

Portfolio Manager Commentary

Overview, strategy, and outlook: As of May 31, 2011**Money market overview by Dave Sylvester**

Since we are approaching the end of the latest phase of quantitative easing by the Federal Reserve (the Fed), it might be useful to look at what effects this program has had on the Fed's balance sheet, and how the balance sheet has been transformed by the other actions the Fed has taken to address the liquidity and credit crisis that began in the summer of 2007. Announced on November 3, 2010, the second round of quantitative easing—known as "QE2"—is a tool that the Fed has used to increase liquidity and lower interest rates by purchasing a total of \$600 billion in U.S.

Treasury securities. While the final installment is scheduled for June 9, the Fed will continue to reinvest the principal and interest payments received on its holdings of agency and mortgage-backed securities in U.S. Treasuries.

In its QE2 operations, the Fed buys U.S. Treasury securities in the open market from its primary dealers; it pays for the Treasuries by creating money and crediting the dealers' bank accounts. The banks then keep the money at the Fed in the form of excess reserves and are paid interest on their

Federal Reserve balance sheet

ASSETS (\$B)	5-24-06	5-23-07	5-28-08	5-28-09	5-26-10	5-26-11	2011 vs. 2006
Mortgage-backed securities				430.9	1,117.9	922.6	922.6
U.S. Treasury securities	760.4	790.2	491.1	597.6	776.9	1,504.6	744.2
Federal agency securities				79.8	167.4	119.2	119.2
Other net assets	39.1	38.7	104.7	69.6	93.4	125.9	86.8
Maiden Lane I, II, III				62.2	67.6	64.5	64.5
AIA Aurora and ALICO (AIG)					25.4		0.0
American International Group				44.2	26.1		0.0
Float	0.2	-0.9	-1.1	-2.0	-1.7	-0.8	-1.0
Central bank swap agreements				184.9	1.2		0.0
Treasury currency	38.0	38.5	38.8	42.4	42.9	43.9	5.9
Gold	11.0	11.0	11.0	11.0	11.0	11.0	0.0
Discount window	0.2	0.1	16.0	38.2	5.2		-0.2
Special drawing rights	2.2	2.2	2.2	2.2	5.2	5.2	3.0
Commercial Paper Funding Facility				154.7			0.0
Term ABS Loan Facility				15.5	44.3	14.7	14.7
ABCP MMF Liquidity Facility				26.4			0.0
Primary Dealer Credit Facility			12.3				0.0
Repos	22.9	22.0	105.0				-22.9
Term auction credit			150.0	372.5			0.0
Total assets	874.0	901.8	930.0	2,130.1	2,382.8	2,810.8	1,936.8
LIABILITIES (\$B)	5-24-06	5-23-07	5-28-08	5-28-09	5-26-10	5-26-11	2011 vs. 2006
Reserve balances	10.1	9.7	10.7	866.3	1,084.7	1,571.5	1,561.4
Currency	793.9	808.9	823.3	908.7	937.7	1,017.8	223.9
Supplementary Financing Program bills				200.0	200.0	5.0	5.0
Treasury general account	5.5	4.9	4.9	26.7	26.1	84.3	78.8
Other liabilities and capital	33.5	39.1	45.8	51.1	71.7	73.7	40.2
Reverse repos	23.2	32.2	37.5	70.0	58.1	55.3	32.1
Misc. deposits	7.6	6.7	7.5	7.0	4.3	3.1	-4.5
Treasury cash	0.2	0.3	0.3	0.3	0.2	0.1	-0.1
Total liabilities	874.0	901.8	930.0	2,130.1	2,382.8	2,810.8	1,936.8

Source: Federal Reserve Board Statistical Release H.4.1

excess reserves at the higher end of the federal funds target rate, currently set at 0.25%. In aggregate, the banks really have no choice in this matter; the overall level of reserves in the banking system is a decision made by the Fed, not the banks. QE2 was designed to dramatically raise the amount of reserves in the system. The effect of the new money entering the system and the strength of the Fed's ongoing bid for U.S. Treasuries has been to drive interest rates lower and increase liquidity in the system. In a perfect world, this spurs an increase in economic growth. While we may not have seen stunning economic growth yet, QE2 and other measures taken during the financial crisis have resulted in a dramatic transformation of the Federal Reserve's balance sheet.

Five years ago, the Fed's balance sheet was relatively simple: the Fed's assets primarily consisted of about \$800 billion in U.S. Treasury securities, and its liabilities were a reasonably similar amount in currency outstanding. A few repurchase agreements (repos) and reverse repos were used to manage the effective federal funds rate over the near term, and that was about it. Since that time, the size of the Fed's balance sheet has more than tripled, from \$874 billion in 2006 to more than \$2.8 trillion. On the asset side, in addition to nearly doubling the amount of its Treasury holdings through QE2, the Fed had previously added more than \$1.0 trillion of agency debt and agency mortgage-backed securities to its portfolio. On the liability side of the balance sheet, what we see is an explosion in excess bank reserves. Whereas three to five years ago, excess bank reserves were generally in the \$10 billion area, they now approach \$1.6 trillion!

