WELLS FARGO | ADVANTAGE FUNDS

Portfolio Manager Commentary

Overview, strategy, and outlook: As of December 31, 2011

Money market overview by Dave Sylvester

Money market participants remained focused on Europe last month. Even though the hoped-for "big bazooka" solution ended up looking more like a popgun than a rocket launcher, European leaders made considerable progress toward ameliorating the effects of the peripheral debt crisis. The European Central Bank's (ECB's) efforts to provide liquidity to the region's banks—especially the three-year unlimited Long-Term Refinancing Operation (LTRO) and the fact that the central bank swap lines were in place—gave some reassurance that Europe's banks would be able to fund themselves through the crisis. Still present are the fundamental issues of competitiveness between nations that gave rise to this crisis, but emergency liquidity means the banks are on more solid footing in terms of being able to repay maturing debt. This may buy the banks time while policy officials develop and implement longer-term solutions.

It is worth bearing in mind that one of the main reasons that the peripheral sovereign debt crisis became a bank problem at all is that the banks shared the common risk of owning relatively large amounts of European sovereign debt, much of it in the now troubled peripheral nations. Many of those banks chose to take on the sovereign debt exposure, in part at least, because at the time, all of the European nations were assigned a risk weighting of zero. It therefore made sense from a capital efficiency standpoint to choose, for example, the higher-yielding peripheral debt. The banks could also pledge all of this sovereign debt as collateral at the central bank on equal terms, so the liquidity factor further enticed the banks to participate. We must remember that at one time, all European sovereign debt traded very close in yield. In the middle of 2008, five-year government bonds issued by Greece, Ireland, and Germany all traded within 50 basis points (bps) of each other; today, the spreads are measured in thousands of basis points. Clearly, it was not as simple as a flawed regulation; the market now reflects differences in risk that either were not present or were simply not recognized just three short years ago.

In the U.S., we have our own practice of homogenizing different types of sovereign debt into one monolithic market we call "governments." This market includes not only securities issued by the U.S. Treasury, but a component commonly referred to as the "agency" market, which includes a number of true U.S. government agencies, government-sponsored enterprises, and other federally sponsored or chartered entities. Agency securities play a prominent role in many money market fund portfolios. Money funds are permitted to include certain government securities in the assets used to meet their daily and weekly liquid asset targets under Securities and Exchange Commission (SEC) Rule 2a-7 ("the Rule").

In addition, under the maturity-shortening provisions of the Rule, money funds are permitted to invest in some adjustable-rate government securities that mature

Rates for sample investment instruments

Current month-end % (December 2011)

SECTOR	1 day	1 week	1 month	3 month	6 month	12 month
U.S. Treasury repo	0.02	0.03				
U.S. Treasury bills			0.00	0.01	0.04	
Agency discount notes	0.01	0.01	0.01	0.03	0.05	0.14
LIBOR	0.15	0.21	0.30	0.58	0.81	1.13
Asset-backed commercial paper–First Tier		0.51	0.39	0.55		
Dealer commercial paper–First Tier		0.26	0.33	0.58		
Municipals–First Tier	0.07	0.10	0.13	0.15	0.20	0.25

Source: Bloomberg, LP

Past performance is no guarantee of future results.

beyond the 397-day limit that applies to other money fund investments. And though it's not always been the case and may not be in the future, right now all of the agencies trade at the same yield. This includes the two big housing agencies, the Federal National Mortgage Association, nicknamed Fannie Mae, and the Federal Home Loan Mortgage Corporation, or Freddie Mac, which are kept solvent only through financial support from the U.S. Treasury. However, because there is no differentiation between the various agencies under the Rule, it is especially important for money funds to note that unlimited support of Fannie Mae and Freddie Mac will end after 2012. In our credit section this month, we take a closer look at these two agencies and some of the options that are being considered for their future.

