The Municipal Bond Market: Emerging from the Tunnel

By

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April 2012

Executive Summary

Members of the Standish Tax-Sensitive Fixed Income Team say they remain positive about municipal bond fundamentals in 2012. But they caution that investors should temper their expectations about total returns and prepare for increased price volatility as the market grapples with uncertainty surrounding supply and demand issues, federal government moves on taxation and financial market regulation as well as continued sovereign debt problems in Europe and the U.S. Nonetheless, the team continues to see attractive opportunities in high-quality issuers of municipal bonds tied to essential services. They also compare the risk and return characteristics of comparable-quality municipal bonds to those of sovereign bonds, arguing that non-U.S. investors might also want to include municipals in their fixed income portfolios for their competitive yield, lower volatility and low correlation with other asset classes. The following Q&A addresses the main issues the team expects to affect the asset class in the coming year.

In our March 2011 publication of "*The Municipal Market: Oncoming Train, or Light at the End of the Tunnel?*" we suggested that state and local governments would remain creditworthy and observed that the fundamentals of the municipal bond market were stabilizing. The market appeared to agree with us, and, in a year filled with financial and political turmoil, municipal bonds delivered impressive results. In our view, the stability of those returns was notable and in stark contrast to the risk on/risk off volatility that characterized many other asset classes.

We expect many of last year's biggest challenges for investors to linger through 2012, including:

- Changing patterns in the supply of, and demand for, tax-exempt bonds
- A larger federal role on taxation and regulation of financial markets
- Potential credit risks as fiscal and economic problems spill over from Europe and Washington

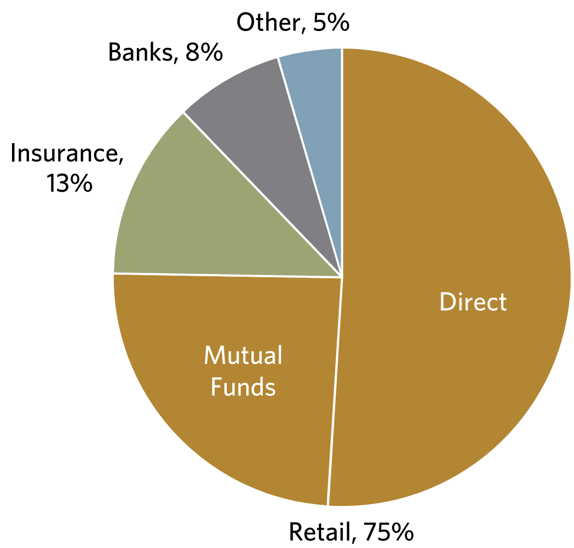
While we continue to see opportunities, we believe municipal bond investors should be cautious about the coming year, as the markets continue to digest some major issues that will likely influence bond valuations.

We believe the municipal market opportunity is relevant for a broader range of fixed income investors, including those outside the U.S.

Supply and Demand Issues

What sorts of changes in demand might disrupt the municipal market?
The tax-exempt bond market has traditionally relied overwhelmingly on the individual investor for support. Recent Federal Reserve data show the $3.7 trillion municipal bond market to be significantly larger than the previous estimate of $2.9 trillion and a greater-than-expected dominance of retail investors (see Exhibit 1).[1]

Exhibit 1 — Retail Investors Dominate Municipal Bond Market
Holders of Municipal Bonds



Source: Federal Reserve as of December 31, 2011.

