WELLS FARGO Asset Management

INVESTMENT PERSPECTIVES

A guide to ultra-short-term bond funds for cash investors

More than 99% of money market funds yielded less than 0.10% as of March 31, 2021.[1]

Cash investors have been steadily moving into ultra-short-term bond funds to satisfy their search for yield.

Why? Because ultra-short-term strategies use two primary levers—extending maturities and taking additional credit risk—to add yield.

This guide explains what ultra-short-term bond funds are and why they may be appropriate for both individuals and institutional cash investors as they seek to optimize their overall cash portfolio. In today's low-yield environment, these types of funds are one place where cash investors can find high-quality sources of income while maintaining their primary objectives of capital preservation and liquidity. Ultra-short-term bond funds occupy a space just beyond money market funds (MMFs) in the spectrum of liquidity solutions, and many cash investors have already begun their journey to this space. According to Morningstar, ultra-short-term bond funds held $322 billion in assets as of December 2020.

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Investors chose ultra-short-term bond funds for additional income

As investors think about increasing returns on cash investments, it's important to understand the primary driver of total returns is income. Income return—from yield and/or coupon payments—is and always has been the largest contributor to total return in high-quality short-duration fixed income.

Cash investors typically have two primary levers they can pull to generate additional income: extending maturities further out the yield curve or taking on more credit risk. Or they can do both depending on their appetite for risk and need for liquidity. Pulling one or both of these levers serves to increase income in portfolios, increasing total return potential.

1. iMoneyNet as of March 31, 2021.

- **Extend maturities.** There is typically a term premium that investors can pursue by holding longer-maturity instruments. Specifically, in the current market environment, the yield curve begins to steepen meaningfully after the two-year mark, allowing investors to pick up additional yield. They also can benefit from "rolling down the yield curve," which refers to the natural decline in yield as the maturity shortens, providing price appreciation that adds to total return.

- **Go down in credit and/or into additional sectors.** Other sources of income include diversifying a cash portfolio into lower-rated credits or investing in a broader set of fixed-income sectors. For example, allocations to investment-grade corporate bonds, asset-backed securities (ABS), or agency mortgage-backed securities (MBS) can add yield and increase diversification with relatively modest increases in risk. Investments in other high-quality sectors, like U.S. agency debentures, sovereigns, supranationals, or foreign agency bonds, may also be used to increase diversification of a portfolio and its sources of income.

Opt for a combination. If the goal is to capture diversified sources of income to drive reliable long-term risk-adjusted returns over time, it may often make sense to do both—that is, to extend maturities and take additional credit risk by investing in additional high-quality sectors. The key objective is to determine the most client-appropriate mix of maturity profile and sector allocation to increase income.

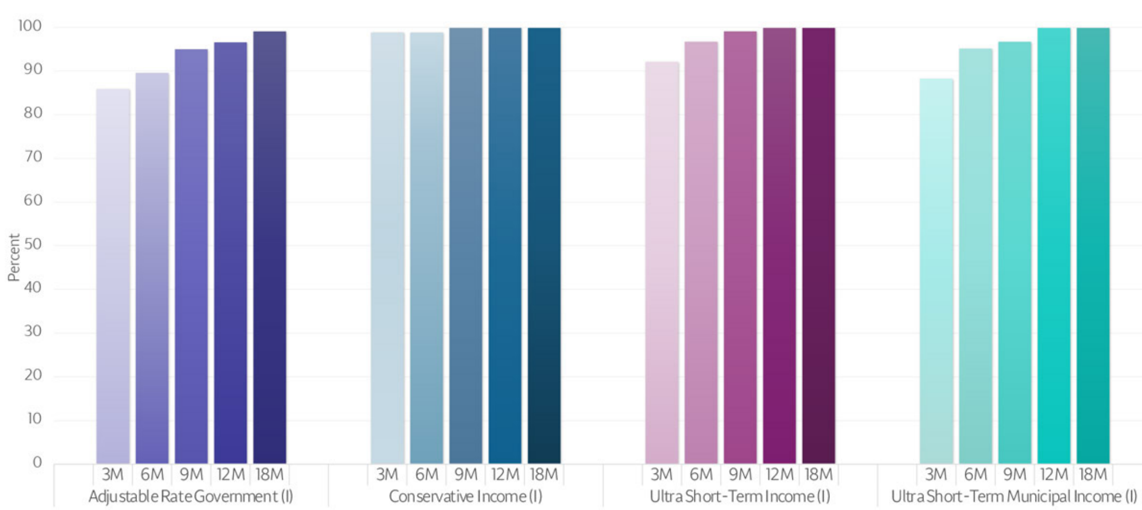
A key difference from MMFs is NAV volatility

A main difference is the amount of net asset value (NAV) volatility that ultra-short-term bond funds experience. That's why this asset class is not appropriate for daily liquidity needs. Ultra-short-term bond funds may be appropriate for cash that is needed between 1 and 12 months in the future or for longer-term strategic cash.

