

MTB Fixed Income Funds

MARKET OVERVIEW¹

Over the third quarter, Treasury yields sank to historic levels as economic growth slowed, and the Federal Reserve (“Fed”) signaled that fed funds rates are likely to remain exceptionally low through mid-2013. Not even S&P’s downgrade of long-term U.S. Treasury debt could raise Treasury yields this quarter.

The yield curve flattened rather dramatically during the quarter as the Fed announced “Operation Twist.” The intent of this latest unconventional policy is to further reduce longer-term rates. The Fed plans to purchase \$400 billion of Treasuries maturing between 6 and 30 years, while selling \$400 billion of securities with maturities of 3 years or less.

The 2-year Treasury yield declined by 21 basis points during the quarter to yield 0.24% on September 30, 2011. The 10-year Treasury yield declined by 124 basis points to 1.91%. The yield curve flattened by 103 basis points during the quarter. The 30-year Treasury yield declined by 146 basis points to 2.91%, which is still above its all-time low yield of 2.52%, reached in December 2008.

The 3-month total return of the 30-year Treasury was an unbelievable 31%. The 10-year Treasury returned 12%.

Corporate bonds underperformed Treasuries for the second consecutive quarter, this time by 511 basis points. August alone saw 333 basis points of underperformance, making it the third-worst month for corporate excess returns.

The average investment-grade risk premium increased by 85 basis points to 238 basis points at quarter-end, up from 153 basis points at June 30. The aversion to risk was spurred by fears of both a double-dip recession and the effects of the European sovereign credit crisis on the global financial system.

The financial sector was especially hard hit, with risk premiums widening by 155 basis points to close the quarter at an average of 332 basis points. Financials lagged Treasuries by 729 basis points for the quarter.

Speculative-grade bonds also suffered. The Barclays Capital High Yield Index returned -6.1% for the quarter, leaving it with a year-to-date total return of -1.4%.

Mortgage-backed securities also underperformed for the quarter, as concerns over faster prepayments resulted from record low mortgage rates and expectations of increased refinancing activity. Risk premiums widened and the sector lagged Treasuries by 212 basis points.

STRATEGY REVIEW

As economic weakness emerged in the early summer we began to reduce our exposure to both investment grade and high yield corporate securities in our taxable portfolios. We have sold larger banks/broker issuers as well as issuers who we deem to be susceptible to a prolonged period of sub-par economic growth. We are continuing to focus on companies that can propel their brands globally and/or pass along higher input costs to their customers.

Recently, within the taxable portfolios, we have added to our prime conventional Fannie Mae and/or Freddie Mac mortgage-backed securities allocation. We view the sec-

JAMES M. HANNAN

Managing Director of Fixed-Income Strategy; Co-Portfolio Manager, MTB Short Duration Government Bond Fund, MTB Income Fund and MTB U.S. Government Bond Fund



Mr. Hannan is responsible for directing the fixed-income strategy and process at MTB Investment Advisors and for managing fixed income separate accounts and mutual funds. He has over 20 years of investment industry experience. Mr. Hannan earned his B.S. from the University of Maryland and his M.B.A. from George Washington University.

WILMER C. STITH III, CFA

Portfolio Manager, MTB Intermediate-Term Bond Fund and MTB Short-Term Corporate Bond Fund; Co-Portfolio Manager, MTB Income Fund and MTB U.S. Government Bond Fund



Mr. Stith is responsible for managing fixed income separate accounts and mutual funds and for coordinating fixed-income trading for the firm. He has over 19 years of investment industry experience. Mr. Stith earned his B.A. from Kenyon College and his M.B.A. from Loyola College in Maryland.

Past performance is no guarantee of future results. Returns of individual securities do not represent the performance of any specific fund.

100 basis points equals 1.00%

¹Data source: Bloomberg

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tor as providing favorable risk/reward dynamics. They serve as a highly liquid and high quality alternative to other sectors in the bond market. They also offer compelling yields in this historically low interest rate environment. Furthermore, the Fed announced on September 21, 2011 that they will reinvest all cash flow within their \$2.8 trillion portfolio into MBS, resulting in roughly \$25 billion a month in purchases. This latest development is just one of several reasons why we have added to MBS and anticipate to remain invested over the course of 2011.

OUTLOOK

For the remainder of 2011 we are anticipating a flatter yield curve as lower inflation, and Fed purchases of longer maturing Treasuries, will lead to lower long-term interest rates. However, the Fed's "Operation Twist" will result in \$400 billion worth of shorter maturity Treasuries being sold in the open market over the course of the next 10 months. As a result we expect to underweight the 3-year maturities and shorter portion of the U.S. Treasury yield curve.

Past performance is no guarantee of future results. All investments are subject to risk, including possible loss of principal. Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices. Income generated by these funds may be subject to the federal alternative minimum tax.

References to indexes are made for comparison purposes. Indexes are unmanaged and cannot be invested in directly. Financial and statistical information provided is obtained or derived from sources deemed reliable but is not guaranteed as to accuracy or completeness.

The Barclays Capital High Yield Index covers the universe of fixed rate, non-investment grade debt, including corporate and non-corporate sectors.

The Federal Funds Rate – The interest rate at which one depository institution lends immediately available funds (balances at the Federal Reserve) to another depository institution overnight

Mortgage-backed securities (MBS) – A debt obligation or asset backed security that is a claim on the cash flows from mostly residential mortgage loans

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