

Diversifying Your Income Strategy

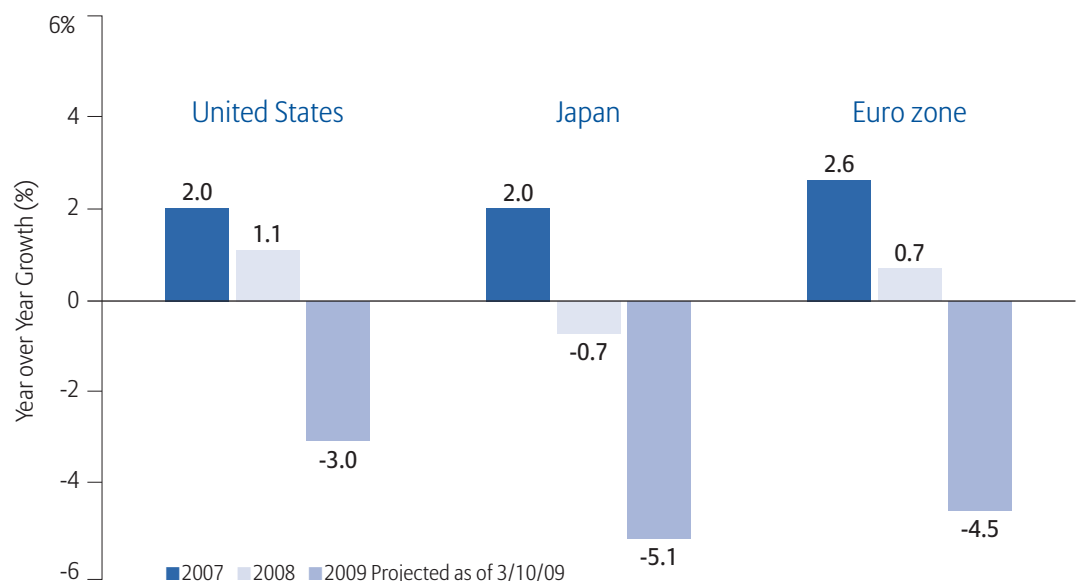
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Executive Summary: A number of market observers believe that, in the coming years, we will witness slower economic growth and less robust capital appreciation from many asset classes. Thus, many investors may need to bolster their portfolios with income-generating assets that have the potential to increase total return. What is more, **investors may be wise to follow a diversified approach to income-generation**—one that helps prepare them for potential bumps in the road to a global economic recovery.

A realignment of global power is underway

- According to the World Bank, global GDP growth is projected to contract by 1.7% in 2009—its first decline since World War II—creating a drag on financial markets worldwide.
- Growth rates in developed economies are expected to turn negative in the short term and are likely to remain lower over the next few years as the global economy struggles with the ongoing effects of deleveraging.
- Since low GDP growth tends to weigh on corporate profits, capital appreciation of equities, in particular, is likely to be subdued in the coming years—especially when compared to returns investors saw in the '80s and '90s.
- During periods when capital appreciation is muted, income tends to be a relatively important component of total return.

Low growth rates in the U.S., Japan and Europe are projected to turn negative



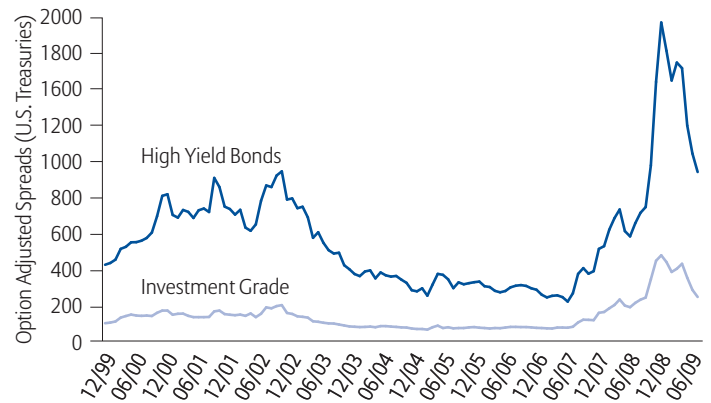
Source: IMF.

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Investors may need to draw on a wider opportunity set for income

- In an environment in which Treasuries—a traditionally reliable source for income—are producing unusually low returns, investors may need to access a wider tool set to find the income they need. High yield and investment grade corporate bonds, for example, currently offer more attractive income than Treasuries (see chart, right).
- Any economic recovery in the foreseeable future is likely to be fraught with volatility, making the case for a diversified approach to income generation.
- Investors may wish to consider assets with a low correlation, or tendency to move in tandem, with traditional income holdings in an attempt to achieve an attractive risk/reward balance.

Relative to Treasuries, corporate bonds may be a better source of income



Source: Bloomberg. Past performance is no guarantee of future results. Data through 6/30/09. High yield bonds are represented by the Merrill Lynch High-Yield Bond Master II Index. Investment grade corporate bonds are represented by the Barclays Capital U.S. Credit Index. Unlike corporate bonds, Treasuries involve government guarantees as to the timely payment of interest and principal.

There are a number of compelling income opportunities in today's markets

- Due to market dislocations there are significant values available in higher grade bonds relative to historical norms. As a result, conservative investors may want to consider a high-quality, multi-sector, actively managed bond fund—one that is primarily focused on income and employs rigorous bottom-up research.
- Investors who are willing to accept greater risk in exchange for greater income potential might also consider high yield bonds, which have become more diversified. For example, between 1999–2002, 42% of the high yield market was in tech-

nology, media and telecommunications. Today, however, very few industries have even a 10% weighting in the benchmark.

- Convertible bonds pay a yield that is often higher than the dividend yield of the issuer's common stock, giving them attractive income potential. Also, because they give bond holders an option to exchange bonds for a specified number of shares of common stock, they also provide investors with capital appreciation potential should the underlying stock rally. Convertibles may not participate in equity market rallies as robustly as some stocks will.

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Past performance is no guarantee of future results. Each sector of the bond market entails risk. Shareholders of a municipal bond fund will, at times, incur a tax liability, as income from these funds may be subject to state and local taxes and, where applicable, the alternative minimum tax. The guarantee on Treasuries, TIPS and Government Bonds is to the timely repayment of principal and interest. Shares of mutual funds that invest in them are not guaranteed. Mortgage-backed securities are subject to prepayment risk. With Corporate bonds there is no assurance that issuers will meet their obligations. High-yield bonds typically have a lower credit rating than other bonds. Lower rated bonds generally involve a greater risk to principal than higher rated bonds. Investing in non-U.S. securities may entail risk as a result of foreign economic and political developments; this risk may be enhanced when investing in emerging markets. In an environment where interest rates may trend upward, rising rates will negatively impact most bond funds, and fixed income securities held by a fund are likely to decrease in value. Bond funds and individual bonds with a longer duration (a measure of the expected life of a security) tend to be more sensitive to changes in interest rates, usually making them more volatile than securities with shorter durations.

This commentary is presented only to provide information on investment strategies and opportunities. The material contains the current opinions of the author, which are subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.

Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions, or other expenses of investing. One cannot invest directly in an index. The Merrill Lynch High Yield Bond Master II Index tracks the performance of below investment grade U.S. dollar denominated corporate bonds publicly issued in the U.S. domestic market. Barclays Capital U.S. Credit Index is the U.S. component of the U.S. Government/Credit Index.

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