The additional yield these types of funds earn serves as a buffer to potential NAV declines and can improve total returns over time. Exhibit 1 shows how our suite of ultra-short-term bond funds has done over the past 10 years. You can compare the frequency of positive returns over various holding periods, from 3 months to 18 months. In all cases except for the Adjustable Rate Government Fund, total returns have been positive over one-year time frames.

Exhibit 1. Additional yield can buffer NAV volatility for ultra-short-term bonds

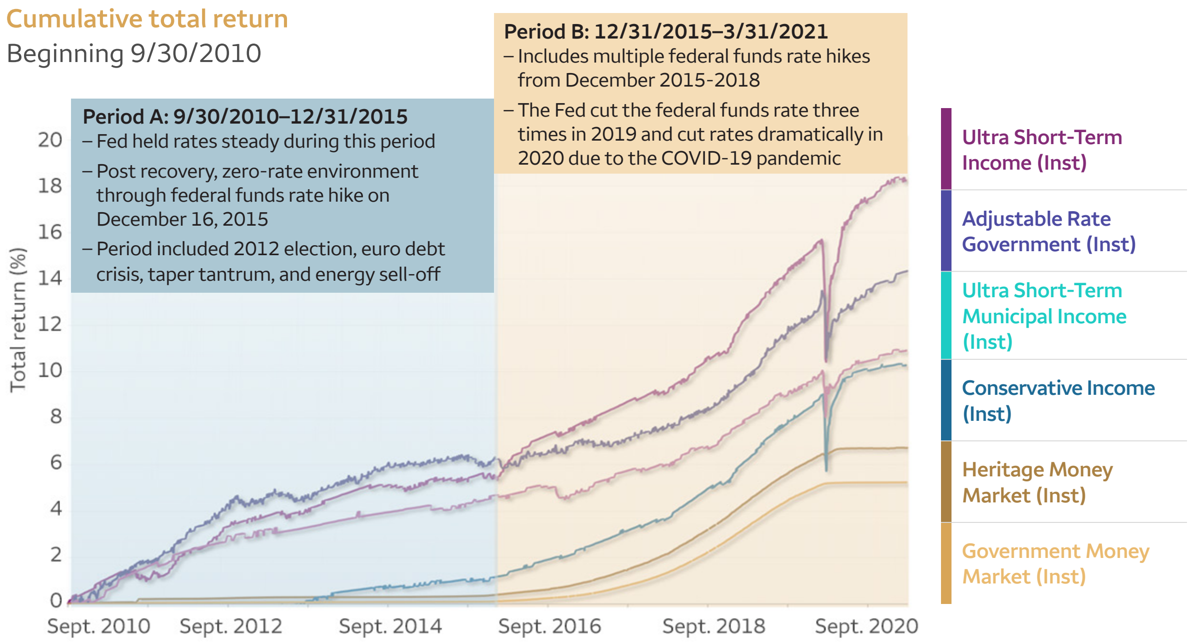
Frequency of positive returns over various holding periods: Past 10 years



*Inception date of the Conservative Income Fund is 5/31/2013.
Source: Zephyr. As of 3/31/2021. **Past performance is no guarantee of future results.**

You might expect ultra-short-term bond funds to do better than MMFs when interest rates remain steady because they have higher yields. But it's important to note that ultra-short-term bond funds have done well even when interest rates were increasing. Exhibit 2a shows in graphic form the cumulative return for our four ultra-short-term bond funds compared with our flagship MMFs. Exhibit 2b shows in table form the cumulative returns plus historical performance data.

