WELLS FARGO ADVISORS

Strategies for fixed-income investors

Investing for rising interest rates

Rising interest rates can have a significant negative effect on the value of fixed-income investments because interest rates and bond prices move in opposite directions — in other words, as interest rates move up, bond prices can fall in value. In this guide, we detail strategies that fixed-income investors can use if they are concerned about rising interest rates.

Together we'll go far

Now may be a good time to re-examine your bond portfolio

As a result of accommodative Federal Reserve policies, longer-term interest rates remain well below levels that could be considered normal during a period of modest economic growth. As you can see in the graph on the following page, Treasury yields have moved lower even in the face of ballooning supply. Clearly the demand for Treasury securities remains strong; however, as the Fed scales back on its purchases of these securities, yields may move higher, pushing prices lower.

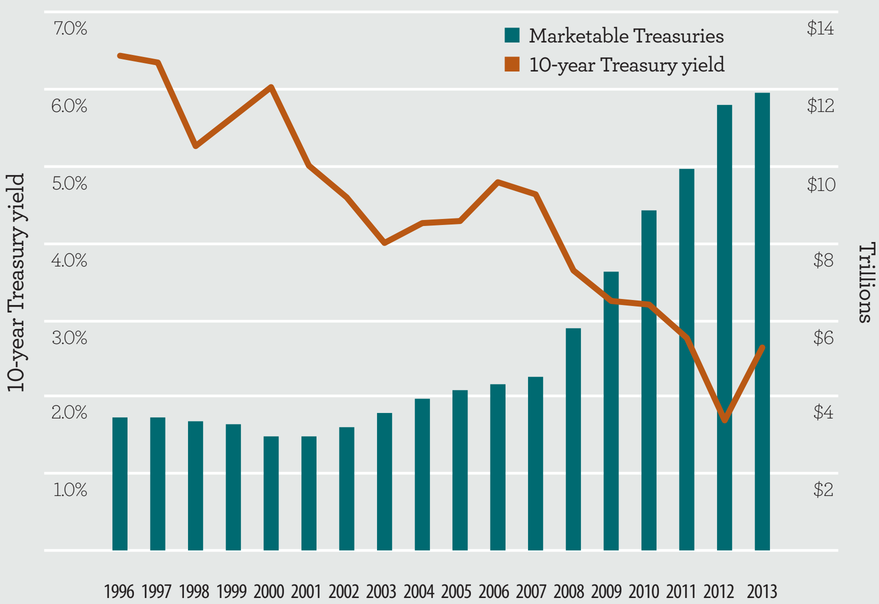
The Advisory Services Group (ASG), which includes Wells Fargo Advisors' top market strategists and analysts, expects interest rates to rise over time. We expect the rise in rates will occur over many years. As a result, investors need to adjust their expectations of fixed-income returns going forward — the strong positive past performance many experienced in fixed-income investments in the past is unlikely to be duplicated in the years ahead.

Even with lower fixed-income return expectations, most investors should not look to divest themselves of recommended fixed-income allocations. Traditional fixed income is a core asset class and remains an important part of most asset allocation strategies. Traditional fixed income provides many benefits to a well diversified portfolio, including: reduced portfolio volatility, a constant stream of income, reduced exposure to catastrophic events, preservation of capital, and access to liquidity. Investors should consider how fixed-income investments fit into their investment plans. A long-term investment plan is a marathon, not a sprint.

Are your fixed-income allocations providing the diversification and performance that they are designed to achieve? In today's market and economic environment, despite the potential need for income, it is critical that portfolios maintain a proper asset allocation and diversification in line with an investor's risk tolerance and investment objectives.

U.S. Treasuries supply and 10-year yield

1996 – July 2013



Source: Bloomberg, Wells Fargo Advisors

So what does this mean for the average fixed-income investor?

For starters, it means that you'll want to understand the relationship between bonds and interest rates. In addition, you and your Financial Advisor will want to discuss fixed-income strategies for rising interest rates. You'll want to decide which strategy is best-suited to your investment style and circumstances.

