

Opportunities Within High-Grade Bonds

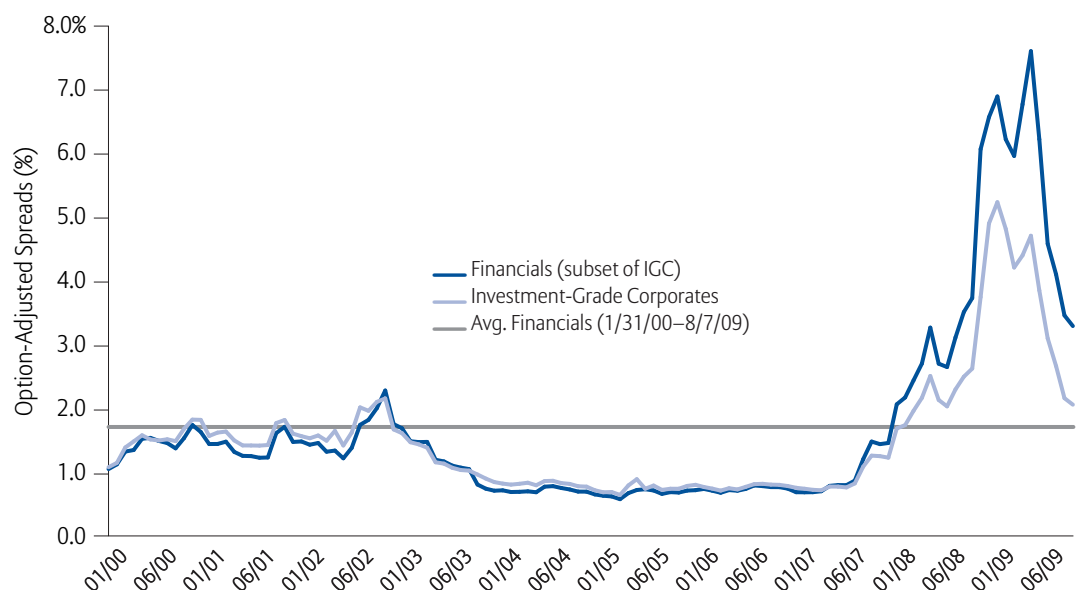
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Executive Summary: Late last year, investment-grade corporate bond spreads traded at their widest levels in 75 years¹—an attractive dislocation in the market caused by the ongoing financial crisis. While these spreads have tightened since then, opportunities remain within certain high-grade industries. This could translate into **equity-like total return potential** for select issues—even though bonds rank higher than stocks in a company’s capital structure and typically entail less risk.

High spreads and low default rates suggest opportunity in select corporate bond sectors

- During the credit crisis of 2008, corporate bonds were sold at very low prices because of little demand for, and little issuance of, corporate debt. This drove up their “spreads” (excess yields) over Treasuries, whose yields had fallen during investors’ initial flight to safety. Since then, these spreads have compressed, but certain high-grade corporate bond industries still look attractive thanks to their excess yields and other strengths.
- For example, while off from their March 2009 high, financials are still showing relatively high spreads of 3.3%.¹ Other factors, such as government investment in certain issuers deemed “too big to fail,” also make financials a high-grade bond industry worth considering.
- Attractive spreads can also be found in utilities, which offer the added benefit of tangible assets that may help them recover in the event of a downgrade; and in pipelines, which have consistent access to capital and stable cash flows.
- Overall default rates of investment-grade corporates remain low at 0.4%, particularly when compared with the 11% default rate for high-yield issues.² This, plus the attractive spreads and inherent strengths of certain industries in this volatile environment, indicates that discerning high-grade bond investors are being well-compensated for taking on excess risk over low-yielding Treasuries.