Exhibit 2a: Ultra-short-term bond funds have done well even as rates rose



Source: Bloomberg. As of 3/31/2021.
*Wells Fargo Conservative Income Fund inception date 5/31/2013. **Past performance is no guarantee of future results.**

Exhibit 2a: Ultra-short-term bond fund performance

Performance for Institutional Class
As of 3/31/2021†

	Period A	Period B	Performance (%)†							Expense ratio	
Fund	Annualized return (%)	Annualized return (%)	7-day current yield	30-day yield	Year to date	1 year	3 year	5 year	10 year	Gross	Net
Ultra Short-Term Income	1.04	2.19	–	0.94	0.04	5.11	2.72	2.21	1.58	0.38	0.27
Adjustable Rate Government	1.11	1.47	–	0.93	0.45	2.84	2.08	1.57	1.28	0.56	0.47
Ultra Short-Term Municipal Income	0.84	1.14	–	0.21	0.14	1.40	1.52	1.19	0.98	0.34	0.25
Conservative Income	0.39	1.69	–	0.27	0.04	2.70	2.08	1.72	–	0.38	0.25
Heritage Money Market	0.07	1.18	0.01	–	0.02	0.26	1.47	1.22	0.63	0.23	0.20
Government Money Market	0.02	0.96	0.01	–	0.00	0.04	1.26	1.00	0.51	0.22	0.20

†Returns for periods less than one year are not annualized.

Figures quoted represent past performance, which is no guarantee of future results, and do not reflect taxes a shareholder may pay on an investment in a fund. *Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. A money market fund's yield figures more closely reflect the current earnings of the fund than the total return figures. Current performance may be lower or higher than the performance data quoted and assumes the reinvestment of dividends and capital gains. Current month-end performance is available at the funds' website, wfam.com.*
Institutional Class shares are sold without a front-end sales charge or contingent deferred sales charge.
The manager has contractually committed to certain fee waivers and/or expense reimbursements. Without these reductions, the fund's returns would have been lower and rankings may have been lower. These reductions may be discontinued.
Performance for the fund or the class shown may reflect a predecessor fund's or class's performance and may be adjusted to reflect the fund's or class's expenses as applicable.
Source: Bloomberg.
*Wells Fargo Conservative Income Fund inception date 5/31/2013. **Past performance is no guarantee of future results.**

Important points when comparing ultra-short-term bond funds

Ultra-short-term bond funds are available in a variety of risk/return profiles to help meet different needs. We believe investors are able to achieve both strategic and tactical allocations with our lineup of complementary strategies, so you'll see both taxable and tax-exempt choices below. While ultra-short-term bond funds—whether our suite of funds or those of other fund families—have a focus on capital preservation and liquidity, they can exhibit more volatility than a prime MMF due to its longer-maturity profile.

Cash investors should understand the portfolio characteristics to assess the risk profile when comparing funds. This can provide insights into how a fund may behave in various market environments. For example, the duration of a fund can inform an investor about how much interest rate risk exists in a fund. Sector allocation and credit quality will provide additional insight in terms of how much credit risk a fund may have.

Exhibit 3: WFAM ultra-short-term funds

Strategy differentiators

	Adjustable Rate Government Fund	Conservative Income Fund	Ultra Short-Term Income Fund	Ultra Short-Term Municipal Income Fund
Morningstar Category	Ultrashort	Ultrashort	Ultrashort	Muni national short
Quality profile	Minimum 100% investment grade; targets maintaining an average AAA rating	Minimum 100% investment grade	Minimum 85% investment grade	Minimum 90% investment grade
Average effective duration range (years)	0.00–1.00	0.25–0.75	0–3	0–5
Average effective maturity range (years)	Weighted average reset period of the adjustable-rate securities; not to exceed 1 year	0–1	0–3	0–5
Additional information	• Is rated AAA-bf by Moody's • Must invest at least 80% in U.S. government-guaranteed MBS and ABS that have interest rates that reset at periodic intervals • May invest up to 20% in fixed-rate obligations and non-government-guaranteed securitized sectors while maintaining an average AAA rating	• May invest up to 30% in BBB-rated securities • Will not buy auction rate securities or structured investment vehicle securities or MBS or ABS primarily backed by sub-prime or Alt-A residential collateral	• May invest up to 25% in U.S.-dollar-denominated debt securities of foreign issuers	• May invest up to 20% in securities subject to federal alternative minimum tax

Sources: Morningstar and Wells Fargo Asset Management. As of 12/31/2020.
The ratings indicated are from Standard & Poor's, Moody's Investors Service, and/or Fitch Ratings Ltd. Credit-quality ratings: Credit-quality ratings apply to underlying holdings of the fund and not the fund itself. Standard & Poor's rates the creditworthiness of bonds from AAA (highest) to D (lowest). Ratings from A to CCC may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the rating categories. Moody's rates the creditworthiness of bonds from Aaa (highest) to C (lowest). Ratings Aa to B may be modified by the addition of a number 1 (highest) to 3 (lowest) to show relative standing within the ratings categories. Fitch rates the creditworthiness of bonds from AAA (highest) to D (lowest).