Interestingly, much of the excess reserve balances are held for the accounts of domestic branches of foreign banks, whose cash assets are now estimated to exceed \$850 billion. The U.S. offices of foreign banks have long served as a source of dollar funding for their parents, borrowing here on their behalf. Now, with the system awash in dollars, it would appear that the overseas parents' need to draw on their U.S. subsidiaries has diminished, and cash assets are accumulating as a result. In addition to furthering the Fed's monetary policy aims, these cash reserves might have a positive side effect by potentially providing a cushion, should the foreign banks experience a tightening in liquidity as a result of the ongoing uncertainty in Europe. If the issues over there make it difficult or economically unpalatable for some European banks to roll over their maturing debt, they might simply draw down their reserves at the Fed in order to replace that funding.

Another interesting thing about the Fed's liabilities has been the growth of currency in circulation, which now stands

at over \$1.0 trillion, an increase of more than 28% since 2006. Indications are that much of this increase is in larger-denomination bills, pointing to an accumulation of currency overseas, where it is often used as a store of value, rather than in the U.S., where currency is a medium of exchange.

Although it's early to expect the Fed to exit its easing programs—after all, we just got here!—the steps that it might take to unwind the quantitative easing and drain bank reserves are fairly well known, having been previously discussed here and in other places in more detail. Basically, there are three specific tools in the Fed's toolbox that could be used.

The first are the Supplementary Financing Program (SFP) bills. In this program, the U.S. Treasury issues Treasury bills specifically for the purpose of leaving the proceeds on deposit at the Fed, moving money from the reserve balances category to another type of liability. While the SFP bills have been popular with market participants, the current collision with the debt ceiling precludes their use right now. The second method of draining reserves is the reverse repurchase agreement (RRP). In this arrangement, the Fed lends securities from its portfolio in exchange for cash, which comes from the RRP counterparties' bank accounts. Many money market funds, including certain *Wells Fargo Advantage Funds*®, have already been approved to conduct RRP with the Fed, and at the end of May it was announced that government-sponsored enterprises (GSEs) would be considered as counterparties. Clearly, the Fed is casting a wide net with the RRP program. The third method of draining reserves is the term deposit. Under this program, the Fed would take deposits from banks for a set period of time. This would have the effect of moving these funds from the reserve balances category to another category of liabilities. Moreover, although it has not been discussed as widely as the other alternatives, currency has a role here, too. If the demand for currency continues to increase, this would also drain excess reserve balances, which would take some pressure off these other alternatives.

While some fear that the flood of cash will trigger inflation, the Fed seems more focused on its current quandary of dealing with a fairly sluggish economy, combined with stubbornly high unemployment and deflationary pressures. Although inflation has received increased attention lately, with some Fed officials calling for a precautionary tightening of monetary policy, it would seem difficult for the Fed to raise rates by much in this environment. We are mindful of the risk of a sudden rise in U.S. interest rates, but we think that if rates spike in the near term, it will be for reasons that are not directly related to Federal Reserve policy.

Rates for sample investment instruments

Current 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

Previous month-end % (April 2011)

SECTOR	1 day	1 week	1 month	3 month	6 month	12 month
U.S. Treasury repos	0.03	0.05				
U.S. Treasury bills			0.00	0.04	0.08	
Agency discount notes	0.03	0.03	0.03	0.07	0.13	0.21
LIBOR	0.13	0.18	0.21	0.27	0.43	0.76
Asset-backed commercial paper–First Tier		0.22	0.25	0.30		
Dealer commercial paper–First Tier		0.11	0.17	0.26		
Municipals–First Tier	0.26	0.26	0.27	0.29	0.30	0.30

Change in basis points (M/M)

SECTOR	1 day	1 week	1 month	3 month	6 month	12 month
U.S. Treasury repos	0.08	0.03				
U.S. Treasury bills			0.04	0.00	0.00	
Agency discount notes	0.00	0.00	0.02	0.00	-0.02	-0.04
LIBOR	0.00	0.00	0.00	0.00	0.00	0.00
Asset-backed commercial paper–First Tier		0.00	-0.02	0.00		
Dealer commercial paper–First Tier		0.03	0.00	-0.03		
Municipals–First Tier	-0.14	-0.08	-0.07	-0.06	0.00	-0.05

Source: Bloomberg, LP

Past performance is no guarantee of future results.

