

Portfolio Manager Commentary

Overview, strategy, and outlook: As of June 30, 2011

Money market overview by Dave Sylvester

As everyone focuses on the current situation in Europe, much has been written about money funds' exposure to foreign banks or, more specifically, European banks. Yet if one really wanted to focus on the core issue, it would be banks in the eurozone or, even more appropriately, a few banks in the eurozone. How did a problem that began in Greece, a relatively small country on the edge of Europe, become a topic that brought money funds back into the spotlight? What are the real concerns, and is there any reason to be at all optimistic?

The debt levels in Greece have been a problem for some time now. The issue first gained wide attention in the spring of 2010 when it was revealed that debt levels in Greece had not only been growing rapidly, but they were actually much higher than had been previously reported by the government. Greece began to encounter difficulty in selling new debt issues, the proceeds of which were needed to pay off maturing debt issues and to fund new spending. Interest rates on Greek government bonds began to climb, further adding to the country's burden. In response, the European Union (E.U.) and the International Monetary Fund (IMF) crafted an assistance package, while the European Central Bank (ECB) began to buy Greek government bonds directly.

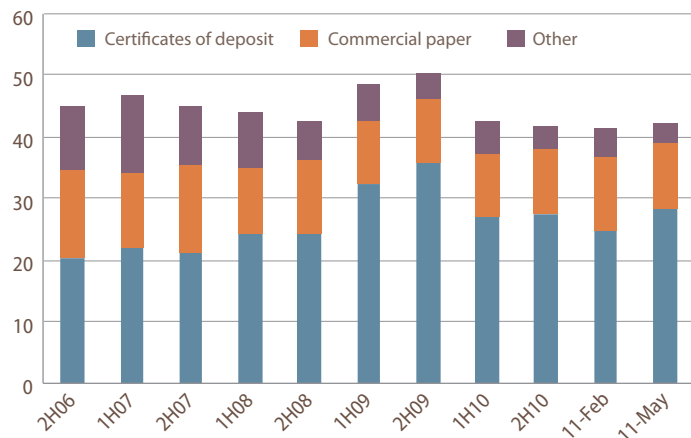
Investor attention then shifted from Greece alone to include other European nations that had heavy financial burdens: Portugal and Ireland. Although conditions in these three countries were much different, they began to be lumped together in what has come to be called the "periphery" of Europe. For a time, Spain and Italy were included in this pack, but those nations took measures to address potential issues and, for now at least, have been successful at separating themselves from the three troubled nations. But where Ireland and Portugal both adopted austerity measures in order to reduce their budget deficits, Greece has been less successful in doing so. High levels of entitlement payments, a history of widespread tax evasion, and an economy that just is not competitive have led to chronic structural deficits.

The IMF and the E.U. require that the nations receiving their assistance take definitive steps to bring their finances under control. At the end of June, the Greek Parliament approved a medium-term plan for fiscal austerity, paving the way for Greece to receive the next tranche of its bailout payment in early July. The next step will be to reach an agreement on a longer-term plan that would enable Greece to work its way out from under its Mt. Olympus of debt. While several alternative proposals have been made, the most favored appears to be the French solution, which is reportedly supported by the Germans: a certain percentage of Greek bonds will be rolled over into long-term bonds at rates that will be reasonably manageable for Greece.

Despite efforts by the Greek government, European authorities, and debt holders to restructure outstanding debts, it's becoming increasingly accepted that the Greeks will almost certainly default on their debts at some point in the future. This is because several rating agencies (these guys again?) have announced that they will classify as a default any restructuring where the terms are worse for the debt holders than the original terms. Of course, if the terms are not favorable to the borrower, there's really no point in restructuring, is there?

So what does this have to do with money market funds? As part of their diversified portfolios, money market funds hold obligations of banks, including foreign banks. Despite protestations from the editorial boards at leading financial publications that they are shocked—shocked!—to find foreign bank debt in U.S. money funds, we are not in Kansas anymore. We have had an interconnected and global financial system for many, many years, and money funds lend to high-quality issuers across the developed world. Some speculate that money funds' exposure to foreign banks has increased as yields have declined, but that's simply not the case. In fact, as shown in the chart on page 2, U.S. money funds' exposure to foreign banks has remained fairly constant for the past five years, at 40% to 50% of money fund assets.

Money market fund exposure to European banks ex-repo (%)



Source: Fitch

Past performance is no guarantee of future results.

