Cash portfolios have been viewed as an asset class in their own right for several decades—certainly since 3-month Treasury bill rates reached the more-than-16% stratosphere in the early 1980s. With interest rates now at the other end of the spectrum—near 0% since the 2008 financial crisis—optimizing a cash portfolio remains an important responsibility of corporate treasurers and investment committees. Today's choices are further complicated by new government regulations and monetary policies that are changing the fundamental operating environment of the short-term investment space.

This paper outlines practical ways to optimize a cash portfolio's investment strategy by using a full spectrum of liquidity solutions. In addition to money market funds for operating cash, solutions may include ultra-short-term and short-duration bond funds for cash that does not need to be available daily.

We have always advised our clients to optimize, or segment, their cash by time horizon and risk tolerance and then invest each segment in a way that maximizes expected risk-adjusted returns. This isn't a new concept, but given the many changes taking place in the market environment, now is an opportune time to reassess a short-term investment strategy to find the best solution for each situation.

**Key points:**

- The optimal amount to invest in each segment—operating cash, working capital, and investment assets—depends on an accurate cash-flow forecast.
- The investment strategies within each segment offer different degrees of liquidity, stability, and return.
- An appropriate investment strategy depends on an assessment of a company's specific needs and risk tolerances, against which the investment policy statement can be reviewed and an investment strategy for each cash segment developed.
Step 1. Cash-flow forecasting

Accurately estimating a company’s cash flows allows a firm to optimize its cash strategies for liquidity, stability, and return. As Table 1 shows, it is helpful to think of three potential segments for cash investments:

1. Operating cash is used for regular cash needs, such as payroll and vendor payments. Its key characteristics are that it must be available on a daily basis, which means it seeks the highest level of liquidity, and capital preservation is important, which means that its investment objectives prioritize low volatility. This segment should also be available for unexpected cash needs.

2. Working capital is used on a less frequent basis for items such as quarterly tax payments or dividends. As a result, its time horizon is longer than that of operating cash and it doesn’t require same-day liquidity.

3. Investment assets do not need daily liquidity and instead have a time horizon greater than one to two years. Ideally, this would be a pool of money that has been maintained on a firm’s balance sheet at a stable amount for a number of years.

Accurate forecasting of how much and how long cash will be available in each of these segments is critical. If the amount of operating cash is overstated, then the benefit of investing the optimal amount in higher-yielding investment strategies is lost. If the amount of cash with a longer-term time horizon is overstated, then a loss could be incurred if cash is not available, should it be needed immediately and unexpectedly. Tapping funds with a longer-term time horizon could prove costly in the short term if the investment environment had changed, such as if interest rates or credit spreads increased.

Table 1 | Spectrum of liquidity solutions

<table>
<thead>
<tr>
<th>Segment</th>
<th>Operating cash</th>
<th>Working capital</th>
<th>Investment assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Used for</td>
<td>Payroll, operating expenses, etc.</td>
<td>Quarterly tax payments, capital expenditures</td>
<td>Long-term spending needs</td>
</tr>
<tr>
<td>Time horizon</td>
<td>1 day to 12 months</td>
<td>6 months to 2 years</td>
<td>Between 2 and 5 years</td>
</tr>
<tr>
<td>Risk/reward tolerance</td>
<td>Low-risk, low-return overnight cash</td>
<td>Medium-risk, medium-return enhanced cash</td>
<td>Higher-risk, higher-return limited duration</td>
</tr>
<tr>
<td>Investment type</td>
<td>Money market funds, bank deposits</td>
<td>Ultra-short-term fixed income, separately managed accounts</td>
<td>Short-duration fixed income, separately managed accounts</td>
</tr>
</tbody>
</table>

Accurate forecasting of how much and how long cash will be available in each of these segments is critical.
Step 2. Understanding the investment strategies of each segment

The investment choices along the liquidity solutions spectrum are most liquid and have the greatest stability of capital on the left and begin to seek additional yield or total return in exchange for less liquidity and stability of principal as the spectrum moves to the right. It is important to understand what each of these investment strategies seeks to provide and then translate that knowledge into whether the expected investment outcome is suitable for a particular company’s cash needs.