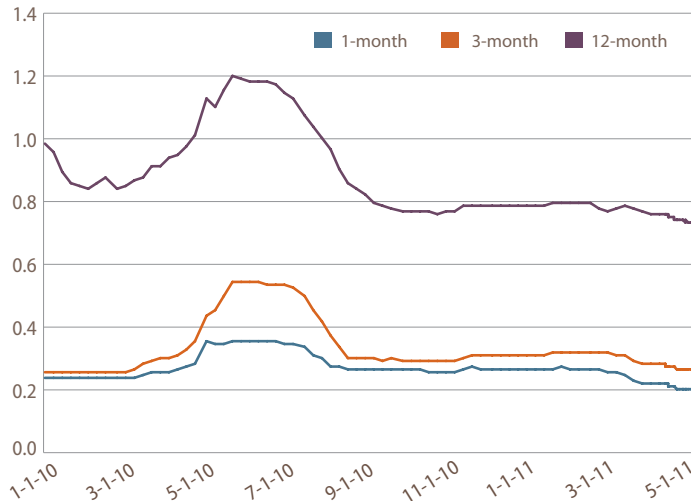
Strategies for the prime funds by Madeleine Gish and Dan Tronstad

In April, the race toward near zero interest rates on repos caused some market participants to cut back on the amount invested in the overnight repo market and pushed them to extend maturities on other investments and to broaden the list of issuers available to purchase—all with the intention of picking up additional yield. That seemed like a bad risk/return trade-off to us. During May, we observed interest rates on repos increase enough to compete with other products, again causing the same market participants to reallocate from time deposits and short-dated financial and nonfinancial commercial paper back into repo (see further discussion on repos below in the government section). In addition to increasing the amount invested in overnight repos, we have seen an increase in the amount invested in

overnight to one-week asset-backed commercial paper, as yields on that paper have become more attractive relative to other short paper.

Even with some relief from extremely low yields on shorter-dated investments, other market participants seemed to continue to reach out the curve to lock in whatever incremental yield pickup was offered. Once again, the impact of the demand for longer-dated investments is reflected in new low yields for London Interbank Offered Rate (LIBOR) settings across all maturity spectrums. One-, three-, and six-month LIBOR hit lows of 0.19%, 0.25%, and 0.40%, respectively, in May. Yields for top-rated bank paper with a three-month maturity that were offered in the low 0.20% at the beginning of May had dropped to the high teens by month-end.

LIBOR (%)



Source: Bloomberg, LP

Past performance is no guarantee of future results.

The total amount (non-seasonally adjusted) of commercial paper shrank by \$27.3 billion in May, further exacerbating the downward yield grind. The majority of this decline was in the financial subsector. Nonfinancial paper managed to eke out a small (\$2.9 billion) increase, while the amount of asset-backed commercial paper outstanding shrank for the third month in a row.

In some circumstances, buying securities with longer maturities and expanding the list of issuers to purchase may be effective in adding yield to a portfolio, but we feel that the additional duration and credit- or spread-widening risk taken on is not worth the yield pickup. With money market rates at such low levels, the amount of yield added seems paltry in comparison to the additional risk of such a strategy. Given the lower money market yields in general and the ongoing credit concerns in particular, our strategy will continue to focus on constructing high-credit-quality portfolios, maintaining enhanced liquidity, and focusing on risk-adjusted returns. While some of these tactics may be implemented at a greater cost, we believe they allow us to quickly respond 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

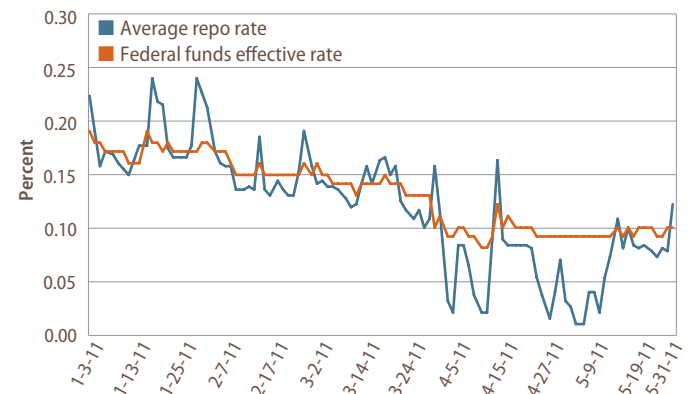
The money markets demonstrated their resilience in May, as the repo market continues to adjust to the various regulatory challenges it has faced in 2011. To recap, three developments have, for various reasons, led to a reduction in securities available for use as collateral in repurchase agreements. First,

the Fed's ongoing QE2 program has resulted in a steady drain of Treasury collateral from the system. Second, SFP bills outstanding were reduced from \$200 billion to \$5 billion, mainly due to constraints from the statutory debt ceiling. Third, the change in the Federal Deposit Insurance Corporation's (FDIC) fee assessment methodology caused a number of repo market participants to withdraw their collateral from the market, as their participation was rendered uneconomic by the new FDIC rules. Each of these changes has been discussed here in greater detail in recent months.

