

Investment Opportunities in Fixed Income

The ongoing credit crisis has caused extremely wide spreads in many fixed income sectors. Spreads are the differences in yields between non-Treasury investments and comparable Treasuries, or U.S. government securities. These wide spreads have led to investment opportunities, particularly in high quality corporate and municipal bonds.

Corporate Bonds: Wide Spreads, Low Defaults

The corporate bond market has been extremely volatile as a result of the credit crisis, with investors moving out of the sector for the relative safety of Treasuries. This has caused falling corporate bond prices, increasing yields, and widening spreads between corporate bonds and comparable Treasuries. Here's why:

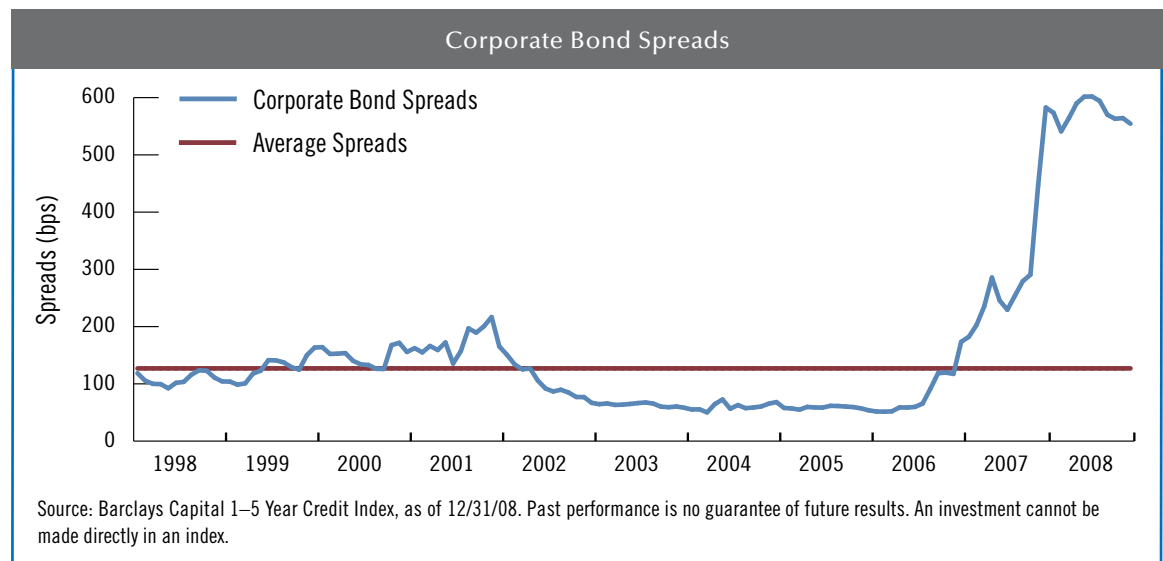
Bond prices and bond yields have an inverse relationship—when prices go down, yields go up, and vice versa. For example, if an investment-grade corporate bond is issued today for \$1,000 at 5.0%, and a year from now interest rates rise and new bonds are being issued for \$1,000 at 6.0%, the 5.0% bond is now worth less. Therefore, its price declines and pushes up its yield. As corporate bond yields

rise, the spreads between corporate bonds and comparable Treasuries widen.

Many investors have sold their corporate bonds fearing an increase in default rates in the face of a continued recession. A bond is in default if a corporate issuer fails to make an interest payment. Default rates measure the percentage of companies that are currently in default.

Many corporations, however, have been strengthening their balance sheets by increasing cash holdings and carrying very little debt to guard against a continued downturn in the economy. As a result, default rates have remained low for high quality investment-grade bonds. (See Moody's rating scale below.)

Today's historic investment grade corporate bond spreads may offer attractive investment opportunities in this sector. These spreads peaked at 600 bps in 2008 versus the historic average of 119 bps. (1 basis point equals 1/100 of a percentage point.)



Moody's rating scale runs from a high of Aaa to a low of C, and is divided into two sections: investment grade and speculative grade. The lowest investment-grade rating is Baa3 and the highest speculative-grade rating is Ba1. **Highest quality:** Aaa. **High grade:** Aa1, Aa2, Aa3. **Upper-medium grade:** A1, A2, A3. **Medium grade:** Baa1, Baa2, Baa3. **Speculative grade:** Ba1, Ba2, Ba3. **Lack characteristics of a desirable investment:** B1, B2, B3. **Bonds of poor standing:** Caa1, Caa2, Caa3. **Highly speculative:** Ca. **Lowest rating:** C.

Municipal Bonds: High Yields and Low Prices

Similar to corporate bonds, the municipal bond market has been extremely volatile, especially over the last year. Investors sold municipal bonds of all maturities and credit qualities, opting instead for the relative safety of Treasuries. This caused some municipal bond prices to fall significantly and yields to move higher.