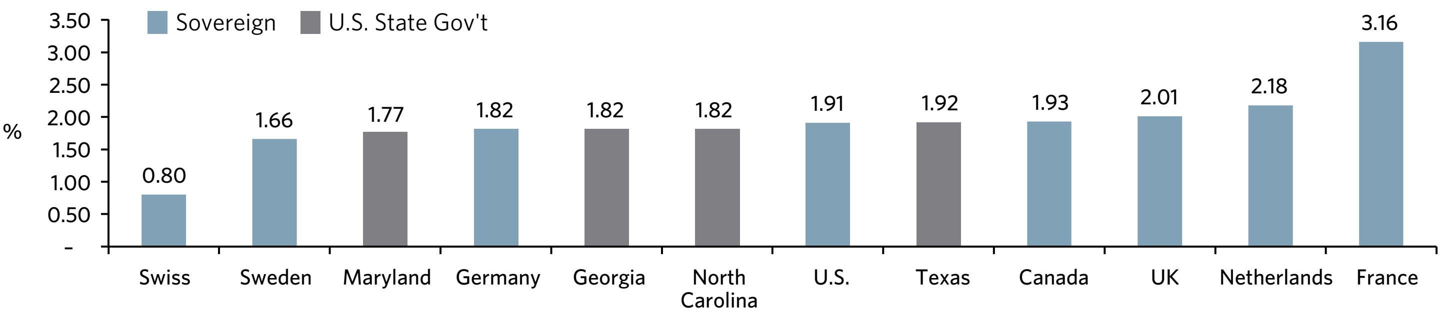
Retail's dominance of municipal bond demand poses liquidity challenges. For example, we observed that fears over municipal bond credit quality caused retail investors to flee the market during the fourth quarter of 2010. Combined with a year-end surge in supply, municipal bond prices plummeted. We believe these types of dislocations have the potential now to recur more frequently, presenting long-term investors with opportunities to capitalize on the market's inefficiency and seek to purchase bonds with significant excess income and the potential for price appreciation.

What other types of investors might consider municipal bonds?
We believe the municipal market opportunity is relevant for a broader range of fixed income investors, including those outside the U.S. Investors could look to municipal bonds, particularly U.S. state general obligations (GO), as a comparably yielding alternative to high-grade sovereign credit (see Exhibit 2).

1 Federal Reserve as of December 31, 2011.

For us, the competitive yield that municipals offer, combined with their low volatility and lack of correlation with other asset classes, makes them an attractive option for investors beyond U.S. retail investors. Modern Portfolio Theory argues that incorporating uncorrelated assets like municipal bonds should enhance the risk-adjusted returns of a total fixed income portfolio by increasing diversification.

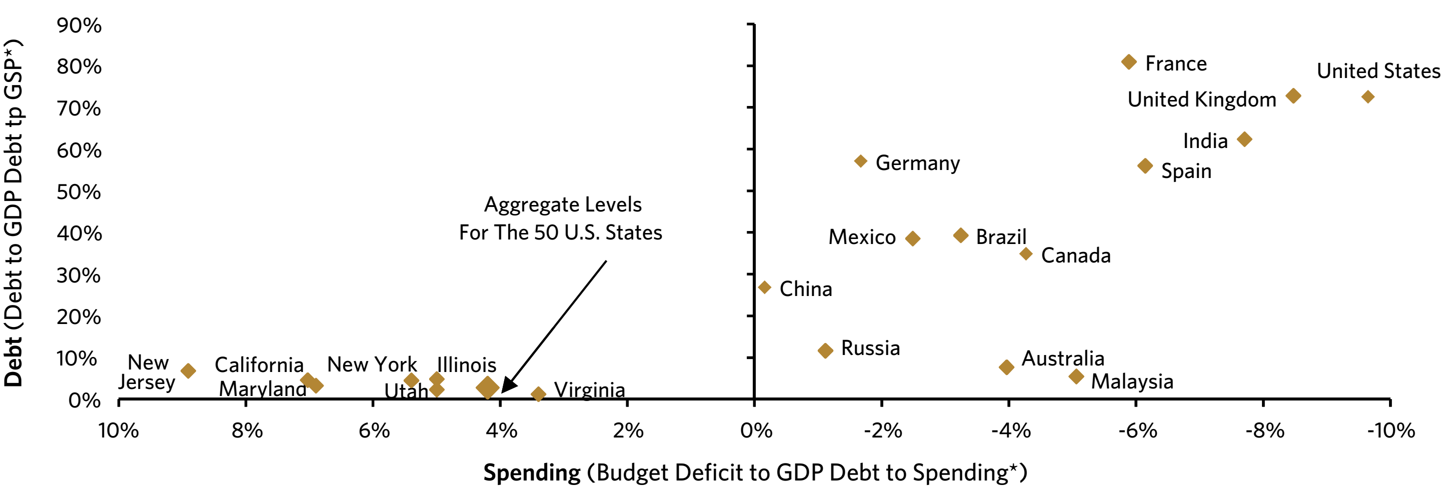
Exhibit 2 — High-Quality Municipal Bonds vs 10-Year Government Bonds; Moody's Aaa-rated — Sovereign 10-Year Yields