This guide starts with an explanation of bonds and interest rates before focusing in on more detailed discussions. Specific topics include:

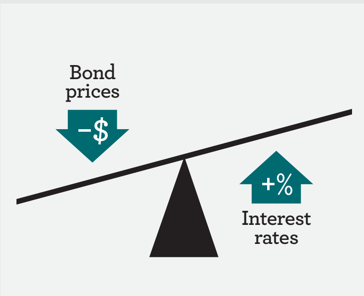
- Strategies for individual bondholders
- Strategies for bond funds, closed-end funds (CEFs), exchange-traded products (ETPs) and separately managed accounts
- How asset allocation should fit into your strategy

The impact of interest rates on bonds

The relationship between bonds and interest rates

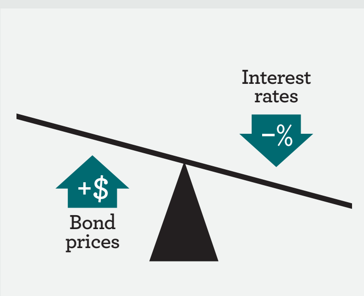
When interest rates rise

The value of outstanding bonds falls because the income they pay is less than what investors could receive on a new bond.



When interest rates fall

The value of outstanding bonds rises because the income they pay is more than what investors could receive on a new bond.



Several factors can cause the price of a fixed-income security to change. They include a change in interest rates, a change in credit quality, and/or a change in secondary market liquidity for bonds (demand).

Market forces work to align bond prices with prevailing interest rates. Generally speaking, if interest rates move higher, bond prices fall since investors can purchase new issues with higher coupons. The opposite occurs as interest rates fall and new issues offer lower coupons. When this happens, investors are willing to pay higher prices for comparable fixed-income investments that have higher coupons.

Several forces can move interest rates:

Supply and demand. During times when investors are looking to take less risk, there is often a strong demand for U.S. government-backed fixed-income investments. As more investors look to purchase Treasury bonds, yields drop while prices rise. Supply can also have a significant effect on interest rates. As companies or governments issue more bonds, the supply of bonds in the marketplace increases, moving yields higher and prices lower.

Economic growth. Interest rates are influenced by changes in the long-term outlook for the economy. As economic conditions improve, investors anticipate that higher interest rates may be needed to "cool off" the economy and keep inflation under control.

Inflation outlook. Inflation, the upward trend of prices over time, can have a significant impact on fixed-income investments. If inflation is greater than anticipated over an investment horizon, it will be difficult to maintain assets' "purchasing power." As inflation increases, interest rates tend to rise.

Monetary policy. The Federal Reserve uses monetary policy to control the money supply in the economy. The fed funds target rate is the most visible tool and directly impacts short-term yields.

Fiscal policy. The government budgetary process contains two main instruments: expenditures and taxes. How the president and legislature manage the process can have a meaningful impact on interest rates. Governments often use fiscal policy to impact economic performance, and they typically increase spending during times of economic duress and scale back spending as things improve. Over a multiyear time horizon, excessive spending can increase the supply of government debt as investors require higher yields to fund the increasing supply of debt.

Risk on/off. During times of economic or political uncertainty, risky assets tend to fall in value as investors favor lower-risk alternatives. In spite of the U.S. debt and deficit issues, Treasury securities remain the asset of choice for investors in search of perceived safe havens. The increased demand generally moves interest rates lower and prices higher.

Understanding duration

It is important for fixed-income investors to understand duration and how they can use the calculation to gauge interest-rate risk and the approximate impact that rising rates may have on a fixed-income investment.

Duration measures the sensitivity of a bond's price to a change in interest rates. The duration calculation can be used by investors to approximate the percentage change in price per 1% parallel shift in the yield curve. For example, the price of a bond with a duration of five years would be expected to rise or fall 5% in price for every 1% decrease or increase in market interest rates. The longer (higher) the duration, the more prices will fluctuate as interest rates rise and fall.

Long-term bonds tend to have longer durations, and their prices can fall quickly when interest rates are on the rise.

Using duration to estimate the impact of rising interest rates

In the table below, you can see the duration and price performance of three generic bonds. The coupon levels (yields) are based on an upward-sloping interest-rate curve. We show the impact on each bond's price in three different interest-rate scenarios.