Taxable credit landscape by Bridget Powers

Freddie Mac and Fannie Mae have been in conservatorship under the supervision of the Federal Housing Finance Agency (FHFA) since September 2008. Together with the Government National Mortgage Association, or Ginnie Mae, Fannie Mae and Freddie Mac have collectively guaranteed more than 80% of the single-family mortgages originated in the U.S. since January 1, 2009. Losses at the agencies have been driven by the impact of declines in long-term interest rates on the fair value of derivatives and provisions taken for credit losses. This is offset by net interest income and guaranty fees. While the U.S. government does not guarantee Fannie and Freddie's securities or other obligations, the FHFA has stated that while they are in conservatorship, all obligations will be met in a timely manner.

Through September 30, 2011, Freddie Mac had requested a cumulative total of $72.2 billion from the U.S. Treasury (drawn under the senior preferred stock purchase program) and had paid $14.9 billion in dividends to the Treasury. Fannie Mae's cumulative draws have been $111.6 billion, while paying $17.2 billion in dividends. Both entities are allowed to draw on the senior preferred stock purchase program at the end of any quarter that they have a net worth deficit, through the end of 2012. At that time, the "unlimited" government support will end, and they will have a combined remaining ability to draw a total of $274 billion. In October 2010, the FHFA published projections of the agencies' financial performances under various housing-price scenarios. This resulted in the projected combined cumulative Treasury draws (including the 10% dividend payments to the Treasury) ranging between $220 billion and $311 billion by the end of 2014.

In general, these financial projections show that under less stressful housing-price scenarios, the cumulative draws from Treasury would stabilize in the next year or so, with the agencies earning enough income to cover dividend payments to the Treasury. However, as the acting director of the FHFA, Edward DeMarco, stated on September 19, 2011, "It ought to be clear to everyone at this point, given [Freddie Mac and Fannie Mae's] losses since being placed into conservatorship and the terms of the Treasury's financial support agreements, that [Freddie Mac and Fannie Mae] will not be able to earn their way back to a condition that allows them to emerge from conservatorship."

One objective of policymakers has been to shrink the size of the agencies. Under the terms of the purchase agreement and FHFA regulation, the agencies' mortgage-related investment portfolio is subject to a cap that decreases by 10% each year until each portfolio reaches a maximum of $250 billion. This does not include the agencies' ability to guarantee loans, but it does mean that, except for purchases of delinquent mortgages out of trusts, they will not be a substantial buyer or seller of mortgages for their mortgage-related investment portfolios. As the agencies' portfolios contract, so does their need for financing. This explains the decreasing size of the agency discount note market, a large portion of which can be used by money funds to meet their weekly liquidity requirements.

The single-family credit losses Fannie Mae realized from January 1, 2009, through September 30, 2011, combined with the amounts they reserved for single-family credit losses as of September 30, 2011, were approximately $135 billion. A substantial majority of those losses are attributable to single-family loans they purchased or guaranteed from 2005 through 2008. At Freddie Mac, provisions for credit losses associated with single-family loans from 2008 through the third quarter of 2011 were approximately $79 billion. Recent loss provisions factor in higher loss severities due to lower expectations for mortgage insurance recoveries, as well as higher volumes of loan modifications. As of September 30, 2011, Freddie Mac had an unpaid principal balance of single-family nonperforming loans of $119 billion.

A number of bills have been introduced in Congress that would bring about changes in Freddie Mac's and Fannie Mae's business models. In February 2011, the Obama Administration delivered a report to Congress that explains the administration's plan to reform the U.S. housing finance market, including options for structuring the government's long-term role in a housing finance system in which the private sector is the dominant provider of mortgage credit. The report identifies a number of policy steps that could be used to wind down Fannie Mae and Freddie Mac, reduce the government's role in housing finance and help bring private capital back to the mortgage market. These steps include:

1. Increasing guaranty fees.
2. Gradually increasing the level of required down payments on insured mortgages to 10%.
3. Reducing conforming loan limits to those established in the Federal Housing Finance Regulatory Reform Act of 2008 (the "2008 Reform Act").
4. Encouraging Fannie Mae and Freddie Mac to pursue additional credit loss protection.
5. Reducing Fannie Mae's and Freddie Mac's portfolios, consistent with the Treasury's senior preferred stock purchase agreements with the companies.

