Capital Markets Review

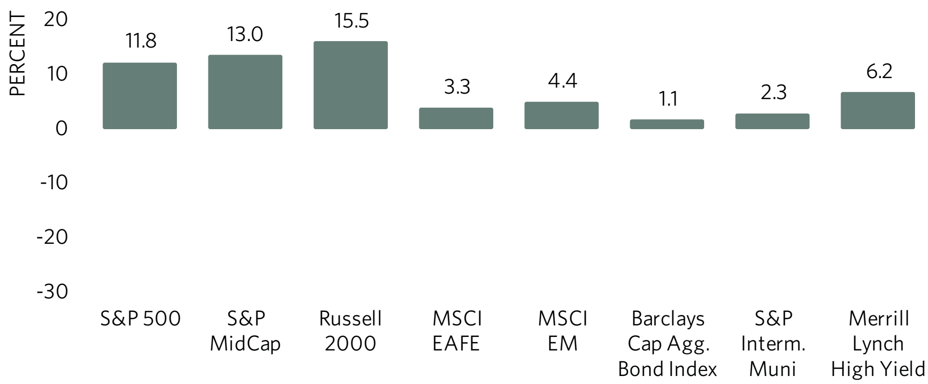
BNY MELLON
WEALTH MANAGEMENT

Fourth Quarter 2011

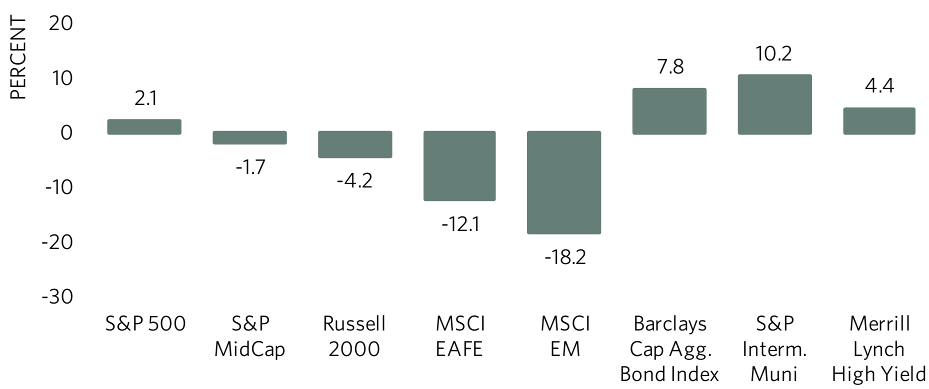
In 2011, markets focused on attention-grabbing news stories, including the tsunami in Japan, the ongoing sovereign debt crisis in Europe and the historic downgrade of U.S. long-term debt. After a strong start during the first few months of the year, the S&P 500 declined 17.9% from April 29 to August 8 in response to these developments and a slowing U.S. economy. The market rebounded in October as evidence mounted that the U.S. economy was not heading into a double-dip recession and that somehow Europe would muddle through its debt crisis. Ironically, one of the last economic reports of 2011 showed a sharp increase in The Conference Board's Index of Consumer Confidence, which had fallen during the summer. Perhaps the improvement reflected a feeling of relief that 2011 was finally ending and the hope that 2012 couldn't be much worse. After all the drama, the S&P 500 finished the year where it started. The S&P 500 index closed the year at 1257.60, compared to 1257.64 at the end of 2010. The total return of the S&P 500 in 2011 was 2.1%, entirely from dividends.

With each crisis during the year, the yields on intermediate and long Treasuries edged lower. In a risk-off environment, Treasuries benefitted from the flight to safety, even as the yields

Fourth Quarter Returns



1-Year Returns



themselves did not seem attractive. The yield on the 10-year Treasury note was 1.88% at year end, compared to 3.29% a year earlier. Although the impetus came from Treasuries, the rally in the bond market was widespread. The total return of the Barclays Capital Aggregate Bond Index was 1.1% during the fourth quarter and 7.8% for the year.

The European debt crisis turned out to be a slow-moving contagion, beginning in 2009 in Greece, with periodic downgrades and reluctant fixes as European leaders were forced to take action in response to market pressures. This environment was unsettling to the international equities markets. Nevertheless, the rally in the U.S.

