ticker

Dynamic Total Return Fund

Traditionally investors have been encouraged to diversify portfolio between stocks and bonds with 60/40 allocation. Dreyfus' Dynamic Total Return Fund takes that process further and can diversify across many asset classes to pursue equity like returns.

What is the background of the fund?

We employ a dynamic total return strategy and our aim internally at Mellon Capital is to deliver equity-like returns within an expected volatility range between 7% and 10% as measured by standard deviation. The fund is a go-anywhere, managed volatility strategy that invests across a variety of asset classes from stocks, bonds, cash, currency, and commodities.

Downside risk management is how we target delivering a smoother equity-like return profile with significantly less volatility. Still, our past performance is no guarantee of future results.

In 2006, this fund was not managed pursuant to the dynamic total return strategy. It was set up with a 60% equity and 40% fixed-income benchmark, and we took extra risk around that. Two years later, the fund was down 34%, two-thirds of that was driven by the decline in the benchmark, and the remaining third was from our exit positions, which were down about 9%.

That prompted discussion with investors on what they desired from a strategy and revealed that their focus was on outcome, not a benchmark-centered approach.

Since 2009 our approach and the fund's strategy have evolved and we are benchmark-agnostic, and we have become more macro-oriented, to capture returns in the most efficient and effective way. For example, we introduced an options program in 2014.

The bottom line is that the strategy today is much outcome-oriented, with our focus internally on delivering smoother equity-like returns within that expected risk range of 7% to 10%.

How do you differ from your peers?

Our strategy fits within the alternative liquid universe that spans from the lower risk/return categories.

We differ in how we run our strategy. First of all, we focus on total rather than absolute return. That's an important distinction, because absolute return strategy aims at avoiding a negative return during any given period. We, on the other hand, may have some negative returns because we aim to deliver a more attractive growth-oriented return.

Our goal is to provide a significant cushion when equity markets fold sharply, and so we take a directional macro-strategy approach because we have a number of risk management tools embedded in the strategy to reduce exposure caused by market environment changes.

Our flexibility to take that directional exposure, as well as the pure long-short, more market-neutral approaches, is one of the reasons why we've developed such strong returns over a 3- to 5-year basis.

Our correlation approach is also a little different in that our correlation with traditional assets varies. Over the last five years, the fund has had a 5-year beta of 0.6 relative to the MSCI World Index, because over that period we tended to find directional exposure attractive.

Not-FDIC-Insured. Not Bank-Guaranteed. May Lose Value.

Sinead Colton serves as Managing Director and Head of Investment Strategy at Mellon Capital. With over 21 years of investment experience Sinead has designed, developed and implemented innovative solutions for both return-seeking portfolios and risk hedging strategies. At Mellon Capital, she develops multi-asset solutions designed to provide attractive return outcomes within a clearly articulated risk framework. Prior to joining Mellon Capital, Sinead was a multi-asset investment strategist at BlackRock (formerly Barclays Global Investors) where she created customized investment solutions for DB, DC and retail clients across the EMEA region. Prior to BlackRock, she was head of currency at Invesco, responsible for active currency strategies across the global fixed income team. Previously, Sinead served as head of portfolio management for Lee Overlay Partners Ltd., an independent active currency management firm. Prior to this role, she worked as a currency portfolio manager at JP Morgan Investment Management. Sinead commenced her career at Chase Manhattan Bank NA, as a foreign exchange and options salesperson.

Vassilis Dagioglu is Managing Director and Head of Asset Allocation Portfolio Management at Mellon Capital. With over 16 years of investment experience, Vassilis leads a team of portfolio managers responsible for the implementation of Mellon Capital's Asset Allocation strategies including Total Return, Global Macro, Tangent-Added, Active Currency and Active Commodities strategies. Vassilis manages a team of Research/Quantitative Analysts in charge of daily updating, monitoring and validating input and output data for all Asset Allocation investment models. The team also conducts portfolio performance, risk analysis and scenario stress testing for all Asset Allocation strategies. Prior to joining Mellon Capital Management, Vassilis designed and implemented financial information systems and consulted on enterprise information application development for IBM Global Services and Sybase. Vassilis is a member of the Risk Management, Investment Management, Fiduciary and Senior Management Committees. Vassilis received his M.B.A. in Finance from University of California at Berkeley.

