seoul. While much of the discussion has focused on the changes to capital requirements, the liquidity standards may have a significant impact on short-term investment opportunities. The liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR) are two standards broadly designed with the intention of improving the resilience of institutions during short-term liquidity disruptions (LCR) and improving asset/liability funding mismatches by incenting the use of longer-term funding (NSFR). Taken as a whole, the measures may improve the risk profile of financial institutions. However, they may also constrain investment opportunities in the short-term space as financial institutions extend funding, purchase liquid assets, and exit or reduce certain issuance programs, even as revised Rule 2a-7 reduces the limit on weighted average final maturity and enacts minimum standards for daily and liquid assets.

The LCR, or “run on the bank,” ratio requires a bank to maintain a stock of unencumbered, highly liquid assets that exceed an estimate of net cash outflows over a 30-day horizon during a “stressed” environment. While implementation is scheduled for 2015, the observation period begins January 2011, and regulators have already pushed financial institutions to increase liquid asset holdings. Liquid assets may include cash, excess central bank reserves, domestic/foreign currency government debt, as well as other liquid instruments (subject to a haircut) as defined in the documentation. Net cash outflows determined over the 30-day measurement period will be calculated according to a matrix drawn up by regulators and considered on-balance-sheet items (deposits) and off-balance-sheet or contingent items (credit and liquidity facilities). One impact of the LCR may be increased demand by banks for the same securities to fill the liquid asset bucket that money funds use to meet their own regulatory liquidity requirements. The requirement to hold liquid assets against credit and/or liquidity facilities and other short-term debt may make certain types of debt issuance cost-prohibitive for both banks and borrowers to continue to issue or sponsor; such programs may include repo, commercial paper, and, in particular, asset-backed commercial paper, as well as other types of supported issuance, such as letter-of-credit-backed municipal debt. Finally, banks will also have to consider the funding dynamics needed relative to their holdings of liquid

assets (cash drag on funding liquid assets with longer-dated funding). All of this may have the effect of reducing lending by financial institutions.

The NSFR, which is expected to be implemented in January 2018, measures the required amount of funding that is expected to be stable over a one-year time horizon, examining on- and off-balance-sheet exposures. The ratio mandates that the available stable funding should be in excess of the required amount of stable funding based on factors proscribed by regulators. Stable funding includes capital, preferred stock, liabilities with effective maturities greater than one year, and a portion of other deposits that are expected to stay on deposit during a stressed event. The effect of the ratio also constrains a financial institution’s ability to issue a significant amount of debt outside the 30-day review period in the LCR. Implementation has been delayed until 2018 because of the significant amount of rule-making yet to be done and because of concerns expressed by various national regulators and institutions that the ratio may not appropriately capture jurisdictional nuances that may affect national banking systems differently.

The Dodd-Frank “Wall Street Reform and Consumer Protection Act,” which was signed into law on July 21, 2010, includes a number of changes affecting the municipal securities market. Most of these provisions relate to future rule-making and study. Dodd-Frank requires studies evaluating the transparency of trading in the municipal bond market, as well as funding for GASB (Government Accounting Standards Board, the municipal equivalent of the Financial Accounting Standards Board—FASB—which governs accounting for corporate entities), within 18 months of signing. The act also requires a review and recommendations regarding municipal disclosure, with a report to be submitted to Congress by July 2012. Among other things, the municipal disclosure report will comment on the advisability of repealing the Tower Amendment. The Tower Amendment currently limits the authority of the SEC or the Municipal Securities Rulemaking Board to require a municipal issuer to make any filing with the SEC prior to the issuance of municipal securities.

There are two types of municipal disclosure: initial offering disclosure and secondary, or continuing, disclosure. Initial offering disclosure improved greatly over the last half of the 20th century. Back when most new issues were sold at competitive auction (as opposed to today’s more prevalent negotiated offering), often the only information a municipal issuer provided was a notice of sale, stating where and when bids would be received. New York City’s financial crisis in the 1970s accelerated the movement toward greater

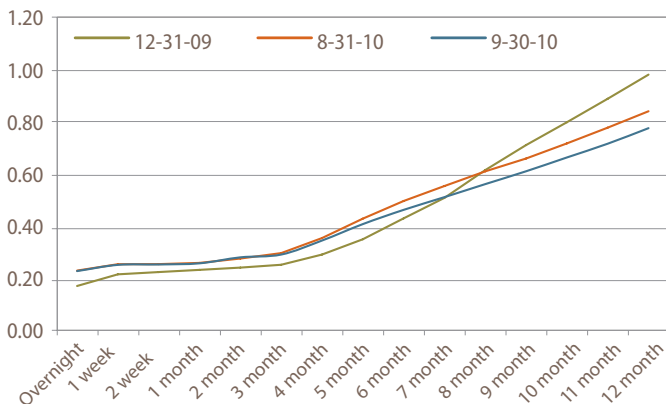
disclosure, as now represented by the publication—in most, but still not all, cases—of a preliminary official statement and a final official statement. Secondary, or continuing, disclosure is more problematic. While some revenue bond issuers provide good ongoing disclosure, the picture can be very different for states, counties, and municipalities. These issuers generally report only on an annual basis, and in some cases their audited financials can be as much as a year late. A number of Web sites have been set up to make continuing disclosure available, and a number of issuers have signed statements pledging to provide timely, ongoing “material” disclosure. However, the record of compliance is patchy, and there are debates over what is or is not required to be disclosed as “material.”