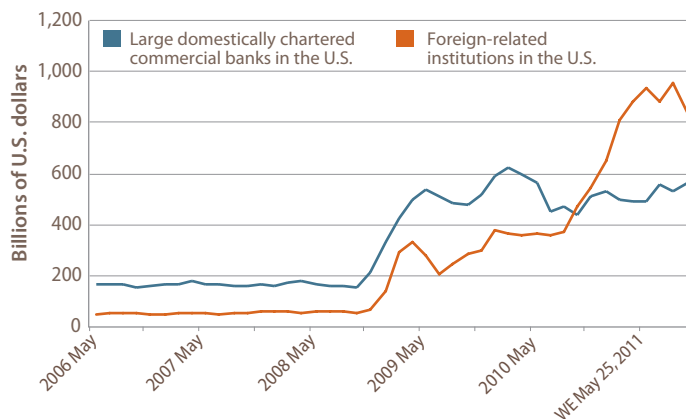
Why have money funds invested in foreign banks? In part, it is simply a supply issue. While the total supply of U.S. dollar-denominated investments that are eligible to be purchased by prime money market funds exceeds \$9 trillion, when U.S. government securities and repurchase agreements (repos) are excluded, that number drops to a level closer to \$2 trillion. Of that \$2 trillion, we estimate that foreign banks and their affiliates issue about 40%. Therefore, money fund exposure to foreign banks is not outsized but in line with the composition of the money markets themselves. It has been no secret that supply in the money markets is very constrained; we have addressed the topic here on a number of occasions.

To us, it is not surprising that money funds have continued to keep a fairly high level of exposure to foreign banks. U.S.-based issuers have been dropping out of the domestic money markets for a couple of years now. As the economic woes have taken a toll in the financials sector, a number of banking institutions were absorbed or purchased by stronger entities. Other firms just no longer meet money funds' requirement that issuers present minimal credit risk. Both of these factors reduced the number of available issuing entities. In addition, as interest rates have plummeted, the remaining high-quality issuers have been taking advantage of these favorable rates by issuing long-term debt. However, foreign banks remained key issuers in the short end. Most have continued to improve their fundamental credit profiles and issue into the money markets.

What have foreign banks been doing with the money raised by all of this issuance? To a great extent, they've been using it to build their cash reserves. Data from the Federal Reserve (the Fed) shows that the cash balances at foreign-related institutions have more than doubled in the past year to approximately \$1 trillion. Much of the increase has come in

the last several months, as foreign banks' cash reserves have increased from \$500 billion at the end of February. Some market observers estimate that of the \$1.5 trillion in excess reserves held at the Fed, more than \$850 billion is held by the U.S. branches of foreign banks.

Cash balances of large domestic and foreign banks



Source: Federal Reserve Release H8 NSA

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How did foreign banks come to accumulate such a war chest in such a short period of time? This is what we think happened: You may recall that at the beginning of April, the Federal Deposit Insurance Corporation (FDIC) changed its method of assessing charges to large banks for its insurance program. Instead of being assessed only on insured assets, large banks were basically assessed based on the total assets, less equity. Although the rate varies from bank to bank, it's been estimated that across the large banks it works out to approximately 10 to 15 basis points (100 basis points equals 1.00%). Since the FDIC assessment became part of these banks' all-in costs, the nominal market rates that they paid to institutional depositors and market participants fell by a commensurate amount. And since the FDIC charge applies to all of the assets, not just insured deposits, large domestic banks cut the amount of funding that they were taking from the money markets.

The first effect was to drop rates in the repo market to near zero, soon followed by rates across the short curve. Since U.S. branches of foreign banks do not offer FDIC insurance, they were not subject to this increased assessment. When rates dropped, these foreign banks were able to issue both here and abroad at very low rates and then simply leave the money in their accounts at the Fed and collect the 25 basis points (bps) that the Fed pays as interest on excess reserves. Since the excess reserves held at the Fed are available on demand and are at a central bank, this probably enabled the

banks to meet the liquidity coverage ratio and net stable funding ratio requirements that have been imposed by their regulator or which are outlined in Basel III.¹ (Although the Basel III requirements have not yet been fully implemented, many banks are beginning to phase them in.) Since the Fed was force-feeding reserves into the system through its second round of quantitative easing, or “QE2,” the reserves had to go somewhere; with large U.S. financial institutions trying to cut their balance sheets to reduce the charge from the FDIC, the money had to flow somewhere. The result was a massive increase in cash reserves at the foreign banks.