				Estimated value after interest-rate change		
	Yield	Duration	Par value	+1%*	+2%*	+3%*
30-year bond	3.50%	18.48	$1,000	$836	$708	$606
10-year note	2.50%	8.80	$1,000	$916	$840	$772
Five-year note	1.40%	4.81	$1,000	$953	$909	$867
Two-year note	0.35%	1.99	$1,000	$980	$961	$942

*Market value after instantaneous increase in the yield curve.

Examples are used for illustrative purposes only and do not reflect the rates for any investments available for purchase through Wells Fargo Advisors.

Duration, always stated in years, can be used to estimate the percentage change in a bond's value that results from a 1% change in interest rates.

As with individual bonds, it is also possible to determine the duration of fixed-income ETPs and bond funds. Your Financial Advisor can provide the duration for funds in your portfolio. This number can be applied in the same manner to determine the approximate price fluctuation you can expect as interest rates change.

Strategies for individual bondholders

A number of strategies can help bond investors position their portfolios for rising interest rates:

- Laddering individual bonds
  - – Shortening duration by redeploying income
  - – Shortening duration by redeploying investments
- Buying premium bonds and selling discount bonds
- Diversify into other fixed-income asset classes

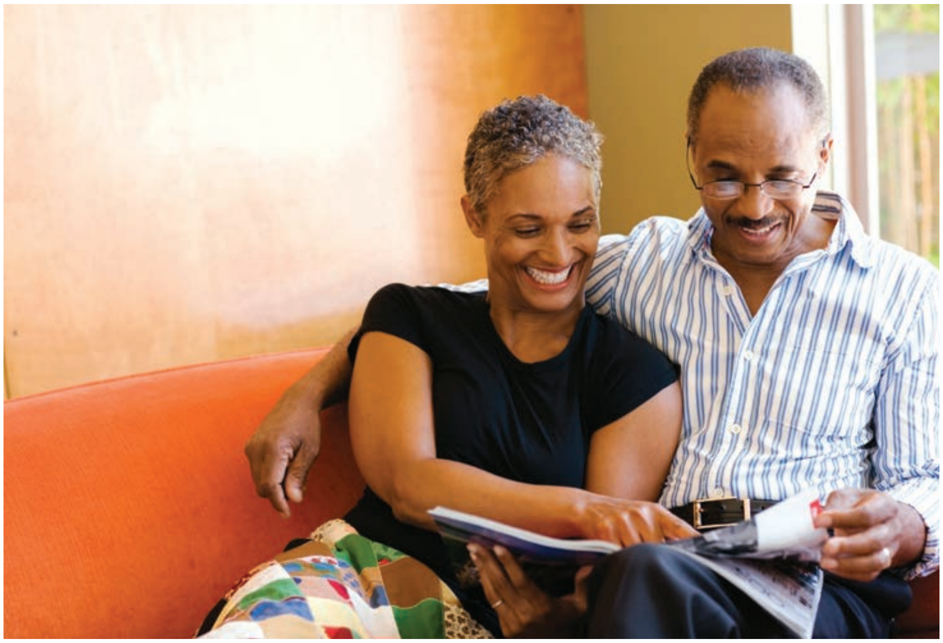
Laddering individual bonds

For investors who purchase individual bonds, consider setting up a bond ladder to diversify your interest-rate risk. Bond laddering in its most basic form entails purchasing bonds that mature at various points in time, such as every year or every couple of years. A bond ladder offers a steady stream of cash flows and can be tailored to an investor's individual needs. If interest rates increase over the next several years, the current market value of a fixed-income portfolio will likely drop. However, as each rung on the ladder matures, principal will become available to invest at the higher prevailing rate.

If interest rates decrease, investors will lock in lower rates with the maturing bonds. Those bonds not maturing, however, will remain locked into the higher rates until maturity.

Shorten duration by redeployment of income

Investors concerned that we are entering a period of rising rates can employ a redeployment-of-income strategy. This strategy works well to gradually shorten the duration of a portfolio in anticipation of higher rates in the next two to five years. As "rungs" of an investor's bond ladder mature, investors can redeploy the principal in shorter maturities rather than at the end of the bond ladder.



