

Dislocation Creates Opportunity

A New Municipal Bond Strategy

Fallout from the subprime mortgage crisis has caused unusual events in the fixed income market. Investors' preference for safety over yield has driven Treasury bill yields to near zero and 30-year bond yields to decade lows. Relative yield spreads on corporate and municipal bonds are near historic highs as investors avoid risk. In the midst of this extreme environment, opportunities exist.

Monoline insurance downgrades and the deleveraging of illiquid, hard-to-value assets have continued to cause extraordinary market dislocation. Both events have increased the demand for higher credit quality and shorter maturity bonds. As a result, the yield curve is steeper, providing incentive for investors to move down in credit quality or out in maturity. The yield spread between U.S. Treasuries and AAA rated municipal bonds remains wide by historic standards (see Exhibit K). While this market is volatile and remains largely illiquid, we believe that an active, disciplined investment process can uncover value.

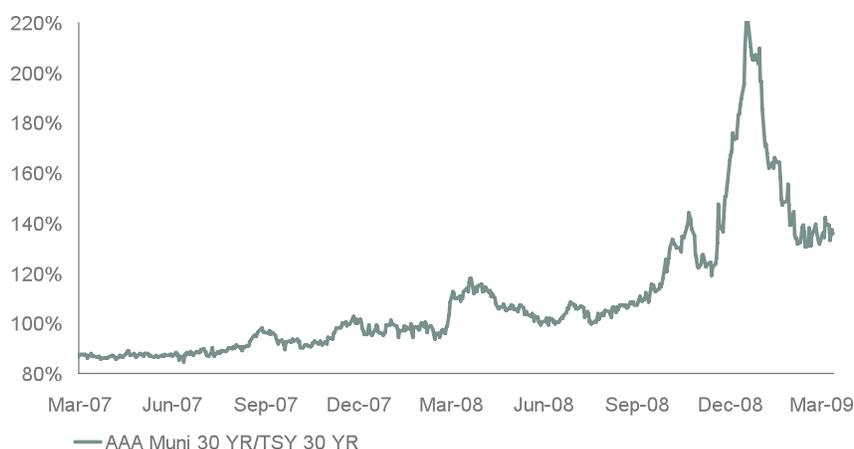
Key to our investment approach is an emphasis on identifying new sources of diversification that can provide long-term value. With corporate credit spreads near historic levels and municipals trading at favorable values compared to taxable bonds, we see an excellent opportunity to generate excess returns. To capitalize on this environment, BNY Mellon Wealth Management recently launched its new Municipal Opportunities Strategy.

The Municipal Opportunities Strategy is designed for clients who seek a tax-efficient fixed income approach and are able to assume additional risk. It seeks to provide a materially higher tax-sensitive yield and total return than our core municipal bond strategy and uses the Barclays Capital Municipal Bond Index (formerly known as the Lehman Municipal Bond Index) as its benchmark. It is an alpha strategy that invests primarily in municipal bonds, but has the flexibility to invest in taxable securities, non-dollar denominated fixed income, and below investment grade issues. In addition to owning bonds long, the strategy can utilize leverage, hedging or structure to increase returns and manage credit or interest rate risk.

The strategy relies on a disciplined, active management approach that incorporates a top-down strategic review of key factors that influence bond returns, combined with a bottom-up, research-driven analysis of market segments and individual securities. We continually analyze factors that influence interest rate changes, including monetary policy, economic activity and inflation. Since we can be more opportunistic in managing this portfolio, we make active calls on interest rate direction and the shape of the yield curve.

Exhibit K

Muni Yields as a Percentage of Treasuries



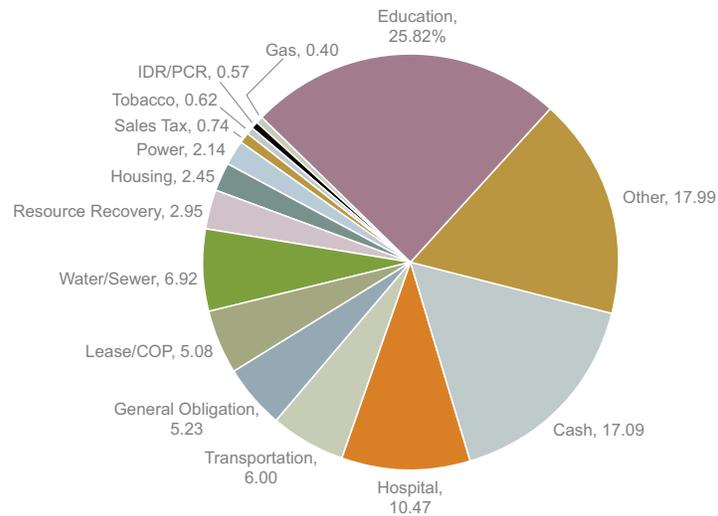
As of 2/28/09
Source: Bloomberg

The strategy enables our portfolio managers to aggressively shift the portfolio's focus based on market opportunities. Through our bottom-up research we uncover sectors, structures and securities that are under- or overvalued due to market events, shifts in supply and demand, or market inefficiencies. In each case, we seek the best balance of risk and returns. For example, we may shift the portfolio's focus from higher to lower quality, shorter to longer duration or noncallable to highly callable bonds. We also may overweight or completely eliminate exposure to some sectors based on market conditions. Therefore, the portfolio may experience a higher turnover and potentially higher exposure to lower quality and longer duration bonds.

The current model portfolio maintains strong diversification, with an emphasis toward long investment grade bonds. High quality municipals are so attractive currently that the portfolio has not needed to move down the credit curve to achieve superior returns. Thus, the portfolio currently holds a combination of the structures and sectors as illustrated in Exhibit L and has an average quality rating of AA+/Aa1, an average yield of 4.82% and an average duration of six years.

Exhibit L

BNY Mellon Municipal Opportunities Strategy Sector Profile



As of 3/5/09
Source: BNY Mellon Wealth Management

In this challenging economic environment, many investors may be concerned about default risk. Historically, municipal bonds have had very low default rates due to the ability to draw upon reserves. However, some municipalities may struggle during this economic downturn; thus it is critical to rely on a bottom-up, research-driven approach to evaluate the issuer's financial strength and creditworthiness.

For clients who can tolerate a more aggressive strategy, says John Flahive, Director of Fixed Income and lead Portfolio Manager of the strategy, it is an ideal time to find value in the municipal bond universe. This solution has the potential to deliver incremental value to clients as part of an overall asset allocation plan designed to meet long-term goals. ■

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