So if issuance by foreign banks has increased and the money funds’ holdings have been constant, who has been buying this paper? Frankly, it’s difficult to tell. No other sector of the money market seems to have the transparency that would allow us to aggregate and examine its investments as we can with money market funds. Flow of funds data from the

Federal Reserve indicates that the large buyers of commercial paper in the first quarter of 2011 were “mutual funds,” as opposed to money market funds. With bond funds surpassing money market funds in assets through May, we suspect that at least a portion of these new monies were deployed in either a temporary or defensive manner into money market instruments. As we commented above on the supply situation, if you are buying prime money market instruments in any size, you are probably buying foreign bank paper.

Now, we are back to Greece. What happens to the European banks if Greece defaults, or even if the bondholders have to take a large haircut? Clearly, the exposure to Greece varies among banks, as does the amount of capital that each bank holds. But we do not underestimate the contagion risk, and we suspect that this would lead to further problems for Portugal and Ireland. In our assessment of whether or not an issuer presents minimal credit risk, we believe that one

Rates for sample investment instruments

Current month-end % (June 2011)

SECTOR	1 day	1 week	1 month	3 month	6 month	12 month
U.S. Treasury repos	0.05	0.01				
U.S. Treasury bills			0.01	0.03	0.07	
Agency discount notes	0.01	0.01	0.02	0.06	0.11	0.18
LIBOR	0.18	0.22	0.24	0.30	0.46	0.78
Asset-backed commercial paper–First Tier		0.25	0.26	0.27		
Dealer commercial paper–First Tier		0.16	0.16	0.19		
Municipals–First Tier	0.05	0.09	0.10	0.15	0.20	0.23

Previous month-end % (May 2011)

SECTOR	1 day	1 week	1 month	3 month	6 month	12 month
U.S. Treasury repos	0.11	0.08				
U.S. Treasury bills			0.04	0.04	0.08	
Agency discount notes	0.03	0.03	0.05	0.07	0.11	0.17
LIBOR	0.13	0.18	0.21	0.27	0.43	0.76
Asset-backed commercial paper–First Tier		0.22	0.23	0.30		
Dealer commercial paper–First Tier		0.14	0.17	0.23		
Municipals–First Tier	0.12	0.18	0.20	0.23	0.30	0.25

Change in % (M/M)

SECTOR	1 day	1 week	1 month	3 month	6 month	12 month
U.S. Treasury repos	-0.06	-0.07				
U.S. Treasury bills			-0.03	-0.01	-0.01	
Agency discount notes	-0.02	-0.02	-0.03	-0.01	0.00	0.01
LIBOR	0.05	0.05	0.03	0.03	0.03	0.02
Asset-backed commercial paper–First Tier		0.03	0.03	-0.03		
Dealer commercial paper–First Tier		0.02	-0.01	-0.04		
Municipals–First Tier	-0.07	-0.09	-0.10	-0.08	-0.10	-0.02

Source: Bloomberg, LP

Past performance is no guarantee of future results.

relevant measure is to examine the level of capital of each bank in relation to its exposure to the peripheral nations. We believe that the efforts to shore up bank capital over the past several years have put many of the large eurozone banks in a position where they have sufficient capital to absorb significant losses on their holdings of the sovereign debt of the peripheral nations, should such a loss be necessary.

We also do not underestimate the risk of a credit freeze. In the past, market participants have shut off credit availability to all issuers in a sector when trouble strikes, no matter what the underlying credit fundamentals might be. However, the fact that foreign banks have such large cash balances and excess reserves held at the Fed gives us a very different set of circumstances in the current environment. In previous episodes, borrowers were financing long-term illiquid assets with short-term funding. When the funding was cut off, those borrowers struggled to replace the funding as the price of the assets declined. In the case of foreign banks today, the assets are largely demand deposits at the Federal Reserve. Quality, liquidity, and price stability of these deposits are beyond question. If money funds and other market participants choose to not roll over their maturing commercial paper (CP) and certificates of deposit (CDs), those banks could simply draw down their reserves at the Fed. Additionally, European banks have access to liquidity provided by the ECB, which, along with other central banks around the world, has in place swap lines with our own Federal Reserve. As such, it appears that there is plenty of liquidity to back up near-term maturities. The fact that in mid-June we saw a sharp drop of \$123 billion in cash held by foreign banks in the U.S. may indicate that this unwinding process is already under way.