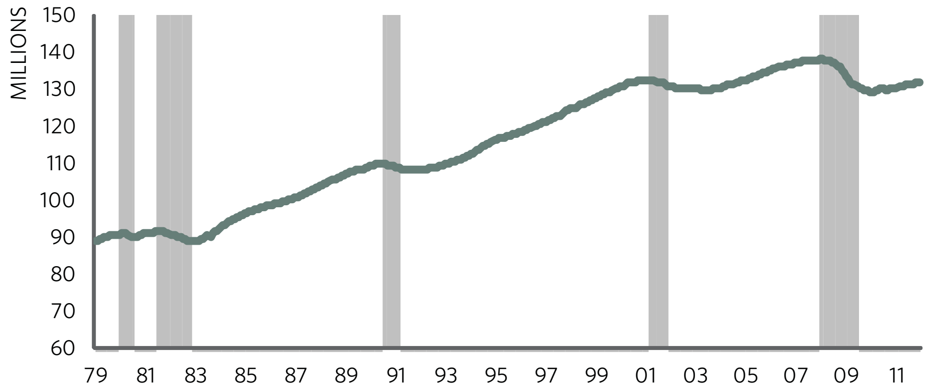
stock market in October spilled over into Europe. The total returns of EAFE in U.S. dollar terms were 3.3% during the fourth quarter and -12.1% for the year as a whole. Although the euro was volatile against the U.S. dollar during the year, the net effect of currencies on EAFE total returns for U.S. investors was small. Emerging markets also rallied during the fourth quarter but were pounded for the year as a whole. The total returns of the MSCI Emerging Markets Index in U.S. dollar terms were 4.4% during the fourth quarter and -18.4% for the year. The decline reflected the risk-off sentiment and concerns about slowdowns in the growth rates of emerging markets countries.

Domestic Economy

During the first three quarters of 2011, many economic indicators came in below expectations and highlighted that the U.S. economy was in a slowdown. Downward revisions of certain indicators showed that economic growth was even weaker than initially estimated. This pattern continued throughout most of the year. As an example, in late October the preliminary real GDP report for the third quarter showed a seasonally adjusted annual growth rate of 2.5%, close to the trend growth rate of the U.S. economy. By the end of the fourth quarter, the growth rate was revised to show an increase of only 1.8%.

The economic reports released during the fourth quarter generally reinforced the picture of an economy growing relatively slowly, with persistent problems in employment and the housing industry, but performing better than had been the case earlier in the year. The index of leading economic indicators, which declined during April

Total Nonfarm Payroll Employment



December 2011: 131.9
Source: U.S. Department of Larbor

and barely rose during September, increased 0.9% (on a month-to-month basis) in October, helped by the stock market rally, and 0.5% in November. Auto sales surprised on the plus side during the fourth quarter, helped by replacement demand and low interest rate financing.

Initial claims for unemployment insurance remained steadily above 400,000 on a four-week moving average basis (to smooth out the effect of weekly gyrations) from the beginning of the financial crisis until mid-February 2011. This persistently high level reflected the continual layoffs and the difficulties in finding employment opportunities. Claims dropped below 400,000 for a few weeks until later in April 2011 but then remained above 400,000 for much of the rest of the year. Starting in mid-November, claims once again edged below 400,000, a sign that, if not robust, at least the employment picture seemed to be showing modest improvement. The unemployment rate at year-end was 8.5%, somewhat better than had been generally expected but still high. Nonfarm payroll employment showed steady growth during the fourth quarter but as of December was still 6.1 million below the peak level. The general assessment in the markets is that the economy is expanding and no longer slowing, but the difficulties in the housing market and employment picture will continue to weigh on the economy.

U.S. Equities

Debt was the dominant concern in the equity markets in 2011. The inability of Congress to reach a deal on the debt ceiling during the summer put constant downward pressure on the stock market. Once a temporary measure was finally agreed upon, the subsequent downgrading of U.S. long-term debt by Standard & Poor's resulted in a 6.7% decline in the S&P 500 on August 8. Not surprisingly, measures of consumer confidence fell sharply during this period.

Throughout the summer, the equity markets continued to focus on the debt problems in Europe. It was already clear that the sovereign debt crisis extended well beyond Greece. During July, the debts of Ireland, Portugal and, of course, Greece, were all downgraded to junk status. The concern of the day varied, from the effect of the sovereign debt crisis on French banks to the ability of Italy to meet its substantial financing requirements. Any large down day in Europe spilled over into the opening of U.S. equity markets. With the debt concerns as a backdrop, the total return of the S&P 500 during the third quarter was -13.9%.