Source: Bloomberg, Thomson Reuters, Standish as of January 11, 2012. These states/sovereigns were chosen based on comparable quality. Yields fluctuate. **Past performance and yield do not guarantee future results.**

Compared with where many indebted European countries are on their deleveraging paths, we believe many U.S. states are further along in taking the necessary austerity measures to restore balanced fiscal operations. As a result, we believe event risk for these U.S. states will likely be lower, and credit quality (and credit ratings) significantly more stable for U.S. state issuers than for European sovereigns. In our view, the relatively low debt burdens and high financial liquidity make state GO debt attractive for bond buyers (Exhibit 3).

Exhibit 3 — Debt to GDP Ratios Lower for U.S. States Than Many Sovereign Governments
U.S. Government Debt and Deficits are Relatively Low



Source: International Monetary Fund, Standard and Poor's, September 2011; *Applies to States (GSP is Gross State Product).

Historical data show that the highest quality state general obligation bonds, as well as high grade essential purpose revenue issuers, have traded relatively efficiently during periods of dislocation in the municipal markets.

U.S. state GO debt is issued chiefly for capital borrowing, and is self-amortizing, with an average maturity of approximately 11 years.[2] In contrast, debt issued by France, Germany, Greece and Spain, among others, mostly cover operating shortfalls. With average maturities of six to seven years, these sovereign credits pose greater rollover risks for investors.[3]

In addition, U.S. state governments are also making progress with pension reform in order to manage long-term liabilities and financial stability. While clearly more progress is required, we believe U.S. state public pension liabilities are receiving more active attention than the long-term liabilities of many other sovereign issuers globally.

Historical data show that the highest quality state general obligation bonds, as well as high grade essential purpose revenue issuers, have traded relatively efficiently during periods of dislocation in the municipal markets.[4] We believe liquidity will improve as new classes of institutional investors are attracted to the municipal market in search of yield, credit quality and price stability. Additionally, as the Federal Reserve's Operation Twist program removes nearly a quarter of long-dated Treasuries from the market to drive down interest rates on long-term bonds, making municipals an even more compelling alternative for liability-driven investors seeking high-quality, long-duration assets.

How might substantial infrastructure needs in the U.S. affect municipal issuance in 2012?

The country's continuing infrastructure needs require approximately $210 to $280 billion of tax-exempt borrowing annually for new capital projects, averaging $250 billion from 2002 through 2010.[5] Financial austerity in 2011 cut that amount to $150 billion.[6] We expect a refinancing wave for 2012, as municipal issuers take advantage of current low interest rates and retire higher-coupon bonds. If refinancing supply accelerates beyond demand from reinvesting maturities and coupon income, or investor appetite is diverted to cash or stocks, rates might be pushed higher to absorb the projected new issuance. To date, the trend of limited bond issuance persists, driving yields even lower.

Larger Federal Role in Taxation and Financial Market Regulation

How will Washington gridlock affect the municipal bond market?

In what is shaping up to be a highly charged political year, the U.S. Congress and the Obama administration will be wrangling over several important budget and tax reform measures. While wholesale tax reform and long-term deficit reduction seem increasingly unlikely before the November presidential election, the recurring need to fund government operations without tripping over the country's debt limit will likely highlight two key issues that might affect municipal bondholders:

2 Moody's as of March 31, 2012.
3 *Ibid.*
4 Standish Tax Exempt Trading Desk.
5 Thomson Reuters.
6 *Ibid.*

- Capping or eliminating tax preferences, including the federal tax exemption for municipal bond interest
- Extending or abandoning the Bush-era tax cuts

We think the ultimate resolution of these issues is highly uncertain and could create volatility in the long-term municipal market as the debate heats up.