Does this mean that we are totally complacent? Absolutely not! The widening of credit spreads and the attendant price risk is still a concern, as is the potential for another shift out of prime funds. This is why, for some time now, we have been in favor of short and highly liquid portfolios, sometimes at the expense of yield. We believe that these steps will help to minimize the effects of any short-term price volatility caused by these events.

Finally, it is notable that one of the reasons for the heightened focus on money funds during this episode is increased levels of transparency. Unlike almost every other segment of the financial services industry, people can look through money funds and see exactly what they hold. Data

is reported regularly and in a standardized format. And many money funds, like the Wells Fargo Advantage Money Market Funds, continue to report all of their holdings online after each market day. As we work our way through these events, we invite you to visit us at the [Wells Fargo Advantage Funds Institutional Cash Management website](#).

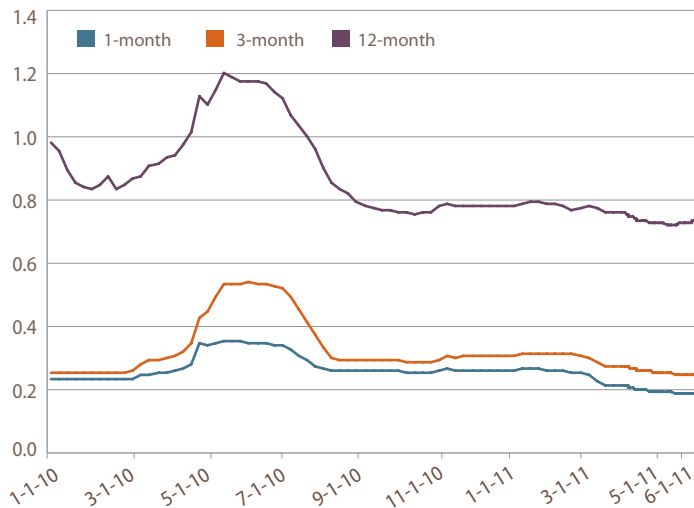
Strategies for the prime funds by Madeleine Gish and Dan Tronstad

As we discussed in our May 2010 commentary, "... concerns over the possibility of Greece defaulting on its debts, questions about the adequacy of the European Union's rescue efforts, and nervousness over contagion in other countries and banks in the eurozone all came to a head during the first week of May. As a result, money market participants pulled in maturity limits on many European banks or ceased lending to them altogether, concentrating instead on investments in domestic banks and financial instruments, as well as U.S. government and agency obligations. This flight to quality resulted in a rally in U.S. government debt, a rally in the U.S. dollar versus the euro, and an increase in London Interbank Offered Rate (LIBOR) across the curve ..."

As we point out again this month, the Greek situation is still with us, as are market concerns about potential contagion. However, this year the market reaction has been very different compared with 2010. So far, there has been neither extreme yield volatility nor a significant flight to quality. The lack of reaction may be attributable to the large cash balances and excess reserve holdings that foreign banks have at the Fed, as discussed above in the overview section.

This difference from last spring's Greek crisis can be observed in LIBOR. As the graph on the following page shows, LIBOR spiked up last year as market participants began shortening maturity limits on European banks or stopped lending to them altogether. This reflected the fact that European banks had to pay higher interest rates in 2010 in order to attract funding. This year, a similar set of news stories has caused market participants to react in a similar fashion, by shortening maturities or ceasing to lend. However, LIBOR has not risen but instead has held steady at historically low yields. This is a good indication that most banks still have sufficient liquidity and, up to this point, have not had to offer materially higher interest rates to attract what funding they do need.

LIBOR (%)



Source: Bloomberg, LP

Past performance is no guarantee of future results.

In this volatile and low-yield environment, we continue to believe that not adding duration or extending down the credit spectrum is the sound strategy. We will continue to focus on constructing portfolios with enhanced liquidity and high credit quality. This will allow us to adjust quickly to changing market conditions, as well as maintain our commitment to preservation of principal and liquidity.

Strategies for the U.S. government funds by Mike Bird and John Kelly

The government markets have spent much of 2011 anticipating regulatory changes and official actions, with each tending to push rates closer to zero. We are now entering a period where many of these expected actions have largely occurred or been completed, and we now begin assessing the market's reaction to their completion.

Foremost among those is the Fed's purchase of Treasury securities in its QE2 program. These purchases had occurred steadily since November 2010 and concluded at the end of June. The program wore short rates down, as securities available for repurchase agreement collateral were removed from the market. July will mark the first month this year that Treasury collateral is not being regularly withdrawn from the market, and while we will watch the market's reaction to the Fed's absence, we do not expect much of a change in yields, at least in the money markets.