Many alternative strategies aim to offer diversification by providing positive returns both in up and down markets. The challenge has been that many of these strategies have underperformed over the last few years while equity markets have posted solid performance.

The challenge with that is that many have delivered disappointing returns over this period. Our approach is more nuanced, as we're comfortable with a higher correlation. Directional exposure looks attractive, with the goal being to have a lower correlation in more risk-averse market conditions.

How do you measure expected risk?

We look at the standard deviation of the total position in terms of our expected risk, which we keep between 7% and 10%. If we have more directional exposure, we'll move toward the higher end; with less directional and more market-neutral exposure, we tend toward the lower end.

What are the core beliefs that drive your investment philosophy?

We believe:

– Long-run fundamental valuation and relative risk within and across global financial markets drive asset pricing

– Changes in investor sentiment, structural factors, and the behavior of local investors, central banks, and non-profit maximizing market participants may create exploitable investment opportunities across global capital markets

– Systematic valuation, risk management, and implementation processes are critical to extracting alpha

– A strategy that is responsive to and resilient in uncertain environments may help mitigate downside risk while preserving the upside potential.

Macro-economic awareness needs to complement valuation, because while valuation-oriented approaches deliver very attractive returns over time, there are periods where the macro environments overwhelm.

A huge case in point was 2008, as was 2011, where we had concerns regarding Greece, Spain, and Italy. The valuations may remain robust, but there are other driving forces that impact markets significantly that can be overlooked.

Our approach is model-driven, but it is not a black box. All the data that we bring into our process on a daily basis is fundamentally driven, whether it's earnings, yield, or current account balance for currency.

For example, in Q1 of this year, we pared our U.S. equity exposure back somewhat because of negative earnings revisions.

We've managed asset allocation strategies using these types of processes for over 25 years, and find them to be effective in delivering robust repeatable performance over time. But models can't account for everything, such as geopolitical risk, so, in such cases, we utilize an element of portfolio manager discretion.

One such example of being outside the model was the negotiations and possible exit of Greece from the euro zone in the last few weeks. So, we assessed how we might expect that particular scenario to unfold, and whether it would be prudent to reduce risk in the portfolio in order to navigate the volatility that might result. We reduced our equity exposure to help manage that uncertainty.

What steps do you take to evaluate investment merits?

We run a model one or more times a day. Our approach across every asset class and market that we cover is to derive an expected return for each.

With equities, for example, for each market that we cover we take positions primarily at the country level, rather than the individual security level. For global stocks, we look at each market we cover, and break it down into individual stocks.

As the primary investment for the U.S. we look at all 500 of the S&P's stocks, starting with the consensus earnings expectation, and adjust them based on factors we've developed in-house: earnings quality, earnings management, trend and revision, and the impact of actual or anticipated economic growth on that particular market. We create an expected return for each stock, and weight them according to the S&P500 Index.

We perform the same process for indexes of every country that we cover; the DAX Index in Germany, the TOPIX Index in Japan, and the FTSE 100 Index in the U.K. The aggregate of those expected returns gives us our global stock return. We are also selective in gauging which markets we think are more or less attractive.

For example, we have been tilting more towards international markets during the past 18 months. We particularly correlate with Germany, but also Japan, and pared back our U.S. exposure. At the beginning of 2014 we had nearly 40% U.S. exposure, today it's more like 20%.

We can also take short positions when a given market looks unattractive; our largest short in the equities today is the U.K. To complement that, we look at expected returns across all asset classes. Our expected return on bonds is similar to yield maturity. We compare expected returns for stocks to those of corporate bonds, taking into account the credit risks premium.