Money market funds

Money market funds will continue to serve cash investors that need daily liquidity. In the future, government money market funds will likely operate much as they do today. However, institutional investors in prime and tax-exempt money market funds will see a number of changes, including floating net asset values (NAVs), liquidity fees, and redemption gates. Money market funds and their partners are working to minimize the disruption to shareholders’ operational and investment experience. To help investors make confident choices, we recommend that they:

- Watch the fund data being posted on fund websites, including market-based net asset values (NAVs) (still a shadow NAV because all funds currently trade at a $1.00 stable NAV), weekly liquidity percentages, and yields. As of April 2016, all funds are required to report this information.

- Talk with us to decide which type of money market fund would be best for specific daily cash needs. For some institutional investors, the stable NAV of a government money market fund may be the best choice. For other investors, expected yields may be an important consideration. We expect there may be room for prime money market fund yields to gap higher than government money market fund yields, given the strong demand for government securities from a number of different investor types amid limited supply.
**Bank deposits**

Bank deposits are likely to become less attractive due to stricter banking regulations. Basel III, the third phase of the Basel Accord from the Basel Committee on Banking Supervision, is scheduled to be fully implemented by 2019, and the Federal Reserve Board of Governors adopted similar, but tougher, measures for U.S. banks that will take effect sooner. Among the reforms designed to strengthen the banking sector’s liquidity is the requirement that banks have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario.

For institutional deposits, nonoperational deposits are considered less stable than operational deposits (which are generally used for services such as clearing, custody, and cash management and are priced without giving a customer an economic incentive to leave excess funds in the account); therefore, banks will be required to fully back nonoperational deposits with high-quality liquid assets. In short, because the new regulations make nonoperational deposits less profitable for banks, they are expected to discourage firms from making nonoperational deposits or charging fees to hold those types of deposits. It will therefore be important for each firm to confirm its deposit types and then assess the yield or fee compared with investment alternatives that provide similar safety and liquidity.

**Ultra-short-term bond funds**

Ultra-short-term bond funds are designed for cash investors who desire additional yield opportunities for a portion of their working capital beyond daily liquidity needs. These types of funds are the first step beyond money market funds and are a type of working capital in the liquidity spectrum. They offer low-volatility NAVs and longer-term allowable maturities of the underlying investments, which allow for additional yield. They typically have an average duration or effective maturity of less than one year.

Funds in the ultra-short-term bond fund universe are not cookie cutter. They represent a range of investment strategies, with varying maturity and credit profiles. For example, all three of the taxable Wells Fargo Ultra-Short Funds (Table 2) are included in both the Morningstar ultrashort bond category and the Lipper ultra-short obligation category despite having different duration targets, credit profiles, and allowable investments. With different types of strategies available in the ultra-short-term space, investors may choose solutions that most closely meet their objectives.
Funds in the ultra-short-term bond fund universe are not cookie cutter. They represent a range of investment strategies, with varying maturity and credit profiles.

Table 2 | Comparison of Wells Fargo Ultra-Short Funds

<table>
<thead>
<tr>
<th>Duration target</th>
<th>Conservative Income Fund</th>
<th>Adjustable Rate Government Fund</th>
<th>Ultra Short-Term Income Fund</th>
<th>Ultra Short-Term Municipal Income Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 1 year</td>
<td>1 year maximum</td>
<td>Maximum effective duration of 1 year and target duration of 6 months</td>
<td>Weighted-average effective duration target of 0.75 years</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Credit quality</th>
<th>Conservative Income Fund</th>
<th>Adjustable Rate Government Fund</th>
<th>Ultra Short-Term Income Fund</th>
<th>Ultra Short-Term Municipal Income Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Invests only in issues with a minimum rating of A-</td>
<td>Targets a AAA-rated average</td>
<td>Has a maximum of 15% in below-investment-grade securities</td>
<td>Has a maximum of 10% in below-investment-grade municipal securities</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Principal investments</th>
<th>Conservative Income Fund</th>
<th>Adjustable Rate Government Fund</th>
<th>Ultra Short-Term Income Fund</th>
<th>Ultra Short-Term Municipal Income Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate bonds, commercial paper, CDs, time deposits, government securities, municipal bonds, MBS, ABS</td>
<td>MBS and CMOs</td>
<td>Corporate bonds, ABS, CMOs, CMBS</td>
<td>Municipal securities such as general obligations and revenue bonds, variable-rate demand notes</td>
<td></td>
</tr>
</tbody>
</table>