The report also outlines three potential options for a new long-term structure for the housing finance system following the wind-down of Fannie Mae and Freddie Mac. The first option would privatize housing finance almost entirely, while the second option would add a government guaranty mechanism that could scale up during times of crisis. The third option would involve the government offering catastrophic reinsurance behind private mortgage guarantors.

In addition to the work being done on winding down the agencies, other legislative and regulatory developments include requests for input on options for sales and rentals of single-family real estate owned (REO) properties held by Freddie Mac, Fannie Mae, and FHA; increasing guarantee fees in 2012; establishing a reserve account within the current servicing compensation structure; and creating a new flat per-loan fee for servicing.

The housing agencies are massive entities, and resolving the issues that confront them is an extremely complex task. While they currently benefit from unlimited support from the U.S. Treasury, that support will be finite in the near future. Together, Fannie Mae and Freddie Mac issue more than 60% of all the agency discount notes that are outstanding, and their wind-down will have a very negative impact on the supply picture in this sector. With significant changes in their future dependent on a Congress and an administration that seem to have difficulty cooperating, it would be reasonable to conclude that yields in this sector might begin to reflect credit differences should they become more pronounced.

U.S. government landscape by Mike Bird & John Kelly

December proved tame by recent standards in the U.S. government market. Gone—at least for the time being—was the wrangling by our political leaders about the best way to get our country's spiraling debt under control. While the discussions continued around the debt ceiling, spending, and taxes, they certainly were not in the forefront of the news, as in prior months.

This temporary lull allowed participants to focus on the impending year-end. Year-ends tend to exacerbate the demand for U.S. Treasury bills (T-bills) and government-sponsored enterprise (GSE), or agency, discount notes as market participants gravitate toward the safety, security, and quarterly reporting optics that these instruments provide. Coupled with the continuing declines in supply, the demand drove the already low yields in both markets even lower. For a time, yields on T-bills were trading in negative territory—below zero percent—as the idea of owning securities in the deepest, most liquid market in the world over the year-end proved more important than the return earned.

Looking ahead to 2012, attention will focus on potential housing reform and its impact on the GSEs, particularly Freddie Mac and Fannie Mae. This month's credit section above provides an in-depth discussion on the topic. The most optimistic scenario from a supply standpoint is that issuance by the GSEs will remain relatively stable, with the most likely scenario being a continuing decline in outstandings due to ongoing reform.

GSE discount notes outstanding ($ billions)

as of 12-31-11

		% of total
Freddie Mac	$161.3	31.53%
Fannie Mae	$146.4	28.62%
Federal Home Loan Bank	$190.2	37.18%
Federal Farm Credit Bank	$13.6	2.66%
	$511.5	100.00%

Source: Jefferies & Co., Inc
Past performance is no guarantee of future results.

In the meantime, we will continue our disciplined approach to investing, laddering maturities in each of the government funds to provide liquidity and looking for strategic opportunities in the *Wells Fargo Advantage Government Money Market Fund* to add GSE discount notes and fixed- and floating-rate securities, as well as securities guaranteed by the Federal Deposit Insurance Corporation (FDIC) as they become available.