Ironically, the declines during the summer set the stage for the rally during the fall. After the stock market's strong performance early in 2011, the trailing four-quarter price/earnings ratio (P/E) of the S&P 500 was 15.5 by the end of April, when the market peaked. By the end of the third quarter, after the sharp retrenchment in the market, the trailing P/E ratio was 11.9, well below the historical average. At the same time, despite the fears expressed by some commentators that the slowdown in the economy could take a turn for the worse, earnings reports remained positive, generally exceeding expectations. Earnings per share of the S&P 500 as of the third quarter (reported during the fourth quarter) were 17.3% higher than a year earlier. While this growth rate was not sustainable, it was clear that the fundamental environment for stocks was essentially favorable: decent growth in earnings combined with reasonable valuations.

During the course of 2011, the European leaders introduced a series of measures, after obvious hesitation, to try to support Greece and help other countries contend with their substantial debt problems. Serious problems remain, and the story is far from over. Nevertheless, so far the darkest forecasts have not played out. In October, reports from Europe of plans to deal with the crisis in a more substantive manner sparked a rally in the U.S. equities markets. On October 27, it was reported that real GDP growth for the third quarter was 2.5% (which, as noted earlier, was subsequently revised downward). In response, the S&P 500 rose 3.4%. From the market's view, the report was validation that even with all the concerns over debt problems in Europe the U.S. the economy was managing to register moderate growth, certainly a better outcome than the possible double-dip recession that concerned some analysts earlier in the year. The subsequent total returns of the S&P 500 were 10.9% in October and 11.8% for the fourth quarter. By year end, the trailing P/E of the S&P 500 was 13.2, still reasonably valued if not the unusually low valuation of a few months earlier.

S&P 500 Sector Returns

Total Returns for Periods Ending December 2011

	4Q11	1 Year	2 Years	3 Years
Consumer Discretionary	12.6	6.1	16.4	24.2
Consumer Staples	10.3	14.0	14.1	14.3
Energy	18.2	4.7	12.3	12.8
Financials	10.8	-17.1	-3.6	2.9
Health Care	10.0	12.7	7.7	11.6
Industrials	16.5	-0.6	12.2	15.1
Information Technology	8.7	2.4	6.2	22.2
Materials	15.4	-9.8	5.0	17.9
Telecommunications Services	7.9	6.3	12.4	11.3
Utilities	8.3	19.9	12.5	12.3
Total	**11.8**	**2.1**	**8.4**	**14.1**

Note: Returns for periods greater than one year are annualized.

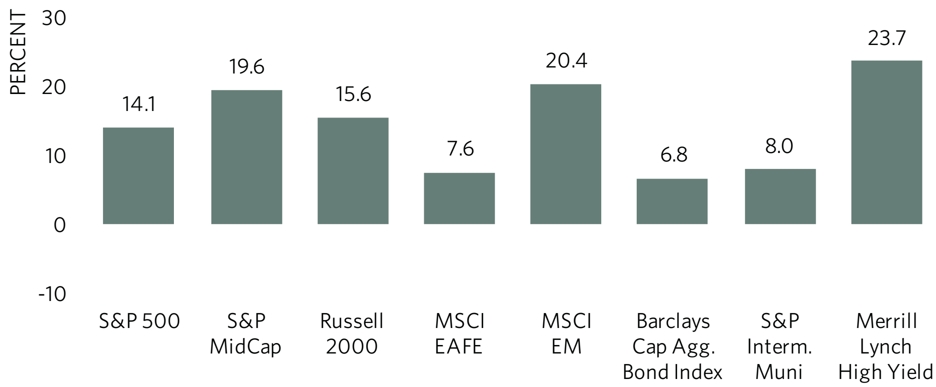
The S&P 500 had a wide dispersion of returns among sectors in 2011. Utilities had the strongest returns as investors sought dividend-paying stocks in a low—and declining—interest rate environment. Consumer staples had the next highest return as these companies provided a visible and relatively consistent stream of earnings in a low-growth economy. Financials had a negative double-digit return as investors remained concerned about the capital adequacy of banks, their exposures to sovereign debt (or their exposures to other banks with exposures to sovereign debt), and, for some financial institutions, the continued fallout from the sub-prime crisis. During the fourth quarter, the energy sector had the best return as a result of the rebound in oil prices. Most sectors had double-digit returns during this period, with the lowest return at 7.9% for telecommunications services.