Case study—moving beyond MMFs

Our case study begins at the start of the pandemic in March 2020. As the month progressed, both stock and bond markets experienced unprecedented levels of volatility. In response to the uncertainty over COVID-19 and the shocks from the Russia-Saudi Arabia oil price war, the Dow Jones Industrial Average sold off almost 32% from its high on February 12, reaching a low of 20,188 on March 16. At the same time, indiscriminate sellers in fixed income overwhelmed buyers and caused yields and spreads to violently spike higher across the fixed-income markets as investors rushed to cash and U.S. Treasury securities.

As investors reduced their holdings of risk assets and sought a safe haven, the MMF industry experienced record-setting inflows into government funds. At the same time, assets also rotated out of prime funds and into government funds. This, in turn, introduced more volatility into the short end of the yield curve and affected ultra-short-term bond funds.

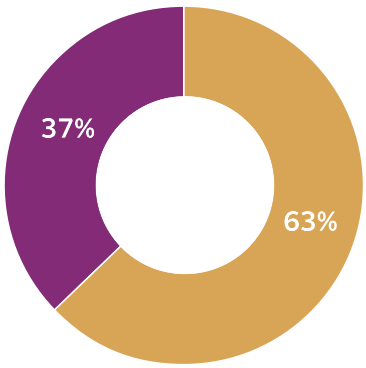
Our client was invested in one of our ultra-short-term bond funds, the Conservative Income Fund, which experienced significant NAV volatility as the short-term bond market sold off due to these dislocations. Not surprisingly, they were very nervous about the NAV volatility and considered selling out of the fund. We strongly believed they should remain invested if they didn't need the liquidity because this was a liquidity crisis, not a credit crisis. At first, we held daily and then weekly meetings with them, which allowed us to keep them updated on market conditions and developments as the Federal Reserve (Fed) acted swiftly and boldly and implemented several lending facilities to restore liquidity to the market. They listened to us and held their shares in the fund while the market and the NAV recovered. But the bigger result was that we gained their trust and confidence as a trusted advisor during a very difficult and uncertain time.

A couple of months later, our client discovered they had more cash than they needed for daily liquidity, or operating cash, in our Government Money Market Fund. They wanted to know the options they should consider to increase returns on this portion of their cash balances because although their government MMF was meeting their needs for capital preservation and liquidity, it was earning very little because the federal funds target rate was anchored near zero.

Based on our discussions and their sensitivity to NAV volatility, our client did not want to extend duration and be subject to additional interest rate risk. Instead, after sharing several hypothetical scenarios and stress tests, they decided to take additional credit risk to increase their potential return profile. Hearing our fundamental outlook for credit also was a factor in getting them comfortable moving modestly lower in credit quality. (Across our short-duration strategies, we took advantage of the market dislocation to purchase securities that were favored by our Global Credit Research team. Due to market dynamics, we had identified instances where bonds from high-quality, fundamentally sound companies could be purchased in two- and three-year tenors at higher yield spreads than longer tenors.)

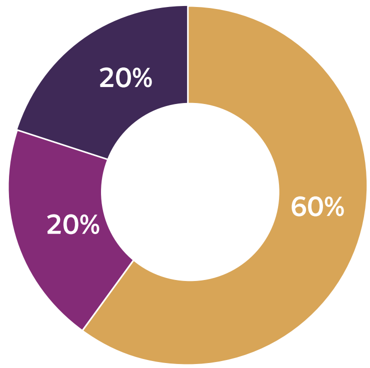
Our client implemented their decision by reallocating a sizable portion from the Government Money Market Fund to the Ultra Short-Term Income Fund, thereby taking additional credit risk and serving as a complement to the Conservative Income Fund while maintaining a similar maturity profile. Their resulting reallocation was approximately 20% in the Government Money Market Fund; 60% in the Conservative Income Fund; and 20% in the Ultra Short-Term Income Fund.