Abbreviations

MBS: mortgage-backed securities
ABS: asset-backed securities
CD: certificate of deposit
CMO: collateralized mortgage obligation
CMBS: commercial mortgage-backed securities

Short-term bond funds

Short-term bond funds are the next step beyond ultra-short-term funds and are part of the investment-asset segment of the liquidity spectrum. In fact, short-term government bond funds can be thought of as an intermediate step between ultra-short and short-term bond funds because they mainly seek additional yield by extending duration and maintaining a high-quality credit profile (government). For nongovernment short-term bond funds, additional yield is sought by extending the bounds for duration, credit quality, and asset type. Funds in the short-term bond fund category have durations of more than 1 year but less than 3.5 years, according to the Morningstar definition. The returns, as measured by the representative indexes in Table 3, show that the investment-asset segment has outpaced those of the working-capital segment but its volatility has been greater as well over the past 3-, 5-, and 10-year periods.
Self-directed investments are an option for treasury departments with the expertise and resources to manage a fixed-income portfolio. It is time-intensive to conduct in-depth credit research, analyze yield-curve shifts, and understand supply and demand technical factors. The ability to achieve best execution in a competitive environment is also important. For total return needs, we believe it is important to be able to judge if a particular security presents a good value at a particular price. It isn’t enough that an asset is cheap because there may be a good reason an asset is cheap and may be at risk of becoming even cheaper. Additionally, portfolio reporting and risk management would need to be undertaken internally.

Separately managed accounts
Separately managed accounts may also be an investment consideration for institutional clients. The benefit of using a separately managed account is the ability to customize investment preferences for risk tolerances, return objectives, and cash flows. Customization can also address gain/loss sensitivity, financial statement implications, and tax concerns.

A comparison of the cash segments
As Table 3 shows, the total returns and volatility (as measured by standard deviation) increase as the duration and investment types are expanded. As expected, the investment types within the operating-cash segment have lower returns and lower volatility than the working-capital and investment-asset segments.

The percentage of time that returns were negative is important information to understand the potential for losses. None of the three indexes for their respective liquidity segments had negative returns over a one-year rolling period since late 2004. Their quarterly returns, however, varied over this time frame. The Citibank 3-Month Treasury Bill Index—representing operating cash—never had negative returns. The Barclays Short-Term Government/Corporate Index—a proxy for ultra-short-term bond funds—had negative returns 1.4% of the time, and the Barclays 1–3 Year Government/Credit Index—representing the short-term bond fund segment—had negative returns 9.3% of the time.

The takeaway is that the working-capital and investment-asset segments can be expected to have some negative monthly returns, but the average rolling one-year returns were flat or positive. Operating-cash investments, which are focused on capital preservation, consistently had returns in positive territory.
Table 3  | **Historical perspective of investment outcomes, as of June 30, 2016**

<table>
<thead>
<tr>
<th>Cash segment</th>
<th>Operating cash</th>
<th>Working capital</th>
<th>Investment assets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment type</strong></td>
<td>Money market fund</td>
<td>Ultra-short-term bond fund</td>
<td>Short-term bond fund</td>
</tr>
<tr>
<td><strong>Representative index</strong></td>
<td>Citibank 3-Month Treasury Bill Index</td>
<td>Barclays Short-Term Government/Corporate Index</td>
<td>Barclays 1–3 Year Government/Credit Index</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Results (%)&lt;sup&gt;1&lt;/sup&gt;</th>
<th>Total return</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 year</td>
<td>0.14 0.59 1.59</td>
</tr>
<tr>
<td>3 year</td>
<td>0.07 0.36 1.22</td>
</tr>
<tr>
<td>5 year</td>
<td>0.06 0.34 1.10</td>
</tr>
<tr>
<td>10 year</td>
<td>0.96 1.58 2.80</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Standard deviation (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 year</td>
</tr>
<tr>
<td>5 year</td>
</tr>
<tr>
<td>10 year</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Percent of time total return was negative since September 2004&lt;sup&gt;2&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-month returns</td>
</tr>
<tr>
<td>3-month rolling returns</td>
</tr>
<tr>
<td>1-year rolling returns</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Average duration (years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.3 0.5 1.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Settlement</th>
<th>Same day</th>
<th>Next day</th>
<th>Next day</th>
</tr>
</thead>
</table>