When the equity markets were periodically in a risk-off mode in 2011, mid cap stocks declined more sharply than the large caps, and the small caps did worse than the mid caps. The total return of the S&P MidCap 400 in 2011 was -1.7%, while the return of the Russell 2000 was -4.2%. During the fourth quarter, when the market was in a risk-on mode, the rallies in mid cap and small cap stocks were greater than that of the large caps but still did not fully compensate for the ground lost earlier in the year.

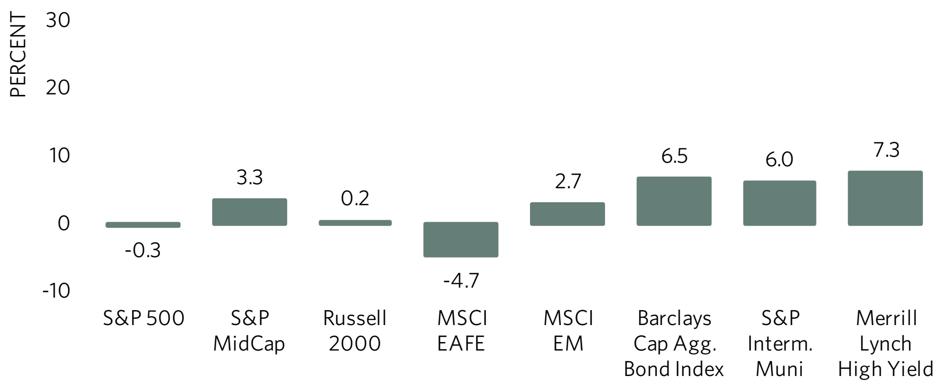
Fixed Income

During much of 2011, one could make the argument that the yields on intermediate and long-term Treasuries were unusually low relative to inflation, equities and past history. As it turned out, these arguments were irrelevant. Investors were concerned about the potential of a contagion spinning out of control or an even deeper collapse in equity prices. They wanted the relative safety of a Treasury security, even after, or rather especially after, the downgrade of U.S. long-term debt. Additional downward pressure was placed on the yields of long term Treasuries by the Federal Reserve's "Operation Twist," a major goal of which was to assure that mortgage rates remained unusually attractive. In its press release in December, the Federal Open Market Committee reaffirmed that it anticipates that economic conditions "are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013." The Fed is being openly and aggressively accommodative in view of the troubled employment situation and its dual mandate, of maximum employment and stable prices.

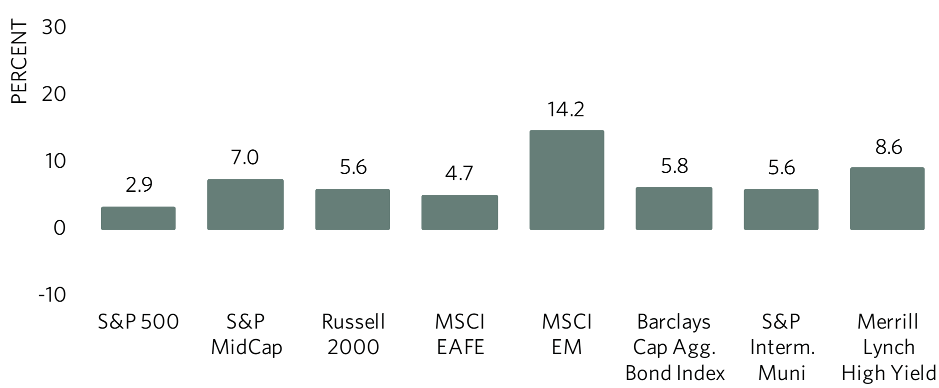
3-Year Returns



5-Year Returns



10-Year Returns



Returns are annualized. As of December 31, 2011.

The Fed continues to adhere to the view that long-term inflation expectations remain stable. Although the headline Consumer Price Index as of November rose 3.4% from a year earlier, reflecting the rise in oil prices, the core inflation rate that the Fed prefers to monitor (the Personal Consumption Expenditures Price Index Excluding Food and Energy) rose 1.7% during the same period, within the Fed's target band.

