A primer on variable-rate demand notes

Variable-rate demand notes (VRDNs) have historically been a core holding in municipal money market funds because of their effectiveness as a tool for managing a fund’s liquidity and average maturity. The safety and soundness of the VRDN structure has been demonstrated through various market conditions and economic cycles, most notably during the 2008 financial crisis. In recent years, VRDNs have become a popular investment alternative for prime money market funds due to their ability to provide liquidity and enhance principal preservation.

What are VRDNs?

VRDNs are longer-term municipal securities that feature both a periodic coupon reset and a demand feature that allows an investor to periodically tender, or put, the securities at par plus accrued interest.

Periodic coupon resets. The interest rate on VRDNs is generally reset daily or weekly based on the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index. This reset feature ensures that VRDN yields reflect the current interest-rate environment.

Demand feature. VRDNs also generally have a one-day or seven-day demand feature, or put option, which enables an investor to tender the securities to a financial intermediary—such as a remarketing agent, tender agent, or trustee—after providing a one-day or seven-day notification. This feature allows VRDNs to be considered under U.S. Securities and Exchange Commission (SEC) Rule 2a-7 as having a maturity equal to the next put date rather than its final maturity date.

Credit and liquidity enhancement. Virtually all VRDNs benefit from third-party credit and liquidity enhancements, ensuring payment of principal and interest on tendered securities. The main types of credit enhancement include letters of credit and standby bond purchase agreements, both of which are typically provided by a highly rated bank or other financial institution. Letters of credit offer a somewhat higher degree of security as they obligate the credit provider to pay principal and interest to bondholders within a certain time frame if the underlying issuer is unable to fulfill its obligation.

Variable rate versus auction rate: What’s the difference?

VRDNs are sometimes confused with auction-rate securities because the interest rate on both of these types of investments resets periodically. One key difference is that VRDNs have contractual features that enable an investor to put back the security at par. In contrast, auction-rate securities failed as the financial crisis unfolded because there was no backup to the auction or remarketing mechanism on which the liquidity of these securities depended. It is important to note that auction-rate securities have never been an allowable investment for money market funds.

Key features make VRDNs attractive for money market funds

There are four features that make VRDNs a desirable investment for money market funds:

- Eligible securities under SEC Rule 2a-7
- Highly liquid with a stable value
- Short term to repayment
- High credit quality

SEC Rule 2a-7 requires a money market fund to maintain at least 30% of its total assets in weekly liquid assets, which includes “securities that mature or are subject to a demand feature that is exercisable and payable within five business days.” The demand feature not only assures liquidity but also promises repayment at par, which means the value of a VRDN remains stable. Further, VRDNs used in our money market funds are analyzed by our credit specialists to determine that they present minimal credit risk.
Market overview

The VRDN market is approximately $265 billion in size and is composed of more than 10,000 individual securities. The vast majority of issuers are public entities. As shown in Chart 1 below, the amount of VRDNs outstanding increased in 2008 as failed auction-rate securities were repackaged as VRDNs. More recently, outstandings declined as this surge of repackaging activity has passed and as issuers have sold long-term bonds in order to lock in historically low interest rates, returning the size of the VRDN market back to where it was in 2004.

Chart 1 | The VRDN market has returned to its precrisis size

As the Federal Reserve continues its extraordinarily accommodative monetary policy, all interest rates have fallen, including yields on VRDNs. However, VRDN yields look relatively attractive compared with taxable instruments, and we believe their price stability makes them an ideal investment from a defensive perspective.

Chart 2 | While VRDN yields stand at near record lows, they provide a defensive strategy against higher interest rates

Pricing remains extremely stable because VRDNs can be put back at par on a daily or weekly basis. However, investors can expect differences in the yield offered on specific issues. Relative supply and demand for an issue will vary based on many factors, such as rates in other related sectors (for example, commercial paper and government repurchase agreements). Other factors include the relative credit quality of the liquidity or credit support provider, whether the issue is subject to state taxes or the AMT or is fully taxable, and dealer inventory levels.

VRDNs and Wells Fargo Advantage Money Market Funds

Prior to the purchase of any security in one of our money market funds, our team of credit analysts conducts a thorough analysis of its credit quality, including the underlying issuer, the terms and conditions of any credit or liquidity enhancement, and the credit quality of any provider of enhancement. In the VRDN sector, this analysis is performed by our dedicated team of municipal credit specialists. Only after a determination is made that a security presents minimal credit risk can it be added into one of our money market funds.

1. The SIFMA Municipal SWAP 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.
2. SIFMA, “U.S. Municipal VRDO Update, December 2012.”

An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Wells Fargo Advantage Money Market Funds seek to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in a money market fund.

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, visit wellsfargoadvantagefunds.com.

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