Undoubtedly, moving all issuers of municipal securities to the same requirements as those of corporations—with their 10-Ks and 10-Qs—would prove a great hardship and expense for many municipal securities issuers. There are more than 70,000 issuers of municipal securities, some of which come to market only rarely and then for very small amounts of debt. However, some improvement in this area would greatly benefit investors. We would welcome greater, more frequent, and more timely disclosure, particularly by large, frequent municipal securities issuers.

### Strategies for the Prime Funds by Laurie White and Madeleine Gish

The London Interbank Offered Rate (LIBOR) curve flattened further this month, with the short end staying relatively unchanged and one-year LIBOR falling another six basis points (bps) after declining 20 bps last month. Market rates are expected to be fairly stagnant around current levels for the foreseeable future. The decrease in rates on the longer end reflects demand from market participants reaching further out on the short-term yield curve to lock in what yield pickup there is over the shorter, one- to three-month tenors.

LIBOR YIELD CURVE COMPARISON AS OF 9-30-2010 (%)



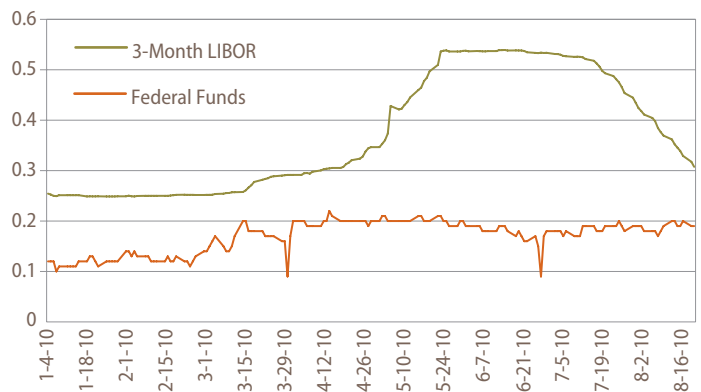
Source: Bloomberg, LP

Demand for very short securities (seven days and less) increased after the SEC Rule 2a-7 revisions became effective. That demand, combined with the issuers’ need to lengthen the term of their liabilities, has driven rates on short-term paper increasingly lower and narrowed the field of acceptable counterparties. The situation became more acute at quarter-end, with issuers reluctant to write paper with maturities in the dates leading up to the end of September.

We expect this trend to be repeated at the end of the fourth quarter as well; indeed, there are already signs that this is occurring. To provide an incentive to investors to buy paper over year-end, issuers are either not posting short dates or are posting low levels for 2010 maturities and paying higher yields for maturities going into 2011. Some of our normal counterparties have refused to write paper with maturities in the last two weeks of December. It has become increasingly customary for brokers to show new-issue paper to the accounts that have that issuer’s paper maturing. Consequently, this month we began to actively seek out issuers that were willing to write paper with maturities in the last two weeks of the year. We believe this strategy works in our favor under any likely year-end scenario: we will either have product available to invest money during a time that markets have traditionally been thin, or we will have cash available to take advantage of investment opportunities presented by issuers that need short-term liquidity at year-end.

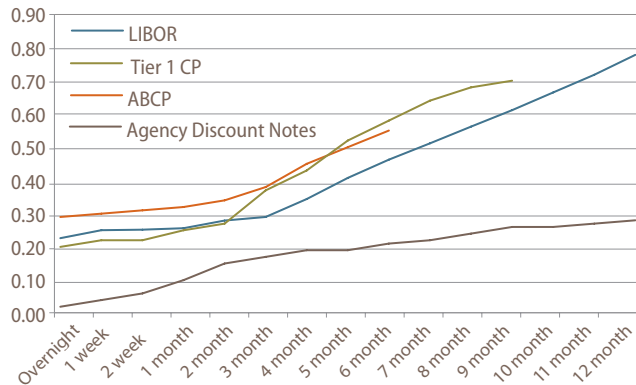
As our inventory of floating-rate notes has matured, we have been reinvesting the proceeds back in that sector; as a result, our exposure remains relatively constant at about 15%. The yield pickup on floaters can be substantial when compared with fixed-rate issuance: the same high-quality banks that are offering six-month fixed-rate paper in the low 0.30% range are issuing one-year final maturities with resets off three-month LIBOR at +10 bps, a current yield of about 40 bps.

FEDERAL FUNDS RATE AND THREE-MONTH LIBOR (%)



Source: Bloomberg, LP

YIELD COMPARISON IN THE MONEY MARKET AS OF 9-30-2010 (%)



Source: Bloomberg, LP

In light of an environment that is relatively similar to what we've seen over most of the past year, it's not surprising that we continue to pursue the same strategy in the prime funds. We emphasize purchasing highly liquid, high-quality names maturing in the one- to three-month area and carrying a very high degree of liquidity—in some cases approaching 40% to 50% of a fund maturing within one week. We believe this strategy gives us the flexibility to respond to rapidly changing market conditions in a relatively short period of time and helps us maintain our commitment to preservation of principal and liquidity.