Even if tax exemption were to be capped at a 28%, municipal bonds would still offer attractive yields rate when compared with the after-tax yields from comparable corporate or government securities.

Could the tax-exemption for municipal bonds be overturned this year?
Assaults on the municipal bond tax exemption have come from a number of fronts. For instance, the 2010 Bowles–Simpson deficit reduction plan proposed completely phasing out the loopholes that reduce individuals' tax liabilities, including the tax exemption for municipal bond interest. That plan, however, was quickly shelved and has not been revived. We believe such a sweeping proposal has virtually no chance of being enacted in 2012.

A proposal from the White House in the American Jobs Act sought to limit tax deductions by wealthy taxpayers to 28%. This plan was a radical departure from previous proposals as it would partly tax interest income from all municipal bonds without grandfathering in outstanding bonds. The Jobs Act failed to clear its first Senate vote in 2011, and we consider it a long shot for 2012. Even if tax exemption were to be capped at a 28%, municipal bonds would still offer attractive yields rate when compared with the after-tax yields from comparable corporate or government securities.

We expect the tax exemption for municipals will not be completely eliminated, for the following reasons:

- Voters like tax-exempt income. While often portrayed as a favorite investment of "the 1%," municipals are not just for the wealthy, but are held widely across the entire range of taxpayers. Indeed, the latest detailed tax data from 2009 reveal that 12 times as many "Main Street" taxpayers with incomes below $100,000 received 1.5 times the amount of tax-exempt interest as those with incomes over $1 million.[7]

- Tax-exempt municipal bonds remain essential tools for state and local elected officials, and lobbying efforts are heating up to keep this low-cost capital financing and its tax status in place.

- Responsibility for U.S. infrastructure maintenance and development has been largely relegated to the state governments, sometimes with contributions from the federal government; U.S. states require favorable financing rates to satisfy this obligation. In our view, the federal government is in no position to take on the additional liability for improving the nation's infrastructure, which received a grade of "D" in the latest American Society of Civil Engineers 2009 report card.

7 Statistics of Income Division, Internal Revenue Service.

The impact of the Volcker Rule on municipal market demand would be muted, however, as banks own only 8% of all outstanding municipal securities due to existing tax laws.

Can we expect higher federal taxes?

Theoretically, an increase in the highest marginal tax rate should raise the valuations of tax-exempt municipals. The historic data, however, do not support this immediate connection.

If there is no agreement on tax reform this year, the Bush-era tax cuts will expire on December 31, 2012. In 2013, the new Medicare tax on investment income takes effect (Exhibit 4). This 3.8% tax will be levied on taxable interest (but not tax-exempt interest), dividends and capital gains. Higher taxes seem likely in the future, with substantial increases on tap for capital gains and dividends. Consequently, we think that intelligently navigating federal taxes as well as state and local income taxes, the federal alternative minimum tax (AMT) and capital gains taxes, will become increasingly important for investors.

Exhibit 4 — Changes in U.S. Tax Rates

Top Federal Tax Rates in 2013 Under Current Law	Current Income Tax Rate	If Bush-era Rates Expire: Income Taxes	If Bush-era Rates Expire: Income Taxes Plus Medicare Tax
Taxable interest	35.00%	39.60%	43.40%
Short-term capital gains	35.00%	39.60%	43.40%
Long-term capital gains	15.00%	20.00%	23.80%
Dividends	15.00%	39.60%	43.40%

Source: Standish. This information is not intended to constitute tax advice. Please consult your tax advisor for more detailed information on tax issues and for advice on your specific situations.

How could proposed regulations affect the municipal market?

