

# Navigating Long-Term Global Economic Change

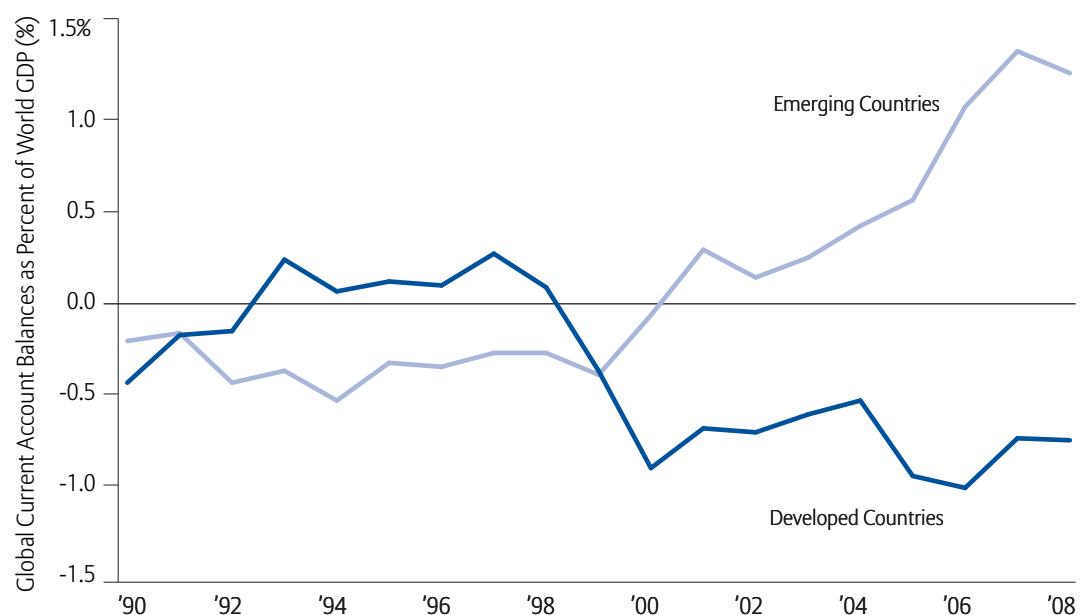
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**Executive Summary:** Fundamental shifts in the global economy and financial markets mean that investors may need to rethink traditional asset allocation strategies in order to stay on track with their long-term goals. **The new optimal portfolio** may not only include a globally diversified set of stocks and bonds, but inflation-hedging and other assets—as well as strategies designed to seek protection from significant market stress.

## A realignment of global power is underway

- The engine of economic growth worldwide has become less dependent on the U.S. and should be increasingly driven by emerging markets. In fact, the IMF projects that emerging economies will represent 32% of world gross domestic product (GDP) in 2009, continuing an upward trend.
- Relative fiscal health and an export boom have resulted in a build-up of foreign currency reserves among emerging economies. Accordingly, creditor nations such as China are now financing the debt of industrialized nations, including the U.S.
- The pronounced accumulation of wealth in certain countries is creating new pools of capital, such as sovereign wealth funds. These are playing an increasingly influential role in global markets, and are likely to drive new capital allocation trends.
- These economic changes will be accompanied by the need for structured finance and other activities that depend on the continued proliferation of derivatives. Thus, markets will likely be more and more driven by financial innovations themselves, which can in turn influence market fundamentals.

Emerging economies are now financing the debt of industrialized nations



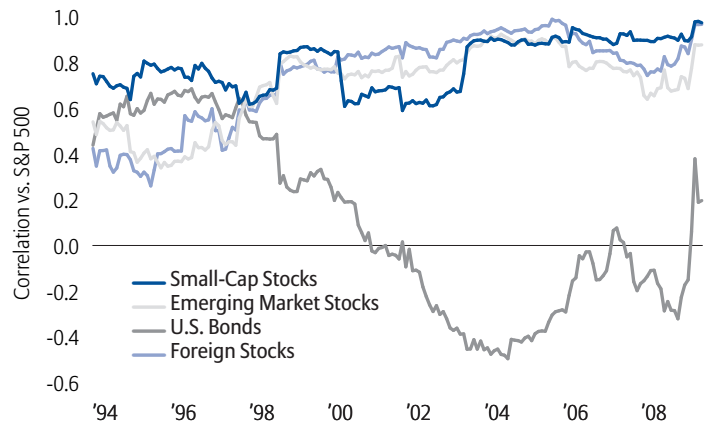
As of December 31, 2008. Source: International Monetary Fund (IMF).

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## Fundamental changes are challenging traditional asset allocation approaches

- As a result of the ongoing changes in the global economy, assets that formerly had a relatively low correlation (tendency to move in lockstep) with each other may not provide the same diversification benefits going forward. For example, foreign, emerging market and small-cap U.S. stocks have correlated closely with large-cap U.S. stocks over the past decade.
- This argues for access to the widest possible range of global asset classes, including stocks and bonds as well as inflation-hedging assets such as TIPS and commodities.
- Asset allocation may also require a qualitative, forward-looking approach that emphasizes diversification across a range of global risk factors.

U.S. and non-U.S. stocks have become more closely correlated



SOURCE: Zephyr Analytics. Data as of 12/31/2008. The correlation of various indices or securities against one another or against inflation is based upon data over a certain time period. These correlations may vary substantially in the future or over different time periods that can result in greater volatility. Foreign stocks represented by the MSCI EAFE Index; small-cap stocks by the Russell 2000 Index; U.S. bonds by the Barclays Capital U.S. Aggregate Bond Index, and emerging market stocks by the MSCI Emerging Markets Index.

## Portfolios may need to address the heightened possibility of severe outcomes

- Given the turbulence likely to accompany the evolving global economic climate, it will be important to employ “tail risk” hedging strategies—those that seek to protect portfolios from periods of severe market stress.
- Leading investment manager PIMCO, an Allianz company, has observed that episodes of systemic crisis tend to coincide with significant macro risks (such as liquidity risk and monetary policy risk). Therefore, active managers can attempt to protect a portfolio against severe outcomes by identifying investment instruments that can hedge against these macro risks.

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Using an asset allocation strategy does not assure a profit or protect against loss. When considering asset allocation strategies, you should consider your personal financial situation, including your investment time frame and risk tolerance level, as well as all of your personal savings, investments and retirement assets. Investing in non-U.S. securities entails additional risks, including political and economic risk and the risk of currency fluctuations; these risks may be enhanced in emerging markets. Commodities are volatile investments and should form only a small part of a diversified portfolio. Gross Domestic Product (GDP) is the value of all final goods and services produced in a specific country. It is the broadest measure of economic activity and the principal indicator of economic performance.

The Russell 2000 Index is an unmanaged index that consists of the 2,000 smallest companies in the Russell 3000 Index and represents approximately 10% of the total market capitalization of the Russell 3000. It is generally considered representative of the small-cap market. The Barclays Capital Aggregate Bond Index is composed of securities from the Barclays Capital Government/Credit Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index. It is generally considered to be representative of the domestic, investment-grade, fixed-rate, taxable bond market. The Morgan Stanley Capital International (MSCI) Europe, Australasia, Far East Index (EAFE) is an unmanaged index of over 900 companies, and is a generally accepted benchmark for major overseas markets. Index weightings represent the relative capitalizations of those markets included in the index on a U.S. dollar adjusted basis. The MSCI Emerging Markets (EM) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. It is not possible to invest directly in an index.

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