The yield on the 10-year Treasury note rose toward the end of October but then fell as a call for a referendum (subsequently dropped) in Greece on the proposed austerity measures led to a worldwide flight to safety once again. The yield then stayed in a narrow trading range for the rest of the year. Despite the relatively low yields earlier in the year, Treasuries rallied in 2011. The total return of the 10-year note was 17.2%, while the total return of Treasuries in the Barclays Capital Aggregate Bond Index was 9.8%. Corporates also had a good year, with a return of 8.2%. Prices of high yield bonds declined during risk-off periods in 2011, but the relatively high yields kept the returns in positive territory for the year. The total return of the Bank of America Merrill Lynch High Yield Master II Bond Index was 4.4% for the year and 6.2% for the fourth quarter. The yield for this index was 8.36% as of year end, compared to 7.50% a year earlier.

In December 2010, a forecast by a noted analyst that there would be numerous and significant municipal bankruptcies contributed to a rise in municipal yields early in 2011. As it turned out, Jefferson County in Alabama filed for bankruptcy in November 2011 in the biggest municipal bankruptcy in U.S. history. The development did not reflect systemic problems in the municipal bond market but rather massive corruption in upgrading the county's sewer system, with the former mayor of Birmingham sentenced to jail. Harrisburg Pennsylvania filed for bankruptcy protection in October 2011 partly as a result of problems with a failed garbage incinerator project. The only other municipal bankruptcy in 2011 was Central Falls Rhode Island in August. These developments were certainly distressing to the holders of these particular bonds, but the municipal market as a whole proved quite resilient even in a weak economy. As it turned out, it was a great year for municipal bonds as yields declined during the course of 2011. The total return of the S&P Intermediate Municipal Bond Index in 2011 was 10.2%. The yield on a 10-year AAA municipal bond fell to 2.29% at year end, compared to 1.88% on the 10-year U.S. Treasury note.

International Equities

The ramifications of the sovereign debt crisis have played out slowly, with Greece constantly in the news. Negotiations are still continuing regarding the austerity measures being imposed on Greece, which is clearly in recession. Other nations introduced austerity measures to deal with their budget problems, resulting in an overall slowdown in economic activity in Europe. Europe, at this point, may well be in recession.

Industrial production declined on a year-over-year basis in Greece, Spain, Portugal, Italy, Ireland and the U.K., with Greece leading the way. Even Germany, which has had the strongest growth in the eurozone countries, is experiencing a slowdown. The year-over-year increase in industrial production in Germany as of November was 3.6%, while earlier in 2011 and for much of 2010 the increases were in the low teens. Fortunately for many European based multinational corporations, a significant portion of their sales is outside of Europe.

International equity markets fared much worse in 2011 than the U.S. The total return of EAFE in U.S. dollar terms was -12.1% in 2011, compared to 2.1% for the S&P 500. The euro was volatile against the dollar during the year, but overall the currency effect in EAFE was quite small for the year. The total return of EAFE in local currency terms in 2011 was -12.2%. During the fourth quarter, the total returns of EAFE were 3.3% in U.S. dollar terms and 4.1% in local currency terms.

Not surprisingly, Greece had by far the worst performance in EAFE in 2011, with a return of -62.8%, following a sharp decline in 2010. The return of the euro bloc countries as a group in 2011 was -16.5%. Countries outside the euro zone generally fared better. As examples, the return for the U.K. was -2.6%, while the return for Switzerland was -6.8%. The effects of the devastation from the tsunami in Japan were evident in the return of -18.7% in local currency terms. With the appreciation of the yen, the return in U.S. dollar terms was -14.3%.