Government bond level positions tend to be a bit more tactical because of where yields are today. We tend to prefer U.S. Treasuries and U.K. Gilts. The biggest short in the portfolio has been the German Bund.

For commodities, our expected return is based on our expectation of surprise inflation, our forecast of inflation relative to consensus. We hold real assets in the portfolio because in the case of surprise inflations, they maintain some capital preservation. When there's an adjustment in inflation expectation, although equities are a great long-term inflation hedge, it's not usually the case short term.

The final area is currency. Over the long term, currency adds risk to the portfolio without adding return. So, we fully hedge all of our exposures back

to the U.S. dollar, making adjustments to our positioning. Essentially, they're active currency positions, not driven by our currency model.

Our currency model looks at relative macro-dynamics: pay acceleration/deceleration, relative interest rates, current account balances, purchasing power parity. For the last three or four quarters we've often been outright long the dollar, mainly through shorting the British pound and the euro.

As we calculate all of the expected returns, we generate our expectations for risk correlation within the asset classes and markets.

How do you construct your portfolio?

The first step is to align all of those aspects to build a robust diversified portfolio. We apply a few risk management filters, starting with the risk concentration screen. Throughout the optimization process, we avoid concentrating undue risk in any one or two positions.

The second step is a liquidity screen. We score every market that we cover based on its liquidity, holding smaller positions in markets that are less liquid.

For example, the U.S. Treasury market is typically more liquid than Canadian government bonds, so even with comparable anticipated returns, our Canadian position would be slightly smaller.

The strength of our more model-driven approach shines, as we analyze close to 2,000 individual securities on a daily basis.

How do you manage downside risk?

Drawdown control and reducing downside risk is important to us. There are four pillars of downside risk management within the strategy that help us do that.

The first is explicit volatility management. We have an internal expected risk range of 7% to 10%, based on long-term expectations. We also view the shorter-term risk forecast. When we see expected risk moving above the upper end of that 7-10 threshold, we start scaling out risk.

Maintaining wiggle room enables us to allow for normal market volatility if we're running at an expected risk of 10%. We manage volatility explicitly because if you see rising volatility, you typically see falling markets. Markets tend to go up the stairs and down the elevator, so proactively managing the shorter-term volatility within the portfolio is an effective downside risk management tool.

The second pillar is the macro environment. We've developed a signal in-house designed to alert us when the global economy is trending downward significantly. This isn't about any short-term differential in economic performance; it's about identifying when we'll have a negative investment environment, which is often a volatile, unrewarding time to hold riskier assets. It relies on economic data, primarily concurrent and forward-looking, and signals when it's time to scale out risk.

In most crisis periods, we'll first work to reduce risk through volatility management and then potentially more through macro-environment signals.

The third pillar is options. Rather than buy the same level of protection, we focus on how to cost-effectively hedge against portfolio risks. If you're worried about a global down trend, it won't matter very much whether you place a put on the S&P, the TOPIX, or the DAX. But the pricing of those instruments can be quite different.

We use options in conjunction with the fourth pillar, stress testing the portfolio, looking at elements outside the model. These are primarily geopolitical events, but economically driven events can wield sudden impact on the market too, having significant impact on the portfolio. A good example was the Swiss National Bank removing the cap on the Swiss franc in January.

What we care about when stress-testing the portfolios is what is coming that might significantly impact the portfolio, and the potential resulting drawdowns. If the drawdown is greater than we're comfortable with, and it appears likely, we'll reduce risk within the portfolio, possibly by combining purchasing some options with selling some equity exposure, or increasing our defensive asset exposure.

For example, with Greece's situation, we had a net equity exposure of about 60%, which we reduced to 45% by the end of June by selling some equity exposure, and moving that into cash. We also had some option protection within the portfolio: puts on the S&P and TOPIX.

As July unfolded, an agreement was reached with Greece and reforms were being put through Parliament. With the additional clarity we had, we put risk back into the portfolio and it's now closer to a 60% net equity exposure again.

How many different country markets do you look at in the global equity realm?