Spreads of select investment-grade bond industries, like financials, are still higher than their historical averages and higher than investment-grade corporate bonds as a whole



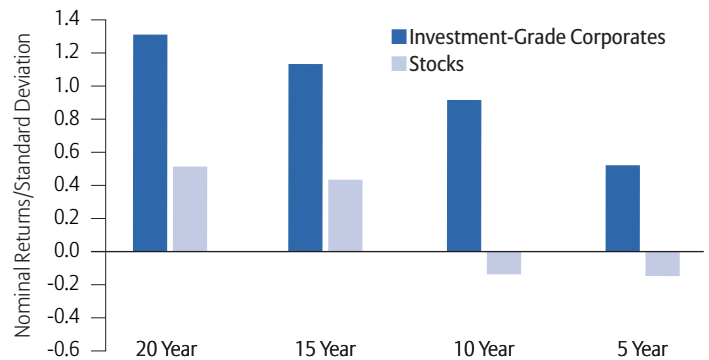
1. Source for chart and text: Barclays Capital U.S. Credit Index. Data as of 8/7/09. This chart is not indicative of the past or future performance of any Allianz Global Investors product.
2. Moody’s, June Default Report, published 7/8/2009.

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Investment-grade issues may offer equity-like return potential with lower risk

- Over the past twenty years, the stock market and the investment-grade corporate bond market have generated similar returns, yet stocks have had nearly three times the volatility.³
- Investors should also remember that bondholders (as lenders) are higher up the capital structure than stockholders (who are owners), which means bondholders are generally in a better position than stockholders to potentially recover losses in case of default.
- While equity markets should eventually recover, they are likely to follow a recovery in the credit markets as weak economic growth weighs on corporate profits.

Corporates compare favorably to stocks on a risk/reward basis



Source: Merrill Lynch as of 06/30/09. This chart is not indicative of the past or future performance of any Allianz Global Investors product. Return per unit of risk is calculated by dividing nominal return by standard deviation. Investment-grade corporates and stocks represented by the Merrill Lynch Investment Grade Index and S&P 500 Index.

Investor interest in high-grade corporates is expected to rise

- Conservative investors may continue to move out of traditional Treasuries and agencies into higher-yielding, high-quality corporate bonds, creating a main inflow to the asset class.
- Investors in riskier areas, such as stocks, may also begin to pursue the relatively attractive returns that have recently been available in investment-grade corporates. In the first half of 2009, investment-grade credit returned 6.9%, while equities returned 3.2%.⁴ Of course, past performance is no guarantee of future results.
- Longer term, demographic trends suggest aging populations will turn toward the relative stability of high-quality bonds versus stocks.
- These trends may result in additional spread-tightening for corporate bonds. Accordingly, corporate bond holders could realize additional capital appreciation, since bond prices generally rise as their yields fall.

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3. Source: Merrill Lynch as of 6/30/09. For the 20-year period, the S&P 500 Index returned 7.75% with a standard deviation of 14.97. The Merrill Lynch Investment Grade Index returned 7.17% with a standard deviation of 5.41.

4. Source: Barclays (Barclays Capital U.S. Credit Index) and Bloomberg (S&P 500 Index). Data represents total returns from 12/31/2008 through 6/30/2009.

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Past performance is no guarantee of future results, and current and future holdings are subject to risk. Investment-grade corporate bonds involve a fixed rate of return if held to maturity and fluctuate in value in response to changes in interest rates. The credit quality of a particular security or group of securities does not ensure the stability or safety of an overall investment portfolio. Corporate debt securities are subject to the risk of the issuer’s inability to meet principal and interest payments on the obligation, and may also be subject to price volatility due to such factors as interest-rate sensitivity, market perception of the creditworthiness of the issuer and general market liquidity. Investments may be worth more or less than the original cost when redeemed. Although an investment in Treasuries is backed by the full faith and credit of the United States in terms of the timely payment of interest and principal, the value of Treasuries will fluctuate in response to changes in interest rates. An investor who sells a Treasury security before maturity can experience a gain or loss. Equities have tended to be volatile, involve risk to principal and, unlike bonds, do not offer a fixed rate of return. Standard deviation is an absolute measure of volatility measuring how widely the returns varied around the average over a certain period of time. The greater the degree of dispersion, the greater the risk. The Standard & Poor’s 500 Stock Price Index is an unmanaged market index generally considered representative of the stock market as a whole. The Merrill Lynch Investment Grade Index is an investment-grade index including bonds across the maturity spectrum within the investment-grade universe. The Barclays Capital U.S. Credit Index is the credit component of the U.S. Government/Credit index. It includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity and quality requirements. To qualify, securities must be rated investment grade (Baa3 or better) by Moody’s. The index is the same as the former U.S. Corporate Investment Grade Index. 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. It is not possible to invest directly in an unmanaged index.

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