The so-called Volcker Rule in the Dodd-Frank Act, which seeks to ban banks from proprietary trading, is scheduled to be implemented later in 2012. As currently proposed, bank holdings of general obligations may not be considered as proprietary trading, and banks would presumably purchase general obligations over revenue bonds. The impact of the Volcker Rule on municipal market demand would be muted, however, as banks own only 8% of all outstanding municipal securities due to existing tax laws.[8] In a subsequent application, the Volcker Rule could classify customer hedges or leveraged investments in municipal bonds by bank affiliates as speculative. While leveraged holdings of municipal bonds are currently a relatively small part of the market, in the years leading up to the financial crisis, tender option bond programs were a major source of demand for longer maturity municipals. These types of leveraged investments would be less likely to reappear if the Volcker Rule is implemented as proposed, possibly limiting the demand for longer maturity municipal bonds.

8 Federal Reserve as of December 31, 2011.

Basel III might stimulate some bank buying of municipal bonds as it applies the same zero-risk weighting for U.S. banks to U.S. Treasury securities and to obligations of "non-central government public sector entities" thought to include state and local municipals.

The Basel III rules for international banks governing capital ratios, liquidity and leverage need to be passed into law by each participating nation before they take effect in 2013. While many of the Basel III regulations are consistent with Dodd-Frank, we think ironing out the differences before the 2013 deadline will be an enormous challenge, especially in a U.S. election year. Basel III might stimulate some bank buying of municipal bonds as it applies the same zero-risk weighting for U.S. banks to U.S. Treasury securities and to obligations of "non-central government public sector entities" thought to include state and local municipals.

At the behest of regulators, banks have repaired their balance sheets and increased their liquid asset holdings. While the spigot of lending to businesses and consumers has not reopened as widely as before the financial crisis, banks have increased their direct lending to state and local governments, skirting the public market and modestly reducing the municipal bond supply.

Macro Pressures from the Sovereign Debt Crisis

How could Europe's sovereign debt problems and stagnant growth affect the municipal market?

In terms of the effect on exports to Europe, data from the U.S. Department of Commerce indicate that U.S. exports overall to Europe comprise approximately 2% of U.S. GDP, though in some states that percentage is considerably higher. Those states include Utah (5.6%; gold and silver), South Carolina (4.1%; automobiles), West Virginia (3.9%; coal) and Louisiana (3.5%; petroleum). Rocky Mountain states such as Montana, Wyoming and Colorado have the lowest exports to Europe.[9] Absent any other trends, states with above-average dependence on exports to a weakening Europe are more likely to have underperforming economies and a greater potential for revenue shortfalls. These states could pass along their budget challenges to their local governments as a means of closing budget gaps.

However, a prolonged European recession could cause broader economic malaise in the U.S. and result in more widespread budget issues for state governments in the form of lower tax revenues and higher welfare costs. Ultimately local governments that rely on property taxes and state aid, especially school districts, would suffer. We believe our current overweighting of revenue bonds, especially essential purpose municipal utilities and dedicated tax bonds, is prudent to defend against potential credit weakness. We think Europe could potentially cause budget problems in U.S. states and local governments rather than significant credit problems that might lead to major downgrades or even possible defaults. In our view, state and local government debt, whether backed by a general obligation pledge or a specific revenue stream, is well secured. The vast majority of municipal issuers have low to moderate debt burdens and reasonable financial flexibility.[10]

9 "U.S. States with Exposure to a European Recession," Wells Fargo Securities, November 14, 2011.
10 *Ibid.*

As we have argued before, essential purpose revenue bonds represent separate operating entities and have demonstrated stability and resilience of revenue and operations.

Would a further downgrade of the U.S. credit rating lead to downgrades of municipal bonds?

Our view is that the relationship between the credit quality of municipal bonds relative to the that of the U.S. is tenuous. State and local government credits will remain generally strong, regardless of the federal government's credit ratings; we believe any downgrades of these credits and resulting spread widening would likely present a buying opportunity. As we have argued before, essential purpose revenue bonds represent separate operating entities and have demonstrated stability and resilience of revenue and operations. We therefore believe that U.S. credit downgrades would be irrelevant to those revenue sectors.