The effect on the repo market has been a steady erosion in rates, from the upper teens (0.17% to 0.18%) early in the year to the lower teens by the end of the first quarter. During this period, the average repo rate was 0.16%, generally trading within a few basis points of the federal funds effective rate (the "fed effective"), which averaged 0.14%. When the FDIC assessment changed on April 1, repo rates tumbled down to nearly zero, with only brief reprieves when additional collateral entered the system with mid-month and end-of-month Treasury settlements. This dislocation was evident in the relationship between repo rates and the fed effective, as repo traded significantly below the fed effective during this time.

Since the middle of May, however, the market has adjusted to its new environment, with rates stabilizing near 0.10%. While not a restoration to first-quarter levels, these rates are at least in the neighborhood, and noticeably better than, the levels posted for most of the second quarter. The relationship to the fed effective has also been restored. Some market participants with the ability to move money out of the repo market into other spaces appear to have done so, tiring of the near-zero return on their investments. The recovery in repo rates has helped rates to back up in correlated government markets as well, such as the Treasury bill and GSE markets.

Repo vs. fed funds



Source: Bloomberg, LP

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These fluctuations in rates have not led us to alter our basic strategy in our government funds. The focus in the *Wells Fargo Advantage 100% Treasury Money Market Fund* has been to ladder maturities across the yield curve. In the *Wells Fargo Advantage Treasury Plus Money Market Fund*, we continue to ladder maturities across the yield curve as yields on U.S. Treasury-backed repurchase agreements have fallen. In the *Wells Fargo Advantage Government Money Market Fund*, where we have a broader selection of eligible investments, most of our activity has been in GSE-backed repurchase agreements, three- to six-month GSE- and FDIC-guaranteed debt, and adjustable-rate GSE- and FDIC-guaranteed securities that reset off one- and three-month LIBOR.

Strategies for the municipal funds by Jim Randazzo

The downward pressure on municipal money market rates that began in April continued in the month of May. Demand from crossover market participants continued to be strong, due to the scarcity of Treasury bills and repo collateral, and a persistent supply drought in the overall municipal market led to increased demand for highly liquid, tax-exempt money market investments.

The downward pressure on rates in May is somewhat uncharacteristic for the month, as the market typically experiences a seasonal uptick in rates in the wake of April tax-related redemptions. However, municipal money market fund assets surprisingly rose by close to \$3.9 billion, or 1.3%, from April 27 to May 25. As a result of this additional cash, demand for daily and weekly investments rose, driving yields to the lowest levels of the year.

In the weekly variable-rate demand note market, demand remained consistent enough to cause the Securities Industry and Financial Markets Association index¹ to reset at a lower rate for five consecutive weeks, falling from 0.27% on April 20 to 0.18% on May 25. The downward pressure on rates in the daily market was also significant, with the average yield on general market high-grade issues falling to 0.10% from 0.19% in April.

Further out on the curve, demand for liquid, high-grade names intensified as some participants extended their investment horizons in an effort to beat overnight and weekly yields. However, rates in these markets eventually followed short-term rates lower, with yields in the one-month to three-month range dropping between 5 basis points and 10 basis points. The continued lack of new-issue supply contributed to a tightening in one-year, high-grade paper, with yields dropping from 0.30% in April to 0.25% in May.

Despite the extraordinary drop in yields over the past few weeks, we continue to manage our portfolios with an emphasis on liquidity and principal preservation. Accordingly, we continue to maintain relatively short weighted average maturities while focusing our purchases on daily and weekly variable-rate demand notes to maximize liquidity. Additionally, we continue to selectively invest in high-grade commercial paper and notes, primarily in the three-month to six-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

There is a lot going on right now that might affect the money markets: Congress and the administration continue to wrangle over the budget and debt ceiling; the situation in Europe remains fluid; the Fed's quantitative easing program is coming to an end; the employment situation in the U.S. remains weak; and food and fuel prices remain elevated. While most of this would argue for a continuation of the Fed's easy monetary policy, inflation is beginning to look troublesome, and the credit environments could lead to wider spreads. We believe this is a good time to heighten the focus on liquidity and principal preservation, even at the expense of a little bit of yield. Although it looks like money market rates will continue to remain exceedingly low for a sustained period, the uncertainty in the markets and small rewards offered for additional risk lead us to conclude that our more conservative posturing of money fund portfolios is most appropriate at this juncture.

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1. 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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