Shorten duration by redeploying investments

For investors concerned that a period of rising rates is imminent, we recommend a redeployment of your current bond ladder. Investors can lock in gains by selling longer-maturity securities (many of which are trading well above par) and redeploying the proceeds into shorter-maturity securities. While investors will sacrifice some current yield and income, the portfolio will be better prepared to weather rising interest rates. As seen in the table below, longer-maturity securities typically underperform when rates rise.

In anticipation of rising rates in the next two to five years, investors can prepare by reinvesting in shorter-maturity securities.

Longer-maturity securities can underperform when interest rates rise

Coupon	Years to maturity	Current price	Current YTM*	+1%† YTM	New price	Percent change
3.00%	2	1000	3.00%	4.00%	$98.1	−1.90%
3.00%	5	1000	3.00%	4.00%	$95.5	−4.49%
3.00%	10	1000	3.00%	4.00%	$91.8	−8.18%
3.00%	20	1000	3.00%	4.00%	$86.3	−13.68%
3.00%	30	1000	3.00%	4.00%	$82.6	−17.38%

*Yield to maturity

†Market value after instantaneous increase in the yield curve.

Source: Wells Fargo Advisors

Premium bonds generally have lower durations than comparable-maturity discount bonds and can help your portfolio play defense when interest rates rise.

Buy premium bonds

Bonds that are offered at substantial premiums to par can generally be purchased at higher yields than comparable par-value or discount bonds. As a result, the yield-to-maturity is frequently higher on bonds trading at a premium. So while it is true that premium bond buyers will receive less at maturity than they paid for the bonds, they will receive higher coupon payments over the life of the bond that may more than make up for the premium.

Premium bonds also offer a distinct advantage amid rising interest rates as they tend to lose less value than a comparable bond purchased at par or at a discount. Investors preparing for rising interest rates should consider selling discount bonds and buying premium bonds. In most cases, investors will maintain or increase their current yield levels while providing added defense for higher interest rates. Investors who use this strategy will see increased income due to the higher coupon payments. To maintain principal, investors should take care to redeploy excess income back into fixed-income investments.

Discount bonds have higher durations

Coupon	Maturity	Price	YTM*	Duration
0.00%	10 years	$610	5.00%	10.00
3.00%	10 years	$844	5.00%	8.36
5.00%	10 years	$1,000	5.00%	7.79
7.00%	10 years	$1,156	5.00%	7.38
10.00%	10 years	$1,390	5.00%	6.93

*Yield to maturity

Source: Wells Fargo Advisors

Increase cash flow

Consider adding allocations to fixed-income asset classes that offer higher levels of cash flows. Mortgage-backed securities (MBS) and preferred securities are fixed-income investments that generally provide increased cash flow to investors over traditional alternatives. There are unique risks associated with these types of investments that should be considered with your Financial Advisor. We advise that investors refrain from “reaching for yield/income” by moving lower in credit quality than is appropriate for their risk tolerance.

Diversifying into other fixed-income asset classes

Investors should consider diversifying into other, less correlated asset classes, though not as a strategy to reduce duration. Exposure to sectors such as emerging-market debt and non-dollar developed international fixed income may reduce the risk associated with an increase in U.S. Treasury rates. While this strategy may increase a portfolio's overall volatility, it may also increase yield potential and help in a rising-interest-rate environment. Diversification is an important part of any portfolio and asset allocation strategy.

Favorable supply/demand dynamics should help support muni valuations even if interest rates rise.

Invest tax-free with "munis"

Municipal bonds tend to lag movements in Treasury securities in both up and down market cycles. While the overall impact of rising interest rates can be muted in the municipal sector, concerned investors can still use our strategies for individual bondholders. In addition, our expectation of higher future tax rates could help support municipal bond valuations even if we are faced with rising interest rates.

Municipal bond income is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal alternative minimum tax (AMT).

Strategies for bond funds, CEFs, ETPs, and separately managed accounts

*If you are not comfortable with the potential for falling prices and are concerned about rising interest rates, try one of these approaches:**

- Swap into bond funds and fixed-income exchange-traded products (ETP) with shorter durations.
- Consider laddering fixed-income ETPs with finite lives.
- Sell a portion of your bond fund or ETP and buy individual shorter-term bonds, keeping in mind the strategies listed in the strategies for individual bondholders.
- Consider investing in a floating-rate fund or bank-loan fund if your risk parameters allow for this type of investment.
- Swap into a CEF that does not employ leverage.