### Strategies for the U.S. Government Funds by Mike Bird

Government securities with relatively short maturities were in vogue during the month, as the upcoming quarter-end shifted investor focus. Whether because of balance sheet constraints, fiscal reporting periods, or general mandates, market participants needing to be fully invested at quarter-end, coupled with declining supply, drove yields lower in securities with maturities in the one-week to two-month area.

The increased appetite for shorter-dated securities was first felt in the U.S. Treasury bill (T-bill) market. As early as the first few business days of the month, demand for T-bills maturing in early October increased significantly. The yield was cut in half in a matter of two days. As the month drew to a close, yields actually went negative, as some market participants needed October T-bills at any cost. At the same time, the overall supply in the T-bill market was declining. This is a typical September occurrence, however, so it did not come as a shock to the market. That said, with a majority of the focus centered on the very short end of the yield curve, the yields on T-bills with maturities in the three- to 12-month part of the curve remained relatively unchanged.

Discount notes issued by government-sponsored enterprises (GSEs or agencies) followed a similar, albeit more muted, pattern. However, it wasn't until yields on T-bills went into negative territory that the demand for short-dated discount notes picked up. Market participants tend to favor the extra safety and liquidity of T-bills but, at the same time, prefer a positive yield; therefore, they will seek alternate investments when yields turn negative. When T-bill yields went negative toward month-end, the yield on agency discount notes maturing in October fell quickly. As an example, the yield on one-month discount notes dropped five bps over a two-day span late in September. This may not seem significant, but on a percentage basis, it was a drop of over one-third. Like T-bills, the remainder of the GSE discount note yield curve remained roughly unchanged during the month.

Our focus in the *Wells Fargo Advantage 100% Treasury Money Market Fund* has been to ladder maturities across the yield curve in an effort to provide liquidity and maintain a stable \$1.00 net asset value (NAV). In the *Wells Fargo Advantage Treasury Plus Money Market Fund*, we have emphasized U.S. Treasury-backed repurchase agreements, which offer price stability and daily liquidity at a higher yield than T-bills. The focus in the *Wells Fargo Advantage Government Money Market Fund* has been on liquidity and a stable \$1.00 NAV. Most of our investments have been in GSE-backed repurchase agreements, three- to six-month GSE debt, and adjustable-rate GSE securities that reset off one- and three-month LIBOR, all of which are consistent with the primary objectives of the Fund.

### Strategies for the Municipal Funds by Jim Randazzo

Between August 25 and September 29, municipal money market funds experienced moderate outflows, with total assets dropping from \$338.5 billion to \$329.2 billion. September's strong equity market performance, corporate tax payments, and quarter-end window dressing all contributed to the redemption pressures.

Despite the slow and steady reduction in asset levels, municipal money market yields have remained range-bound, as the Fed's commitment to low short-term rates for an extended period of time has continued to compress yields across the fixed-income and money market sectors. Additionally, increased demand for variable-rate demand notes from crossover taxable buyers has substituted for the lack of demand from traditional municipal money market funds. While municipal money market rates seem low on

an absolute basis, they are very attractive relative to yields in the taxable markets. As a result, the Securities Industry and Financial Markets Association seven-day floater index averaged 0.28% for the second consecutive month, resetting in a very narrow range between 0.25% and 0.30%.

While overnight and weekly rates remained generally unchanged from the previous month, rates on tax-exempt commercial paper and notes with longer maturities inched northward a few basis points. High-grade commercial paper in the one-month to three-month range increased one to two bps, while the Municipal Market Data one-year note index backed up five basis points to 0.30%. The primary note market was relatively quiet, with no large deals comparable to the massive multi-billion dollar Texas and New Jersey notes issued in August. Secondary market trading in both benchmark names remained in the 0.33% to 0.37% range.

In light of these market conditions and the expectation for the persistence of low absolute rates, our investment strategy across all municipal money market funds continues to be principal preservation with an emphasis on maintaining high levels of liquidity. Accordingly, we continue to favor daily and weekly floating-rate and variable-rate

demand notes as a means of maintaining highly liquid portfolios. Additionally, we have focused our fixed-rate and commercial paper investments in the 30- to 60-day range in order to increase portfolio diversification while maintaining weighted average maturities that are generally shorter than our peer group.

### **The Inside Track**

The Fed's commitment to the zero interest rate policy seems even stronger as discussions about a second phase of quantitative easing have picked up. There continues to be a disconnect between the issuers' desire to fund longer and market participants' need for shorter-term investments—an issue that we do not think will be resolved easily. Although we've seen some securities issued that bridge that gap, demand continues to outstrip supply, and we believe that over the longer term, the yield curve will steepen further. With much rule-writing to be done in the coming months, and a somewhat unsettled credit environment, there is still a fair amount of uncertainty in the money markets. In light of all of this, we think it is wise to continue to focus our investment strategy on that stable NAV and a high degree of portfolio liquidity.

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