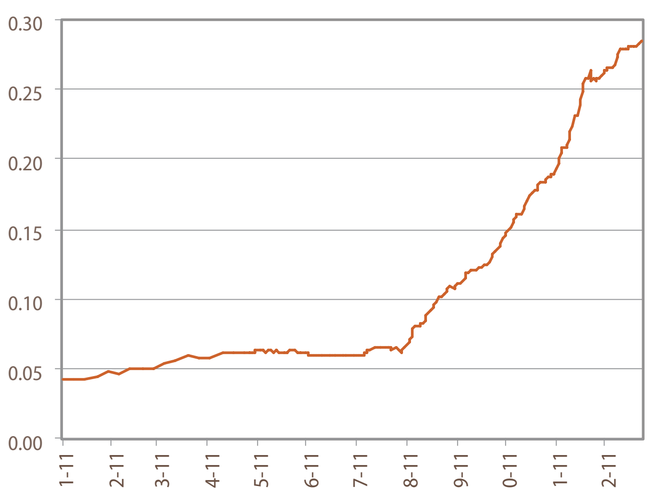
Prime markets landscape by Madeleine Gish & Dan Tronstad

Market concerns regarding the safety of eurozone banks, sovereign credit ratings, and liquidity in the eurozone remained the focus of the prime money markets in December. Toward the end of the month, the ECB's three-year LTRO totaled 489 billion euros, with 523 eurozone banks participating in the operation. While the hope was that this would alleviate year-end funding pressures, as well as encourage downstream lending to households and corporations, in reality, the banks may keep the cash on hand to boost liquidity ratios and be available to repay debt coming due early in 2012. The lack of lending can be observed as deposits held by the ECB reached an all-time high of 452 billion euros on December 27.

In addition, the LTRO thus far has done little to either encourage interbank lending or bring new investors back into the wholesale funding space. One way this can be observed is the continued steepening of the London Interbank Offered Rate (LIBOR) curve even after the ECB LTRO on December 21. As participants' concerns about Europe increased this summer, the spread between one-month LIBOR and three-month LIBOR increased from 5 bps, where it had hovered for the first part of the year, to 25 bps by the end of November. Despite the availability of liquidity through the LTRO, the spread continued to increase in December, albeit at a somewhat slower pace, and closed the year at 28.5 bps. The next LTRO will be held at the end of February, and while the readily available liquidity should give some comfort to holders of maturing bank obligations, we do not think it will do much in terms of restoring investor confidence.

LIBOR spread (%)

1-month vs. 3-month



Source: Bloomberg, LP

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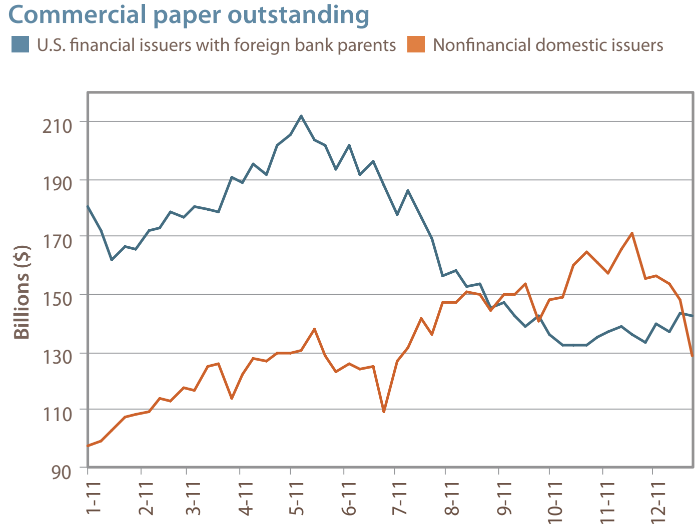
Most money market participants continue to avoid new investments in eurozone countries, especially bank deposits, regardless of credit fundamentals, as the headline risk seems to outweigh credit opinion. The steady reduction in foreign investments since late spring is illustrated by the greater than 30% drop this year in the amount of commercial paper issued by companies with a foreign bank parent. The amount of this type of paper jumped in the first part of the year for a couple of reasons. The currency swap rates were affected by tightening liquidity conditions in Europe, which made it cheaper to borrow in U.S. dollars and swap them to euros than to borrow in euros directly. Then, at the beginning of April, the new FDIC assessment schedule was being put in place. Since the foreign banks did not offer FDIC-insured accounts, they were not subject to the new, increased assessment. This gave them an advantage over domestic banks in their all-in borrowing costs and enabled them to offer investors measurably higher rates. But, as the European credit crisis heated up, foreign-related issues fell out of favor, and market participants rotated out of foreign financials and into the nonfinancial sector. Despite the decline in late November and into December, probably due to year-end window dressing, outstandings of nonfinancial paper increased by a robust $33 billion in 2011.