Sources: Barclays, Citigroup, Wells Fargo Funds Management
1. Total return based on monthly returns, annualized. 2. Percent of time negative was based on rolling returns since September 2004. Past performance is no guarantee of future results.

The Citigroup 3-Month Treasury Bill Index measures monthly return equivalents of yield averages that are not marked to market. The 3-Month Treasury Bill Index is an average of the past three 3-month Treasury bill issues. Returns for these indexes are calculated monthly. You cannot invest directly in an index.

The Barclays Short-Term U.S. Government/Corporate Bond Index contains securities that have fallen out of the Barclays U.S. Government/Credit Index because of the standard minimum one-year-to-maturity constraint. Securities in the Short-Term U.S. Government/Corporate Bond Index must have a maturity from 1 up to (but not including) 12 months. You cannot invest directly in an index.

The Barclays U.S. 1–3 Year Government/Credit Bond Index is the one- to three-year component of the Barclays U.S. Government/Credit Bond Index that includes securities in the Government and Credit Indexes. The Government Index includes Treasuries (that is, public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (that is, publicly issued debt of U.S. government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. government). The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. You cannot invest directly in an index.

Working-capital and investment-asset segments can be expected to have some negative monthly returns, but those returns have averaged to flat or positive returns over one-year periods. Operating-cash investments, which are focused on capital preservation, consistently had returns in positive territory.
Step 3. Assessing needs and risk tolerances

After cash has been allocated to the appropriate investment-strategy segment, an assessment of a company’s investment needs, risk tolerances, and return objectives is needed. Many treasury departments will work with us to develop appropriate investment policies and strategies. This conversation should include a realistic understanding of what each investment strategy would mean to a cash portfolio. Questions that should be asked include:

How liquid is an investment solution?
Government and retail money market funds will continue to transact at stable NAVs, but institutional prime and tax-exempt money market funds will be subject to a floating NAV and fees/gates. We expect some firms will choose government funds that continue to operate exactly as they do today but that many will become comfortable with the new structures of prime and tax-exempt money market funds.

How much interest-rate risk is acceptable?
Start by considering that a 1.00% increase in rates on a one-year duration portfolio would mean a 1.00% decline in market value. This calculation assumes that rates would have risen 1.00% in one day, which is highly unlikely. It is more instructive to look over a reporting period. For example, over the course of one year, a 1.00% rise in interest rates would be offset by coupon income if the investment type had a coupon of 1.00% or higher. Further, ultra-short-term bond funds could potentially have positive returns rather than negative ones as interest rates rise because many of their short-term underlying securities would be resetting at higher yields.

What will rising interest rates mean for the investment-asset segment?
The Barclays 1–3 Year Government/Credit Index returned 2.80% over the past 10 years, with a standard deviation of 1.26%. Although rates have been extremely low for the past six years, this segment produced positive returns despite interest rates rising alongside the increase in the federal funds rate from 1.00% to 5.25% between June 2003 and June 2006.

How can other downside risks be gauged?
A scenario analysis is done by using a proxy portfolio of potential duration and credit profiles to analyze the effect of higher interest rates and negative credit events, such as an increase in the credit spreads for certain portfolio securities. For cash management decisions, it is appropriate to analyze the effect of these potential events on return and income potential over a 3-month and 12-month time period.
Review the investment policy statement

The investment policy statement (IPS) is a document that serves as a policy guide to meet the goals and objectives of an investment portfolio over the long run. Whether reviewing an IPS or broadening it to guide a full spectrum of liquidity solutions, the goal is the same: to fully understand an institution’s specific situation, including investment objectives, risk tolerance, return needs, and investment constraints.

