

Diversifying with Inflation-Hedging Assets

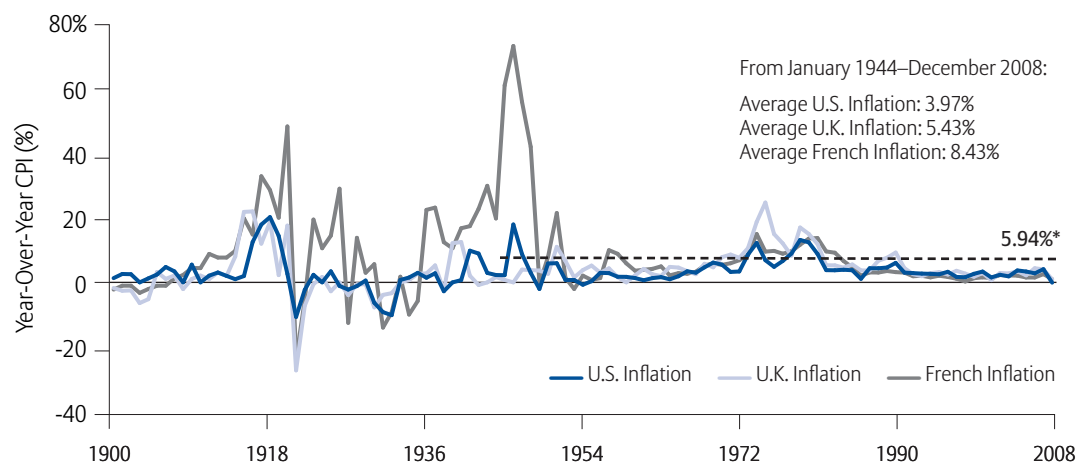
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Executive Summary: Should investors prepare for inflation in a recession? Absolutely. History suggests inflation is a stealth threat that can spike at any time, eroding returns, purchasing power and ultimately threatening investors' long-term goals. In fact, the best time to adjust your portfolio against inflation risk is before it starts. While stocks have traditionally been viewed as an inflation hedge, particularly over the last 25 years when equity returns were above the norm, they provide widely varying degrees of inflation buffering depending on the economy. In today's environment of uncertainty, volatility and likely modest returns, investors should instead consider diversifying their portfolios with **non traditional "real return" assets linked to inflation, such as Treasury Inflation-Protected Securities (TIPS) and commodities.**

Time for inflation hedging is before inflation starts

- Historically, there have been several periods of high inflation: economic environments that witnessed precipitous price rises for goods and services. When this has happened, it has tended to occur quickly—and unexpectedly. That is why one should always hold inflation-hedging assets in a portfolio—because you never know when inflation will strike.
- When inflation has been low for a protracted period of time, as it has been of late, there is a tendency for it to spike once the economy gradually begins to recover and the money supply increases.
- Inflation can have a direct impact on investment returns. Even assuming a conservative portfolio delivering a hypothetical 5% return, an inflation rate of only 2% would reduce those returns to an inflation-adjusted rate of just 3%—enough, over time, to significantly impact an investor's long-term goals.
- For retirees and near-retirees—particularly sensitive to inflation since they tend to live on fixed incomes—inflation can have dramatic financial consequences in the form of a negative impact on their purchasing power.

Historically, inflation can strike at any time, so it may be wise to always maintain some inflation-hedging assets in one's portfolio



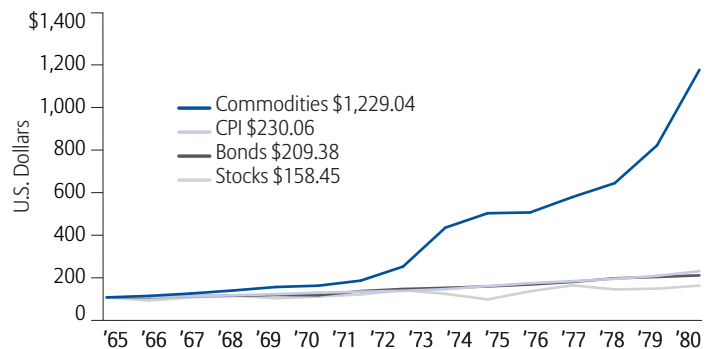
Source: PIMCO. *Average of all inflation shown. Data as of 12/31/08. Past performance is no guarantee of future results. This chart is not indicative of the past or future performance of any Allianz Global Investors product. U.S. inflation is represented by the Consumer Price Index (CPI) which is an unmanaged index representing the rate of inflation in U.S. consumer prices as determined by the U.S. Department of Labor Statistics. U.K. inflation is represented by the U.K. Retail Prices. Index which is the most familiar general purpose domestic measure of inflation in the U.K. French inflation is measured by the France Consumer Price Index which measures changes in the price of a fixed basket of 303 goods and services offered to the public. There can be no guarantee that the CPI or other indexes will reflect the exact level of inflation at any given time.