Understand your alternatives

There are inherent differences among open-end bond funds, closed-end bond funds, separately managed accounts, and bond ETPs.

Short duration bond funds and fixed-income ETPs should not be considered alternatives to money market funds.

Fixed-income ETPs and professionally managed bond funds offer diversification over a broad range of issuers and sectors. Retail investors may also find that it's more efficient managing and rebalancing a fixed-income asset allocation with bond funds, ETPs, and separately managed accounts than with individual fixed-income securities that offer less liquidity and price transparency. In addition, investors may not have adequate investment dollars to achieve this same diversification when purchasing individual bonds.

Investors should consider that most bond funds and fixed-income ETPs do not mature. As such, investors should be well aware of the duration of the ETP or professionally managed portfolio. The duration can indicate the potential volatility that may be encountered in changing-interest-rate environments. Longer duration will generally mean greater price swings and with this, the potential for greater loss in principal.

**Keep in mind that with each transaction there could be tax implications and fees. You should consider these costs against any potential benefits of making these moves. Be sure to speak with your tax advisor if you have any questions regarding tax implications. Wells Fargo Advisors does not provide tax or legal advice.*

Bond mutual funds and separately managed accounts

Bond mutual fund and separately managed account investors should consider that if prices begin to fall, there may be more investors redeeming their shares than buying, which can create a net outflow of funds. This can force the manager to sell bonds in the fund to pay the investors who are redeeming shares. In addition, if no new money is flowing into the fund, the manager may not have as much cash to invest at higher rates. Many fixed-income managers, however, have the ability to shorten the fund's duration to better position it for rising rates. They may also have the ability to shift sector and security allocations in the interest of defending the portfolio against rising rates. This is a significant advantage of a fund since active, professional management may have access to liquidity and securities that are not available or familiar to individual bond investors. The fund's prospectus will outline the portfolio manager's mandate and latitude in investing clients' assets.

Returns and principal value of a mutual fund investment will fluctuate so that shares, when redeemed, may be worth more or less than their original cost.

Staying within the same mutual fund family may be preferable because switching from one mutual fund family to another may involve additional costs or fees. For more information on mutual funds, ask your Financial Advisor for "A Guide to Investing in Mutual Funds."

Closed end funds (CEFs)

CEFs offer clients many of the same features as open-end bond mutual funds, but some additional features can impact returns. Because they do not continuously offer new shares or redeem outstanding shares, CEFs are not confronted with unpredictable cash flow into and out of the fund. The manager can concentrate on the fund's long-term strategy without also planning for potential liquidations or large inflows that need to be invested in what could be an overvalued market.

Unlike most open-end bond funds, some bond CEFs employ the use of leverage. While this can significantly increase current yields and make the funds attractive to investors, the increased leverage can also make the net asset value (NAV) and share price of a CEF that invests in interest-rate-sensitive assets more vulnerable to a rise in interest rates.

A rise in short-term rates could also increase the cost of borrowing for most leveraged CEFs. This would reduce the earnings rate of the CEF, which could eventually result in a reduction in its distribution. The higher a CEF's leverage ratio is, the more substantial the impact of a rise in its borrowing cost will likely be on its distribution.

Investors using CEFs are also exposed to discount risk – the risk that the share price will be lower than the CEF's NAV. Unlike an open-end fund, the price an investor receives upon sale is not the fund's NAV but rather the exchange-traded share price. Should interest rates rise, a CEF's price may fall faster than NAV as investors sell their shares in the open market. Many CEFs are not very liquid, and this can put added downward pressure on share prices during times of significant selling pressures.

A CEF has both an NAV and a price, and these two values may differ. A CEF's NAV is the total value of the securities in the portfolio minus any liabilities divided by the fund's number of common shares outstanding. The fund's price is the market value at which it trades on an exchange. Changes in investor demand for a particular CEF may cause the fund to trade at a price that is greater (lower) than the NAV; in that case, the fund is trading at a premium (discount) to its NAV. Since a fund's premium or discount to its NAV may narrow or widen, a CEF's price return may differ from its NAV return.