Muni/Treasury Ratio

The Muni/Treasury ratio is widely used to measure the value of municipal bonds to determine if they are cheap or expensive relative to Treasuries. Generally, municipal bonds trade at a ratio of 80% to 90% of Treasuries. So if a two-year Treasury is yielding 2%, a two-year municipal bond generally yields about 1.6%. (Since most municipal bonds are tax-exempt, their yields tend to be lower than taxable

bonds.) A higher ratio, like today's ratio, indicates a cheap bond; a lower ratio indicates an expensive bond.

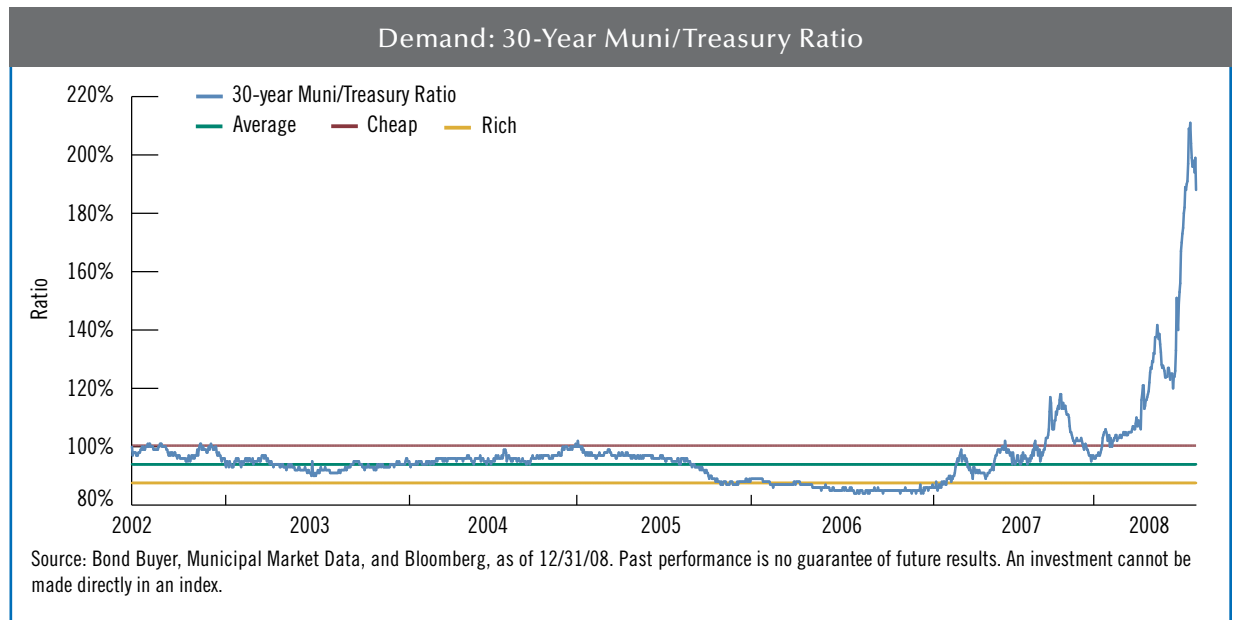
Muni/Treasury Ratio (as of December 31, 2008)

Maturity	2 Year	5 Year	10 Year	20 Year	30 Year
Ratio	258%	171%	170%	168%	197%

Source: Barclays Capital.

The graph below shows that since 2002, the Muni/Treasury ratio (blue line) remained relatively stable. Municipal bond prices also remained stable and the ratio (green line) averaged 94%. In late 2005, when municipal bond prices were rising and yields were falling, the Muni/Treasury ratio moved below the average 88% (yellow line), indicating an expensive environment. But in late 2007 through 2008, municipal bond prices declined and yields rose, causing the ratio to move above 100% (red line), indicating a cheap environment.

Today's historically high Muni/Treasury ratio presents a potential investment opportunity.



FIXED INCOME INVESTING INFORMATION: Investing involves risk. The value of your investment will fluctuate and, when sold, may be worth more or less than its original cost. Fixed income investments are subject to interest, credit, and market risk. Interest rate risk: the value of fixed income investments will decline as interest rates rise. Credit risk: the possibility that the borrower may not be able to repay interest and principal. Low-rated bonds generally have to pay higher interest rates to attract investors willing to take on greater risk. Market risk: the bond market in general could decline due to economic conditions, especially during periods of rising interest rates.

Unlike other investment vehicles, U.S. government securities and U.S. Treasury bills are backed by the full faith and credit of the U.S. government, are less volatile than equity investments, and provide a guaranteed return of principal at maturity.

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