Municipal bonds whose credit quality is linked directly to that of the U.S. government share the same ratings of U.S. sovereign debt: Aaa, negative outlook (Moody's); AA+, negative outlook (Standard & Poor's); and AAA negative outlook (Fitch Ratings). They would be downgraded in lockstep with U.S. government ratings. These bonds include re-rated pre-refunded bonds (both U.S. agency and U.S. Treasury collateral) and housing bonds backed by the Federal National Mortgage Association (Fannie Mae), Government National Mortgage Association (Ginnie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Those credits comprise 3% of the municipal bond market, according to Barclays Capital.[11]

Moody's has a negative outlook on three triple-A rated states (Maryland, New Mexico, and Virginia) as well as 36 triple-A rated local governments, primarily because Moody's believes those state and local economies are highly dependent on the federal government for revenue-generating activity. Especially since the financial crisis, Moody's threshold for downgrade is much lower for the highest-rated issuers; lower- rated credits can endure more economic volatility before they are downgraded, and will be reviewed if the U.S. credit rating were cut. Standard & Poor's (S&P) criteria for state and local governments do not establish a link between municipal ratings and the federal government's rating, but the agency has also signaled a one-notch ceiling for state and local governments over the U.S. Therefore, AAA-rated state and local governments may be downgraded by S&P if the U.S. becomes double-A or lower.

11 Barclays Capital, as of December 31, 2011.

For long-term investors, intermediate municipals can offer a better balance between total returns and volatility.

What would be the effect of federal cuts to aid payments to state and local municipal borrowers?

We do not believe there would be any municipal defaults directly tied to federal aid reductions, and it is unlikely that there would be wide-scale rating downgrades. Federal aid to state and local governments is not directly used for debt service. Virtually all federal aid is used to finance federal programs implemented at the state and local levels; states are under no obligation to pick up the balance of the funding requirements if federal aid is slashed.

The number of municipal defaults and par amount were lower in 2011 than in 2010: through the first 11 months of 2011, 85 tax-exempt bond issues totaling $2.3 billion par amount defaulted, down from 115 and $2.79 billion in the first 11 months of 2010.[12] We believe defaults will likely continue to be rare and limited to unrated and sub-investment grade credits in the riskiest sectors in the municipal market, such as land-secured, retirement facilities and other project financings. There are approximately $8.9 billion (324 bond issues) of tax-exempt debt in default, compared with approximately $3.7 trillion outstanding, a default rate of approximately 0.24%.[13]

Municipal Bond Outlook for 2012

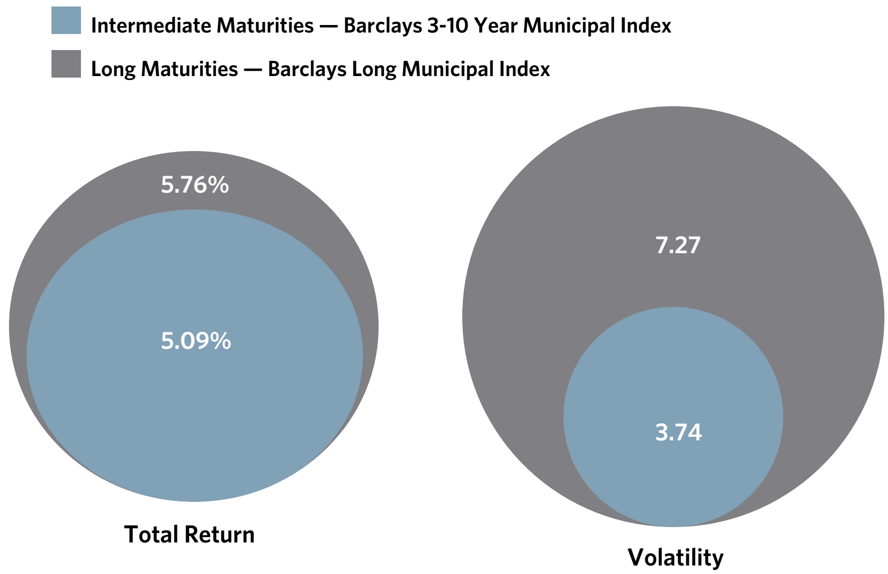
We continue to favor credit-intensive revenue bond sectors that used to be covered by monoline insurers (including airports, essential service utility and healthcare bonds). We find that these high-quality issuers with strong credit characteristics and revenues are better insulated from economic slowdowns and potential political tampering. As retail investors lack the time, expertise or access to analyze and monitor these revenue bond credits, this lack of interest has created inefficiency. Weaker demand for revenue bonds from retail buyers can result in higher yields than would be justified by the sector's strong credit fundamentals. The potential excess income over general obligations from single-A revenue bonds has increased since the significant decrease in bond insurance enhancements in the wake of the financial crisis.