Across the board we're looking at 12 developed markets. We include emerging markets, but at an index level only, because it's only a 4% allocation. Where we're seeing the biggest opportunity, the most divergence, is in the developed markets, so that's where we focus.

What types of bonds do you consider?

Most of our tactical positioning is within government bond markets. We follow six markets: the U.S., Canada, the U.K., Germany, Japan, and Australia. We have some high-yield bonds, about a 5% exposure. Although fixed income, the characteristics align with what we view as a growth asset, essentially more equity-like in terms of the drivers and expected performance.

We can hold investment grade, but currently we don't. Municipals really aren't in our universe.

Why look at government bonds when there are so many asset classes to consider, especially when rates are expected to rise?

Bonds help us diversify. We also vary our net bond exposure. Also, we believe government bonds provide diversification while providing a high degree of liquidity.

If you look at our positioning at the end of March, we had reduced government bond exposure to a net 8%. Within that we had longs and shorts: long Treasuries, long Gilts, and short German Bunds. The reason for such low exposure was because within our model, in addition to the other asset classes, we have an expected return for cash created.

Most of the time that sits in the background, providing an effective hurdle rate for investing. At the end of first-quarter of 2015, bond yields had reached such low levels that our model said expected returns of bonds were not meeting our hurdle rate. We reduced our net bond exposure to 8%, and held 32% in cash.

In second-quarter, as yields backed up in late April and May, we added to our bond exposure. Today, it's 38%. It's not as if we hold bonds regardless. Our model assesses whether a degree of net exposure makes sense and how much. So, despite rates/yields backing up across the board, our bond positioning performance was positive.

We're starting to see much greater divergence across economies, and we should potentially see some tightening by the U.S. Federal Reserve this year and the Bank of England is expected to follow the U.S. But, looking more broadly, the ECB and Bank of Japan are easing, presenting an opportunity to exploit deviations across economies.

Government bonds are attractive; however, we closely monitor the degree of correlation between stocks and bonds and whether a more permanent shift from the negative correlation between stocks and bonds to neutral or slightly positive occurs.

A dramatic shift in those correlation assumptions would signify a different environment, with us potentially reassessing our positions, but given where we are today, and the environment, we see that a lot of opportunity within the bond markets.

How do you determine which asset sets to include or exclude?

The first element for us is liquidity. We aim to ensure that all our asset classes are highly liquid, offering daily liquidity as a mutual fund. Liquidity management is a top priority—it permeates all aspects of a portfolio. A great downside risk management strategy doesn't help if you can't trade the necessary instruments or asset classes.

With sufficient liquidity, the second element is to create a robust model or systematic discipline process to value that asset class, both in its own right and compared to other markets. Research and a significant history of data are required to test the signals we're developing.

Third, we use synthetic instruments to take some leverage in the portfolio, allowing us to hold enough diversifying assets to hedge our growth asset exposures.

Typically, across the board, we hold futures, whether they're equity or bond futures. We use some ETFs and some total-return stocks, but we prefer highly liquid instruments without much counterparty exposure.

Are you open to shorting commodities in certain ways?

Oil is one of the biggest drivers behind our shorts in the U.K. because it's a significant energy component in the FTSE. We implement through a commodity ETF.

Our commodity exposure is pretty small, yet we maintain flexibility to introduce more granularity to that exposure. We have a commodity strategy for institutional investors, which has the ability to short, and the energy market is an area where we've been significantly short, particularly because of oversupply within oil.

How is your research team organized?

We have 26 multi-asset research analysts who hold Master's and PhD degrees and are experts in their fields. They continually seek new ways to enhance the process, whether through an existing signal or developing new signals. A dedicated research team closely aligned to their specialization areas yet capable of cross-pollination is a significant advantage.

Dreyfus' Dynamic Total Return Fund

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Source: Company Documents

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Working together, they develop the most effective strategies and signals within their fields. Sometimes insights from different asset classes help them consider an area they're focused on in a slightly different light, which has proved useful.

What is your portfolio construction process and how do you employ your diversification strategy?