Exchange-traded products (ETPs)

ETPs differ from other types of bond funds in that they generally are not actively managed but rather seek to track a reference benchmark index. Because of the passively managed nature of these funds, they typically assess lower fees than other types of funds. Like CEFs, ETP shares generally trade on an exchange or in the over-the-counter markets; however, unlike CEFs, they continually create and redeem shares via the activities of authorized participants. It is because of the activities of these authorized participants that the market price will usually trade within close proximity to the value of the underlying NAV. (For a more detailed discussion regarding the manner in which ETPs trade, please ask your Financial Advisor for a copy of the report, "Exchange-Traded Tracking Products: The Basics."

ETPs were designed to track many different market segments, such as investment-grade corporate bonds, high-yield bonds, municipal bonds, etc. Also, they let you choose among short-duration funds, intermediate-duration funds, longer-duration funds and ETPs that invest in TIPS. In addition, some fixed-income ETPs with finite lives have been introduced. These myriad types of fixed-income ETPs afford an investor considerable flexibility in managing duration. For example, those investors who want exposure to fixed-income securities but who don't want to be exposed to considerable interest-rate risk may want to consider one of the shorter-duration (but perpetual) bond ETPs or select one or more relatively shorter maturities from the ETPs that have finite lives. Other investors may want to "ladder" maturities, investing in each available maturity in equal amounts.

ETPs are subject to risks similar to those of stocks. Investment returns may fluctuate and are subject to market volatility so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. ETPs seek investment results that, before expenses, generally correspond to the price and yield of a particular index. There is no assurance that the price and yield performance of the index can be fully matched.

Bank-loan and floating-rate funds

Bank loans provide individual investors with an opportunity to invest in a class of assets that is normally only available to institutional investors. Most bank loans are rated below investment-grade and may not be suitable for all investors. The majority of bank loans are priced at some spread over LIBOR*, and as short-term rates increase, fund yields would be expected to increase if credit spreads do not materially weaken. Should credit spreads widen, they may offset the increasing yield gains. Bank-loan funds give investors some buffer against rising interest rates.

Floating-rate loans will adjust with the market and pay higher dividends to investors. However, investors are exposed to the credit risk of speculative (below investment-grade) issuers and are at greater risk of loss of principal than higher-rated securities. As with many bond funds, investors may face limited liquidity. This is especially true of an asset class that is subject to credit contraction, and issuers may have limited ability and access to the capital markets. Bank-loan and floating-rate funds should not be considered alternatives to money market funds.

Bank loans provide individual investors with an opportunity to invest in a class of assets that is normally only available to institutional investors. Most bank loans are rated below investment-grade and may not be suitable for all investors.

** LIBOR (London Interbank Offered Rate) is a standard financial index banks use in setting rates on many consumer loans.*

Pay attention to your asset allocation

Fixed-income investments are an important part of most asset allocation strategies, and the asset class should remain an important part of your allocation strategy even when interest rates are on the way up. Investors who are unsure about what percentage of their portfolio to allocate to fixed-income investments can ask their Financial Advisor for the current Wells Fargo Advisors asset allocation models.

Diversification and asset allocation do not guarantee a profit or protection against loss in a declining market.

One year's leader can be the next year's laggard and vice versa. This chart shows how various fixed-income asset classes have performed during the past 10 years.

Fixed-income investments' historical performance

'03	'04	'05	'06	'07	'08	'09	'10	'11	'12
Emerging Market 34.1%	Emerging Market 12.9%	Emerging Market 12.9%	Emerging Market 12.7%	International 11.5%	Treasuries 14.0%	High Yield 57.5%	High Yield 15.2%	Treasuries 9.8%	Emerging Market 22.8%
High Yield 28.1%	International 12.1%	Treasuries 2.8%	High Yield 11.8%	Treasuries 9.1%	International 10.1%	Emerging Market 34.8%	Emerging Market 15.0%	Corporates 7.5%	High Yield 15.6%
International 18.5%	High Yield 10.9%	High Yield 2.7%	International 6.9%	Emerging Market 6.2%	Corporates -6.8%	Corporates 19.8%	Corporates 9.5%	Emerging Market 5.9%	Corporates 10.4%
Corporates 8.3%	Corporates 5.4%	Corporates 2.0%	Corporates 4.4%	Corporates 4.6%	Emerging Market -15.4%	International 4.4%	Treasuries 5.9%	International 5.2%	Treasuries 2.2%
Treasuries 2.3%	Treasuries 3.5%	International -9.2%	Treasuries 3.1%	High Yield 2.2%	High Yield -26.4%	Treasuries -3.7%	International 5.2%	High Yield 4.4%	International 1.8%