Somewhat offsetting the lack of Fed purchases is a flight-to-quality trade stemming from the uncertainty in other sectors of the market, especially the prime sector. The ongoing negotiations around an increase of the U.S. statutory

debt ceiling are further contributing to that element of uncertainty. The U.S. has reached the legal limit on the amount of debt it can issue, and, absent action by Congress to raise the cap, it can't issue any more debt. Over the past few weeks, the U.S. Treasury has met its obligations by drawing on cash it can access through various accounting methods but has forecast that this will enable it to meet its needs only through August 2. The U.S. has dealt with this issue in the past, and in each case Congress has eventually acted to raise the debt ceiling. The market will be watching the progress on these negotiations carefully. While we would consider a default by the U.S. Treasury to be of such low probability that it approaches zero, we acknowledge that the outcome of such an event would be extremely negative. The inevitable action to raise the debt ceiling could result in the Treasury reviving the Supplementary Financing Program, which would likely add \$200 million of bills to the market; this additional supply would be expected to raise short-term government rates.

Our basic strategy in the government funds remains consistent. We continue to ladder maturities across the yield curve in all of the government funds. In the *Wells Fargo Advantage Government Money Market Fund*, which has a broader selection of eligible investments, we also continue to purchase government-sponsored enterprise- and FDIC-guaranteed debt, including adjustable-rate securities that reset off one- and three-month LIBOR.

Strategies for the municipal funds by Jim Randazzo

Rates in the municipal money markets continued their slow and steady march lower during June, as different issues on the credit and supply fronts contributed to increased demand from crossover market participants for high-grade, very liquid short-term municipal securities. The combination of increased demand from nontraditional buyers, as well as the well-documented drought in supply of variable-rate demand notes (VRDNs) and commercial paper caused benchmark rates to fall to all-time lows, despite the somewhat lighter demand resulting from heavy outflows from tax-exempt funds during the month.

Demand was particularly strong in the overnight market, as the average yield on general market VRDNs dropped to roughly 0.06% during the month, after averaging close to 0.10% during the month of May. In the weekly VRDN market, the Securities Industry and Financial Markets Association (SIFMA) index² reset lower for the 10th-straight week; after steadily dropping each week, it eventually fell to 0.09% on June 29, from 0.18% a month earlier.

Further out on the curve, yields on high-grade tax-exempt commercial paper continued to follow overnight and weekly rates 5 bps to 10 bps lower as some participants extended their investment horizons in an effort to pick up yield. The unofficial start of “note season” got under way during the month, resulting in the significant increase in issuance of benchmark cash-flow notes from the customary school districts and municipalities. Demand for these short-term notes was generally strong, and as a result, the one-year high-grade scale tightened a few basis points to 0.23% from 0.25% at the end of May.

In light of these current market conditions, we continue to manage our portfolios with a strong emphasis on liquidity and principal preservation. Therefore, we continue to focus our purchases largely on daily and weekly VRDNs to maximize liquidity, despite the persistence of low absolute yields. However, we do continue to selectively invest in high-grade commercial paper and notes, primarily in the one- to three-month range, in order to enhance the diversification of our portfolios while adhering to our commitment to preservation of principal and liquidity.

The inside track

For some time we have been emphasizing liquidity and principal preservation, even at the expense of a little bit of yield. Our view has been that though it looks like the Fed intends to keep money market rates exceedingly low for a sustained period, the uncertainty in the markets and small rewards offered for additional risk called for a more conservative posturing of money fund portfolios. With questions swirling about European banks, the U.S. debt ceiling, and municipal finance, uncertainty has been mounting. But we are optimistic that solutions—at least short-term ones—will be found for all of these issues. Nonetheless, money market securities can be subject to price volatility, and shareholders still depend on money funds for liquidity and stability. Especially in light of the increased uncertainty, we continue to feel that a more conservative portfolio structure is the best bet in these markets.

See you in September

The *Portfolio Manager Commentary* will be off for summer vacation next month. We will return with our usual monthly commentary in early September.

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1. Basel III is a set of regulatory standards on bank capital and liquidity requirements developed by the Basel Committee on Banking Supervision.

2. The SIFMA seven-day floater index, produced by Municipal Market Data (MMD), is a seven-day high-grade market index composed of tax-exempt variable-rate demand obligations from MMD’s extensive database. You cannot invest directly in an index.

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