Commercial paper outstanding



Source: Bloomberg, LP, and Federal Reserve

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Since our portfolios have been positioned with a bias toward a short weighted average maturity and high quality, our response to the continuing deterioration in the credit environment has been relatively seamless. Given the uncertainties still facing the markets in 2012, we continue to believe that focusing on quality and maintaining a high degree of liquidity is the prudent strategy in this environment. This strategy will allow us to adjust quickly to changing market conditions as well as maintain our commitment to preservation of principal and liquidity.

Municipal landscape by Jim Randazzo

While the municipal market started out the year confronted by countless headlines regarding systemic fiscal stress at the state and local level, the dire predictions of gloom and doom involving mass defaults never materialized. Instead, the market closed out 2011 as a relative safe haven as investor concerns gradually shifted toward Europe. During the month of December, the municipal market continued to be the beneficiary of the flight-to-safety mentality and experienced strong demand for high-grade variable-rate demand notes (VRDNs) and commercial paper as many participants were content to maintain their high liquidity profiles going into year-end.

The increase in demand at year-end outweighed eligible supply in the overnight and weekly VRDN markets, leading yields in these segments to drop by a few basis points. Even a surprise $3.3 billion new-issue weekly VRDN from the Michigan State Finance Authority during the holiday-shortened final week of the year was easily digested by the market and did not prevent the Securities Industry and Financial Markets Association VRDN index* from falling to 10 bps from 12 bps a week earlier. As we have seen throughout the year, nontraditional (that is, taxable) buyers continued to be a big presence in the VRDN markets, which have seen supply decline steadily throughout the year.

In fact, municipal new-issue supply hit a 10-year low in 2011 as many large issuers continued to focus on expense and debt reduction as a means to balance strained budgets. This belt-tightening approach led new-issue supply to drop by more than 30% from 2010 levels and contributed to declining interest rates throughout the municipal space. Further out on the money market curve, yields in the high-grade municipal commercial paper and note markets were firm, with scales tightening anywhere from 1 bp to 2 bps between 30 and 90 days, while the AAA one-year scale remained unchanged at 25 bps.

In light of these market conditions, we have continued to manage our portfolios with a strong emphasis on liquidity and principal preservation. As we head into 2012, nothing in recent developments suggests to us that a change is in order. Accordingly, we have focused our purchases primarily on daily and weekly VRDNs in order to maximize liquidity, while selectively investing in one- to three-month high-grade commercial paper and notes to diversify our portfolios, thus adhering to our commitment to preservation of principal and liquidity.

On the horizon

There are many challenges facing the money markets in 2012. European sovereign credits, and by extension banks and other entities in those countries, remain under siege as they struggle to cope with slowing economies and elevated debt levels. World governments face a staggering $7.6 trillion in debt maturing this year. The U.S. is certainly not immune from these problems; the two largest refinancing burdens belong to Japan, with $3 trillion maturing, and the U.S., with $2.8 trillion, and debates over yet another increase in the U.S. debt ceiling are already beginning. Clearly, the rise in interest rates that so many money market participants are hoping for would have a significantly negative effect on government finances. The rest of Asia is not immune from these stresses, though the lack of transparency in China makes this factor particularly difficult to evaluate. Money funds themselves face some uncertainty, as debates over the next steps, if any, in money fund regulation are beginning to heat up.

In light of the stresses facing the markets and money market funds, we continue to believe that a conservative portfolio structure, featuring portfolios with relatively short weighted average maturities, a high degree of liquidity, and relatively short-term final maturities concentrated in high-quality issuers, will best be able to stand up to those risks, while meeting the goals of liquidity and stability of principal.

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*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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