We also recommend that an IPS be reviewed for consistency with the new money market fund regulations. The U.S. Securities and Exchange Commission has stated that the adoption of a floating NAV for money market funds will not, under normal circumstances, preclude shareholders from classifying their investment in money market funds as cash equivalents for purposes of U.S. generally accepted accounting principles. Within the permitted investments part of an IPS, a fund (money market or short duration) should be an approved investment type itself, as opposed to looking at each security within a fund on an individual basis. With regard to 2a-7 registered money market funds, in particular, it may be helpful to document and approve within allowable investments that prime and tax-exempt funds include floating NAVs, liquidity fees, and redemption gates as of October 2016.

For more on developing an investment policy statement, see A Primer on Cash Investment Policy Statements on our website.

Develop an investment strategy for each segment

An investment strategy should be developed for each cash segment based on the investment objectives, which are generally prioritized in the order of capital preservation, adequate liquidity, and competitive returns. Because risk tolerance and return requirements are at the heart of a firm’s investment objectives, it’s worth a closer look with regard to each investment segment.

Investment risk tolerance

While a risk-averse client is likely to seek capital preservation above all other objectives, there are a number of sources of risk that an investment committee needs to consider, such as credit risk, interest-rate risk, and liquidity risk. The potential effect of these risks on a cash portfolio should help an investment committee understand the risk it may be undertaking and the amount of risk it is willing to take.

Return requirements

Here an investment committee should consider how much return is needed and is realistic for various yield environments. The type of return matters as well. Shorter-term operating-cash portfolios may not require much in terms of total return and may focus primarily on capital preservation. Others may need a certain amount of income or yield, and still others may seek a combination of income and capital appreciation and therefore specify total return requirements.
Conclusion

Because of the many regulatory changes affecting issuance, investor demand, money fund operations, and investor flows in the short-term fixed-income investment space, now is a good time to focus on optimizing a cash investment strategy.

Money market funds are likely to remain a good choice for many investors, particularly for operating-cash needs. Ultra-short-term and short-duration strategies are designed to offer more yield and total return potential for less liquidity and more volatility. In thinking about optimizing investments along the liquidity spectrum, it is important to keep in mind that ultra-short-term and short-duration funds are not money market funds but are designed for cash investors who desire additional yield opportunities for a portion of their working capital beyond daily liquidity needs. These types of investment strategies seek to manage NAV volatility by limiting interest-rate risk, owning high-quality securities, and depending on experienced credit research teams.
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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 your investment professional or visit wellsfargofunds.com. Read it carefully before investing.

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. The use of derivatives may reduce returns and/or increase volatility. Certain investment strategies tend to increase the total risk of an investment (relative to the broader market). The Adjustable Rate Government Fund, Conservative Income Fund, and Ultra Short-Term Income Fund are exposed to mortgage- and asset-backed securities risk. Consult the fund’s prospectus for additional information on these and other risks.

Adjustable Rate Government Fund: Securities issued by U.S. government agencies or government-sponsored entities may not be guaranteed by the U.S. Treasury. The U.S. government guarantee applies to certain underlying securities and not to shares of the fund.

Conservative Income Fund: This fund is exposed to foreign investment risk and municipal securities risk.

Ultra Short-Term Income Fund: Loans are subject to risks similar to those associated with other below-investment-grade bond investments, such as credit risk (for example, risk of issuer default), below-investment-grade bond risk (for example, risk of greater volatility in value), and risk that the loan may become illiquid or difficult to price. This fund is exposed to foreign investment risk and high-yield securities risk.

Ultra Short-Term Municipal Income Fund: This fund is exposed to Pennsylvania municipal securities risk, high-yield securities risk, and nondiversification risk. A portion of the fund’s income may be subject to federal, state, and/or local income taxes or the Alternative Minimum Tax (AMT). Any capital gains distributions may be taxable.

Definitions: Duration is a measurement of the sensitivity of a bond’s price to changes in Treasury yields. A fund’s duration is the weighted average duration of the bonds in the portfolio. Duration should be interpreted as the approximate change in a bond’s (or fund’s) price for a 100-basis-point change in Treasury yields.

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