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Diversifying with an inflation hedging asset can lower overall risk

- Lower correlation (the tendency to move in lockstep) between assets in a portfolio tends to produce broader diversification and lower overall risk. In this context, inflation hedging assets, such as TIPS and commodities, can help diversify a portfolio since they tend to have a low correlation with traditional stocks and bonds.
- While we have not experienced a period of serious inflation in some time, the divergence of an inflation hedging asset, like commodities during the last inflationary period was pronounced. From 1965–1980, commodities (TIPS were only introduced in 1997) outperformed the Consumer Price Index (CPI), but stocks and bonds did not. (See chart at right, which depicts growth of \$100 from 1965–1980.)

Commodities outperformed during the last inflationary period



Past performance of these asset classes is no guarantee of future results. Index returns are unmanaged. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not take into account any fees, sales charges or the effective taxes. One cannot invest directly in an index. Sources for index returns: Commodity returns: Gorton and Rouwenhurst (data from 1965–1970) and S&P GSCI Commodity Index (post 1970); Consumer Price Index: benchmark for inflation; Bonds: 10-Year Treasuries and Stocks: The Dow Jones Industrial Average. See below for additional information about asset classes.

Investors may consider a range of inflation hedging strategies

- Investors should keep in mind that the bull market of the '80s and '90s may have been an anomaly. Should inflation resume and equity performance return to its historical norm, TIPS, which are explicitly linked to inflation, could provide a solid hedge against an ensuing rise in prices for goods and services. While inflation-indexed bonds, including TIPS, are structured to provide a hedge against inflation, a rise in real (inflation-adjusted) interest rates can lead to a decrease in the value of inflation-indexed bonds.
- Over the long term, the economic drivers for commodities should remain favorable. It is likely that, once the global economy begins to recover, demand for commodities will again begin to drive up prices, making them a potentially solid hedge against inflation. Commodities-linked investments can be volatile and speculative.
- Foreign currency exposure may be able to help counter the U.S. dollar weakness that is typically associated with inflationary periods. Of course, currency rates in non-U.S. countries may fluctuate significantly over short periods of time, and investors should be prepared to accept this additional risk.
- Investors may want to consider actively managed, diversified real return strategies, which may draw on the above suggestions, as well as other asset classes in an effort to generate positive after-inflation returns.

Investors should consider the investment objectives, risks, charges and expenses of this Fund carefully before investing. This and other information is contained in the Fund's prospectus, which may be obtained by contacting your financial advisor or by calling 1-888-877-4626. Please read the prospectus carefully before you invest or send money.

A mutual fund, which has concentrated investments in TIPS and commodities, may under some market conditions be subject to greater volatility than investments in traditional securities. Investments in commodities may be affected by overall market movements, changes in interest rates, and other factors, such as weather, disease, embargoes and international economic and political developments. Commodities are assets that have tangible properties, such as oil, metals, and agricultural products. The value of a commodity-linked derivative is generally based on: price movements of a commodity, a commodity futures contract, a commodity index, or other economic variables based on changes in the commodities markets. Use of derivative instruments may involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk and the risk that a fund could not close out a position when it would be most advantageous to do so. Portfolios investing in derivatives could lose more than the principal amount invested in those instruments.

Treasuries are backed by the full faith and credit of the United States government as to the timely payment of interest and principal. Stocks, commodities and non-government bonds involve no such guarantees. Commodities can be speculative investments and are highly volatile. The value of Treasury Inflation-Protected Securities (TIPS) is likely to change in response to changes in "real" interest rates (current market interest rates minus the expected impact of inflation). In other words, a rise in real interest rates can lead to a decrease in the value of inflation-indexed bonds.

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