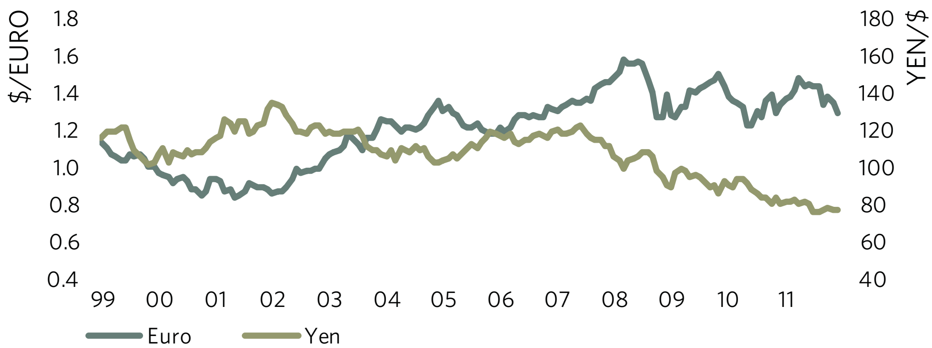
The euro rose steadily against the U.S. dollar from mid-2010 through the spring of 2011 and then drifted down slightly. It became apparent that prior measures were not sufficient to keep Greece from defaulting outright and that the European economies were weakening more visibly. Various measures were introduced to deal with the sovereign debt crisis, and the euro gyrated for a few months before declining steadily during the last few months of the year. It was not until early

November that the European Central Bank reduced its refinance rate from 1.50% to 1.25% and then in December to the current 1.00% in recognition of the seriousness of the slowdown in Europe. The euro still has an interest rate advantage over the U.S. dollar. Nevertheless, Europe is probably in recession now, while the U.S. continues to register modest growth.

From time to time during the last several years, the dollar benefitted from risk-off sentiment. Whenever markets calmed down, the dollar would tend to weaken. With the interest rate differential narrower now than during most of 2011, the euro could come under periodic downward pressure as market participants focus on the weakness in the European economies. Ironically, with all the movement during the last few years, the net change in the euro in 2011 was rather small. The euro was 1.30 against the dollar at the end of 2011, compared to 1.34 a year earlier, a decline of 3.0%.

Emerging markets equities declined sharply during risk-off periods in 2011, with concerns about slowing growth in emerging markets economies intensifying the downward pressure. Starting in 2010, China tightened its monetary policy by raising interest rates and increasing banks' required reserves in an attempt to control accelerating inflation. Food inflation peaked at 14.8% in July and then drifted down to 9.1% by December. Overall inflation reached 6.5% in July but eased to 4.1% as of December. As inflation appeared to come under tighter control, and as the weakness in the global economy became more evident, with clear

Euro and Yen



December 31, 2011: Euro: 1.30; Yen: 76.9
Source: Bloomberg LP

implications for Chinese exports, China reversed its monetary policy starting at the end of November with a 0.5% reduction in its required reserve ratio for banks. Real economic growth in China is slowing, but still exceeds rates in developed countries. Real GDP in China as of the third quarter of 2011 rose by 9.1% over the prior year. In contrast, for the first half of 2010, the increases were in the low double-digits. The median forecast for China's real GDP growth in 2012 according to the Bloomberg L.P. survey is 8.5%. This would represent a clear but manageable slowdown.

The total return of China in the MSCI Emerging Markets Index in 2011 was -18.4%, the same as the overall index. Most countries had double-digit negative returns. Indonesia had the best performance with a return of 6.0%, followed by Malaysia, the Philippines, and Thailand. India had the worst performance, with a return of -37.2%.

Conclusion

For most of 2011, traditional fundamental analysis of equities, such as earnings estimates and assessments of valuation measures, almost seemed beside the point. The markets reacted more to headlines about the potential for a messy contagion in Europe or the latest proposal for another bailout. For a while, the ongoing saga of a dysfunctional Congress grabbed the markets' attention. With regard to Europe, several fixes were introduced in 2011, but the need to deal with heavy debt burdens and substantial refinancing requirements remains. It is clear that growth in Europe is slowing, but we will have to see just how intense the slowdown becomes. The weaker euro and continued growth in the emerging markets will help European exporters.

In the United States, substantial obstacles to growth, particularly the housing situation and the slow progress in creating jobs, are fully recognized, but the economy is nevertheless showing the ability to plough ahead with moderate, though below par, growth. Particularly in an election year, one cannot expect a deeply divided Congress to address major budget issues in a bipartisan manner. The legislators will probably wait until a major deadline looms to arrive at some solution that buys enough time to get us through the crisis. Beyond this political theater, investors will see that earnings are continuing to grow at a moderate pace, while valuations are not stretched. Overhanging this relatively benign situation, however, is the continuing fear that the euro bloc can have a messy breakup or oil prices could spike as a result of tensions from Iran. The basic backdrop for equities is positive, but other events could cause continuing volatility.