Original allocation



- Government Money Market Fund
- Conservative Income Fund

Revised allocation



- Government Money Market Fund
- Conservative Income Fund
- Ultra Short-Term Income Fund

Conclusion

Ultra-short-term bond funds may be one way to invest cash that isn't needed on a daily basis and thereby help optimize an overall cash portfolio. The investment strategies of ultra-short-term bond funds seek to efficiently manage cash with appropriate amounts of volatility by limiting interest rate risk, owning high-quality securities, and relying on experienced credit research teams to manage credit risk. The two primary levers used to add income are extending maturity/duration and moving modestly lower in credit quality.

Now is a good time to explore ways to optimize your cash portfolio's investment strategy because the current federal funds target range of 0.00% to 0.25% is expected to remain in place for the foreseeable future until the economy fully recovers. Current Fed policy anchors short-term yields and has created an opportunity cost for investors holding large amounts of cash in a strategy designed for daily liquidity, and cash investors may be better able to meet their return and risk objectives by expanding their opportunity set beyond MMFs or bank deposits.

For more information

Please contact our Institutional Sales Desk at 1-888-253-6584. Or, visit our website at wfam.com. (Click "*Select your role*" in the top navigation and select "*Institutional Cash Investor.*")

- In addition, a total return calculator is available on our website to help investors understand how the yield and NAV movement of floating NAV MMFs versus stable NAV MMFs could affect returns.

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Mutual fund investing involves risks, including the possible loss of principal, and may not be appropriate for all investors. Stock values fluctuate in response to the activities of individual companies and general market and economic conditions. Bond values fluctuate in response to the financial condition of individual issuers, general market and economic conditions, and changes in interest rates. Changes in market conditions and government policies may lead to periods of heightened volatility in the bond market and reduced liquidity for certain bonds held by the fund. In general, when interest rates rise, bond values fall and investors may lose principal value. Interest rate changes and their impact on the fund and its share price can be sudden and unpredictable.

Funds that concentrate their investments in a single industry may face increased risk of price fluctuation over more diversified funds due to adverse developments within that industry. Foreign investments are especially volatile and can rise or fall dramatically due to differences in the political and economic conditions of the host country. These risks are generally intensified in emerging markets. Smaller- and mid-cap stocks tend to be more volatile and less liquid than those of larger companies. High-yield securities have a greater risk of default and tend to be more volatile than higher-rated debt securities. Consult a fund's prospectus for additional information on these and other risks.

For municipal income funds: A portion of the fund's income may be subject to federal, state, and/or local income taxes or the alternative minimum tax. Any capital gains distributions may be taxable.

Floating NAV (FNAV). *For floating NAV money market funds: You could lose money by investing in the fund. Because the share price of the fund will fluctuate, when you sell your shares they may be worth more or less than what you originally paid for them. The fund may impose a fee upon sale of your shares or may temporarily suspend your ability to sell shares if the fund's liquidity falls below required minimums because of market conditions or other factors. An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The fund's sponsor has no legal obligation to provide financial support to the fund, and you should not expect that the sponsor will provide financial support to the fund at any time.*

For government funds: The U.S. government guarantee applies to certain underlying securities and not to shares of the fund.

Government. *For government money market funds: You could lose money by investing in the fund. Although the fund seeks to preserve the value of your investment at $1.00 per share, it cannot guarantee it will do so. An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The fund's sponsor has no legal obligation to provide financial support to the fund, and you should not expect that the sponsor will provide financial support to the fund at any time.*

Carefully consider a fund's investment objectives, risks, charges, and expenses before investing. For a current prospectus and, if available, a summary prospectus, containing this and other information, call 1-888-253-6584 or visit wfam.com. Read it carefully before investing.

The views expressed and any forward-looking statements are as of March 31, 2021, and are those of Jeffrey Weaver, head of Municipal and Short Duration Fixed Income; Michael Rodgers, senior portfolio specialist; and/or Wells Fargo Asset Management. Future events or results may vary significantly from those expressed in any forward-looking statements; the views expressed are subject to change at any time in response to changing circumstances in the market. Wells Fargo disclaims any obligation to publicly update or revise any views expressed or forward-looking statements.

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