We start by developing bench returns for each market and asset class. We also develop our expected risk for each market and asset class, and their correlations. We use an optimization process to create a portfolio at a particular risk level. The optimization process keeps us from concentrating risk in any one or two positions, and ensures that the overall portfolio is diversified.

The second element is the liquidity screen, by which we score the entire market. For markets that are less liquid, we take a slight haircut on those positions within the optimizer so that the targeted risk level of the portfolio the optimizer produces is diversified.

What benchmark do you use?

As we practice dynamic total return strategy, we are benchmark-agnostic. Internally, we aim to deliver an equity-like return within the expected risk range of 7% to 10%. We can be outright short certain asset classes, we can have some leverage in the portfolio, and we can, in an extremely risk-averse scenario, be 100% in cash. What that means is that over short periods of time, our positions and our performance could look quite different than a more traditional benchmark.

Over a 5- to 7-year basis, we're fine with people comparing our returns to those of the equity market, whether that's the U.S. dollar-based MSCI World Index or MSCI ACWI [All Country World Index]. In addition to comparable returns, we want to deliver a much higher Sharpe ratio, delivering returns at a significantly lower risk level.

How do you define and control risk?

Ultimately, we focus on delivering outcome, so our risk lies in not meeting that outcome, losing money and getting back less principal than was invested.

There are a number of measures that we monitor within the portfolio. The first is the expected risk, which is really the standard deviation of our positions, or the expected volatility of those positions. We also monitor the potential drawdown.

We have our own measures for the standard deviation we allow concerning risk that we created in-house. However, we also use third-party measures as a second pair of eyes on what our risk estimates are.

Outside of that, we look at potential drawdowns in the portfolio. It comes back to our stress testing, what's coming down the track that might have a big impact on the portfolio.

We assess and continually monitor the overall liquidity of the portfolio in order to ensure that, regardless of the market environment, we can liquidate our position, when necessary.

In terms of measuring how well we've done, overall we're focused on generating return. We want to see a higher Sharpe ratio. We also want to see a better Sortino ratio. It's about seeking to minimize the drawdowns so that investors are in a better position to continue accumulation moving forward.

Average Annual Total Returns (as of 9/30/15)

Dynamic Total Return Fund	1 Year	3 Year	5 Year	Since Inception (5/2/06)
Class I	-0.52%	6.17%	6.60%	3.30%
Class A (NAV)	-0.79%	5.90%	6.27%	2.97%
Class A (5.75% max. load)	-6.48%	3.84%	5.01%	2.33%

Class I annualized standard deviation (9/30/15):

1 Year	3 Year	5 Year
7.59	7.02	8.77

The performance data quoted represent past performance, which is no guarantee of future results. Share price and investment return fluctuate and an investor's shares may be worth more or less than original cost upon redemption Current performance may be lower or higher than the performance quoted and recent returns have been negative. Go to dreyfus.com for the fund's most recent month-end returns. Class I availability is restricted to eligible investors.

Dreyfus has contractually agreed, until March 1, 2016, to waive receipt of its fees/or assume the direct expenses of the fund so that the expenses of none of the classes (excluding Rule 12b-1 fees, shareholder services fees, taxes, interest, brokerage commissions, commitment fees on borrowings and extraordinary expenses) exceed 1.25%. Total Expense Ratios: Class A 1.54%; Class I 1.21%. (Net Expense Ratios: Class A 1.50%; Class I 1.21%).