- **BofA Merrill Lynch U.S. Treasury Master Index** – Includes approximately 160 issues in the form of publicly placed, coupon-bearing U.S. Treasury debt.
- **BofA Merrill Lynch Global Emerging Market Sovereigns Index** – Tracks the performance of sovereign debt issued and backed by more than 20 emerging-market countries.
- **BofA Merrill Lynch High Yield Corporate Master II Index** – Tracks the performance of U.S.-dollar-denominated below-investment-grade corporate debt publicly issuedin the U.S. domestic market.
- **BofA Merrill Lynch U.S. Corporate Master Index** – Reflects investment-grade bonds with average maturities of at least one year.
- **Citigroup Non-USD WGBI (USD) Index** – Comprises fixed rate government bonds with a maturity of one year or longer and amounts outstanding of at least $25 million.

As of Dec. 31, 2012. Past performance is no guarantee of future results. You cannot invest directly in an index. See Important Disclaimers for risk considerations.

Quick reference guide for rising interest rates

	Individual bonds	Open-end bond funds	Closed-end bond funds	Fixed-income ETPs
Maturity	In most cases matures at face value unless company is in a distressed situation	No maturity date	Most do not have a maturity date	Most do not have a maturity date
Duration *(sensitivity to changes in interest rates)*	Duration should decrease as bonds approach maturity	Duration ranges from short to long based on the fund's objective. Duration within the fund can be managed depending on the interest rate environment.	Duration should be managed in relation to fund goals; managers may have flexibility to adjust duration. Additional leverage may magnify interest-rate sensitivity.	Most track a reference index; durations may increase or decrease as benchmark durations change
Strategies for a rising-interest-rate environment	• Ladder bonds • Shorten duration by redeployment of income • Shorten duration by redeploying investments • Buy premium bonds and sell discount bonds • Diversify your fixed-income investments	• Swap into funds with shorter durations • Consider bank-loan and other floating-rate funds • Buy individual bonds • Diversify your fixed-income investments	• Consider bank-loan and other floating-rate funds • Swap into a fund that does not employ leverage • Buy individual bonds • Diversify your fixed-income investments	• Swap into fixed-income exchange-traded products with shorter durations • Consider laddering finite life fixed-income exchange--traded products • Buy individual bonds • Diversify your fixed-income investments

An Advisory Services Group (ASG) report, August 2013

Brian Rehling, CFA
Chief Fixed-Income Strategist

Important disclaimers

Past performance is not an indication of future results.

Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment.

Investing in fixed income securities involves certain risks such as market risk if sold prior to maturity and credit risk especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility. All fixed income investments may be worth less than original cost upon redemption or maturity.

There are special risks associated with investing in preferred securities. Preferred securities generally offer no voting rights with respect to the issuer. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. Preferred dividends are not guaranteed and are subject to deferral or elimination.

The yield, average life and the expected maturity of mortgage-backed securities are based on prepayment assumptions that may or may not be met. Changes in prepayments may significantly affect yield, average life and expected maturity.

Although Treasuries are considered free from credit risk, they are subject to other types of risks. These risks include interest-rate risk, which may cause the underlying value of the bond to fluctuate, and deflation risk, which may cause principal to decline and the securities to underperform traditional Treasury securities.

Any bonds called prior to maturity result in reinvestment risk for the bond holder.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Talk to your Financial Advisor today

It's always important to be ready for changes in the economy through sound investment strategies backed by analysis, research, and experience. If you'd like to apply strategies discussed in this report to your own fixed-income portfolio or would like to know more about your alternatives for addressing rising interest rates, talk to your Financial Advisor.

84110B-v4

0813-00543