For long-term investors, intermediate municipals can offer a better balance between total returns and volatility. As Exhibit 5 indicates, over the 10 years ended December 31, 2011, intermediate municipals (as represented by the Barclays 3-10 Year Municipal Index) produced annualized investment returns that were 88% of the returns generated by the Barclays Long Municipal Index, with only 51% of the volatility of returns. We expect the yield curve will remain steep in 2012, with short rates anchored by the Federal Reserve's stated commitment to maintain accommodative policy. In this environment, we expect municipal bond investors to benefit from the incremental yield of high-grade intermediate bonds.

12 *Municipal Market Advisor, November 2011,* December 6, 2011.
13 *Ibid.*

While we believe it is unlikely that the market will repeat the total returns generated during the market rally of 2011, we expect high-grade intermediate municipal bonds to continue to provide attractive after-tax income, with stable credit quality and relatively low volatility.

Exhibit 5 — Intermediate vs Long Maturity Municipals



Source: J.P. Morgan, Standish as of December 31, 2011. **Past performance does not guarantee future results.**

The direction of longer interest rates is more difficult to predict, so we avoid bonds where duration increases with rising interest rates. Instead, we focus on sector and security selection to seek excess income in the face of an uncertain economic and interest rate environment. While we believe it is unlikely that the market will repeat the total returns generated during the market rally of 2011, we expect high-grade intermediate municipal bonds to continue to provide attractive after-tax income, with stable credit quality and relatively low volatility. Moreover, as the credit cycle turns, we expect municipal after-tax returns to exceed those of Treasuries plus inflation.

Index Definitions

The Barclays Municipal Index is a market capitalization weighted index of U.S. public municipal bonds that have maturities of one year or more and have an investment grade credit rating no lower than BBB/Baa3. The index tracks the performance of municipal security trades in the U.S. Bond Market.

The Barclays 3-10 year Municipal Index is a market capitalization weighted index of U.S. public municipal bonds that have maturities of two to 12 years and have an investment grade credit rating no lower than BBB/Baa3. The index tracks the performance of municipal security trades in the U.S. Bond Market within this maturity range.

Barclays Long Municipal Index: This index is the Long Bond (22+) component of the Municipal Bond index.

The GO Bond Index component of the Municipal Bond index. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.

The BofA Merrill Lynch Global Broad Market Sovereign Plus Index tracks the performance of investment grade sovereign debt of large and small cap issuers publicly issued and denominated in the issuer's own domestic market and currency. In order to qualify for inclusion in the Index, a country (i) must have an investment grade foreign currency long-term sovereign debt rating (based on an average of Moody's, S&P and Fitch); (ii) must have at least $10 billion (USD equivalent) outstanding face value of Index qualifying debt (i.e., after imposing constituent level filters on amount outstanding, remaining term to maturity, etc.); (iii) must be available to foreign investors; and (iv) must have at least one readily available, transparent price source for its securities. Euro sovereigns are treated as a group with respect to minimum size requirements, but each member country is evaluated individually with respect to all other criteria. To qualify as a Euro member, entry into the European Monetary Union must be announced on or before the country qualification date (September 30) and must take effect on or before January 1 of the upcoming year. Qualification with respect to all country criteria other than rating is determined annually based on information as of September 30th, but does not take effect until December 31st. Conversion of local currency outstanding face value into USD terms is based on the average of the previous 12 month-end exchange rates up to and including the September 30th evaluation date. Qualification with respect to country rating criteria is determined monthly based on information available as of the third business day before the last business day of the month and takes effect on each month-end rebalancing date.

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