Beta coefficient measures a security or portfolio's volatility relative to an index. A beta of 1 indicates that the security's price will move with the market. A beta less than 1 means that the security will be less volatile than the market. A beta greater than 1 indicates that the security's price will be more volatile than the market. **Standard Deviation** is a statistical measure of the degree to which an individual portfolio return tends to vary from the mean, based on the entire population. The greater the degree of dispersion, the greater the degree of risk. **Sharpe Ratio** is a risk-adjusted measure that measures reward per unit of risk. The higher the Sharpe Ratio, the better. The numerator is the difference between the portfolio's annualized return and the annualized return of the risk-free instrument. **Correlation** measures the degree to which the performance of a given asset class moves in relation to another, on a scale of -1 to 1. Negative 1 indicates a perfectly inverse relationship, 0 indicates no relationship and 1 indicates a perfectly positive relationship. **Sortino ratio** differentiates harmful volatility from general volatility by taking into account the standard deviation of negative asset returns, called downside deviation. The Sortino ratio subtracts the risk-free rate of return from the portfolio's return, and then divides that by the downside deviation.

The S&P 500 Index is a widely accepted, unmanaged index of overall U.S. market performance. An investor cannot invest directly in any index. The DAX Index is a stock index that represents 30 of the largest and most liquid German companies that trade on the Frankfurt Exchange. The TOPIX, also known as the Tokyo Stock Price Index, is a capitalization-weighted index of all companies listed on the First Section of the Tokyo Stock Exchange. The Financial Times Stock Exchange (FTSE) 100 Index is an average of share prices in the 100 largest, most actively traded companies on the London Stock Exchange. MSCI World Index is designed to measure global equity performance of developed markets. The index includes select designated MSCI national developed market indexes. MSCI ACWI – All Country World Index is maintained by Morgan Stanley Capital International, and is comprised of stocks from both developed and emerging markets.

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Investors should consider the investment objectives, risks, charges and expenses of a mutual fund carefully before investing. To obtain a prospectus, or a summary prospectus, if available, that contains this and other information about a Dreyfus fund, contact your financial advisor or visit Dreyfus.com. Read the prospectus carefully before investing. Class I availability is restricted to eligible investors.

MAIN RISKS

Diversification Risk: Diversification and asset allocation cannot ensure a profit or protect against loss of principal. **Equity Risk** Equity funds are subject generally to market, market sector, market liquidity, issuer, and investment style risks, among other factors, to varying degrees. **Bond Risk** Bonds are generally subject to interest rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest rate changes, and rate increases can cause price declines. **Foreign and Currency Risk** The fund's performance will be influenced by political, social and economic factors affecting investments in foreign companies. Special risks associated with investments in foreign companies include exposure to currency fluctuations, less liquidity, less developed or less efficient trading markets, lack of comprehensive company information, political instability and differing auditing and legal standards. These risks are enhanced in emerging markets countries. Investments in foreign currencies are subject to the risk that those currencies will decline in value relative to the U.S. dollar, or, in the case of hedged positions, that the U.S. dollar will decline relative to the currency being hedged. Each of these risks could increase the fund's volatility. **Short Sale Risk** Short sales may involve substantial risk and "leverage." Short sales expose the fund to the risk that it will be required to buy the security sold short at a time when the security has appreciated in value, thus resulting in a loss to the fund. **Leverage Risk:** Some derivatives involve economic leverage, which could increase the volatility of these investments as they may fluctuate in value more than the underlying instrument. Certain derivatives have the potential for unlimited loss, regardless of the size of the initial investment. **Derivatives Risk** The use of derivatives involves risks different from, or possibly greater than, the risks associated with investing directly in the underlying assets, and could involve leverage. Derivatives can be highly volatile, illiquid and difficult to value and there is the risk that changes in the value of a derivative held by the fund will not correlate with the underlying instruments or the fund's other investments. **Commodities Risk:** Exposure to the commodities markets may subject the fund to greater volatility than investments in traditional securities. The values of commodities and commodity linked investments are affected by events that might have less impact on the values of stocks and bonds. Investments linked to the prices of commodities are considered speculative. Prices of commodities and related contracts may fluctuate significantly over short periods for a variety of factors.

The Dreyfus Corporation serves as the fund's investment adviser. Mellon Capital Management serves as sub-investment adviser. Mellon Capital's comments are provided as a general market overview and should not be considered investment advice or predictive of any future market performance. Mellon Capital's views are current as of the date of this communication and are subject to change rapidly as economic and market conditions dictate.

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