Quarterly investment review

# Dorset County Pension Fund

3rd Quarter 2016

Allianz Global Investors

**Understand. Act.**

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## Client contact


Jo Wheatley
Telephone: +44 (0)20 3246 7573
Mobile: +44 (0)7701 397806
Email: joanne.wheatley@allianzgi.com


## Administration


UKICSTeam@allianzgi.com

Allianz Global Investors GmbH
199 Bishopsgate
London, EC2M 3TY

Telephone: 44 (0)20 3246 7000
Web site: www.allianzgi.com

# Section one

# Key points

## Mandate

- Best Styles Global Strategy managed on a segregated basis.
- The Best Styles team implement a well-diversified blend of the five long-term successful investment styles Value, Momentum, Earnings Revisions, Growth and Quality.

## Investment objective

- The investment objective of the Portfolio is to maximize excess returns relative to the Benchmark, targeting an annualized excess return of 1-2% per annum net of fees over a rolling 3 year period with a tracking error in the range of 1-3% p.a.

## Inception date

- The inception date for the portfolio is 17 December 2015.

## Change in value

- Closing value of GBP 240,602,011 as at 1 July 2016.
- Closing value of GBP 240,284,850 as at 30 September 2016.
- There was a net redemption of £20,000,000 during the period.

## Recent performance

- The portfolio returned 8.22% versus the benchmark return of 7.92% for the quarter ending 30th September 16.

# Performance

## Recent performance

| Returns to 30 September 2016 | Portfolio (Gross) | MSCI World TR | Relative |
|---|---|---|---|
| Quarter | 8.22% | 7.92% | 0.30% |

## Long term performance

| Returns to 30 September 2016 | Portfolio (Gross) | MSCI World TR | Relative |
|---|---|---|---|
| Year to date | 17.10% | 19.76% | -2.66% |
| Since inception 17 Dec 2015 | 18.56% | 21.55% | -2.99% |

Portfolio Return - Gross of fees/total return/GBP

[1] Annualised

# Section two

# Market review

- Global equities rallied over the quarter, recovering from a sharp sell-off at the end of June following the UK's unexpected referendum result. Signs of improvement in China's economy also supported share prices. The information technology sector led the advance, and the financials, materials, consumer discretionary and industrials sectors also posted meaningful gains. However, after robust returns in the first half of the year, more defensive sectors, such as consumer staples, telecommunication services and utilities, retreated as investors rotated into more cyclical stocks.

- US equities rallied modestly over the quarter, with the S&P 500 Index touching new record highs, helped by better-than-forecast company earnings and generally supportive economic news. However, some weak economic data reports weighed on the market in September, as did an increasing focus on November's presidential election.

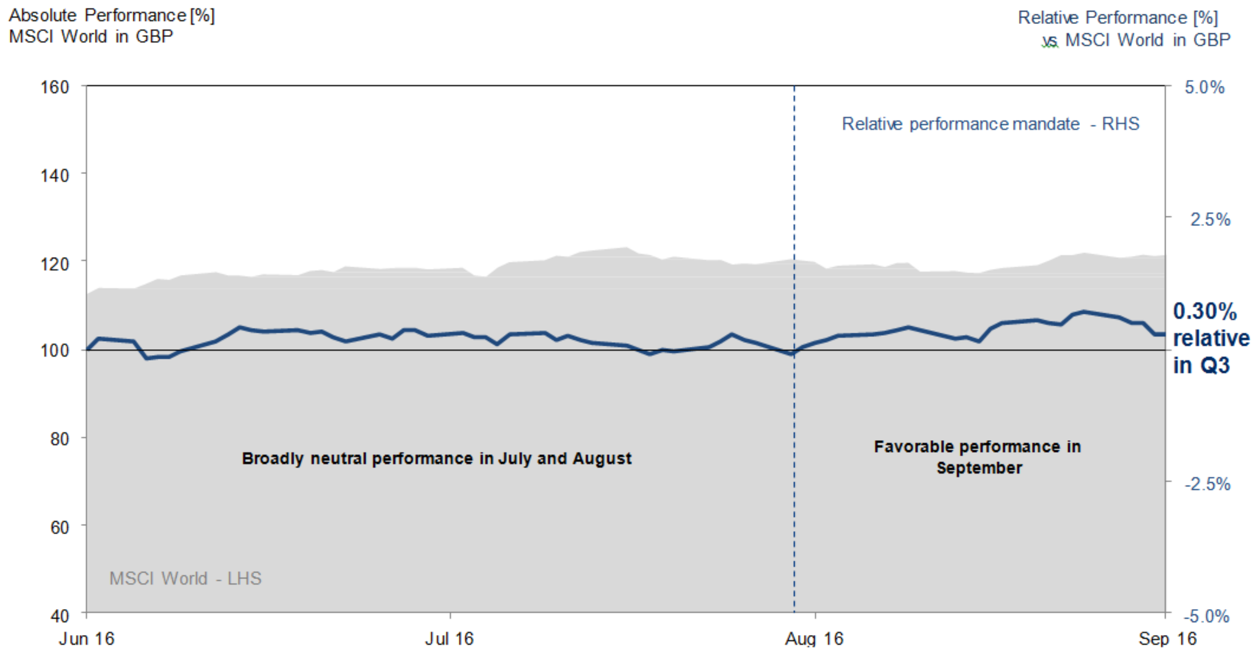
- European equities advanced over the quarter, as they continued to recover from their sharp sell-off in the wake of Brexit. Returns at a country level were mixed, with Germany posting robust gains while Denmark retreated. Japanese equities overcame disappointing economic news to deliver robust returns over the quarter, boosted by stimulus measures from both the government and the Bank of Japan. However, the strength of the yen continued to present headwinds, with surveys of manufacturing activity continuing to fall, while the purchasing managers' index of service sector activity fell below 50 in August, also indicating a contraction.

- Emerging market equities delivered robust returns over the quarter, with the MSCI Emerging Markets Index touching its highest level in over a year in September. All three regions gained, with Asia leading the advance, followed by Latin America and then Eastern Europe.

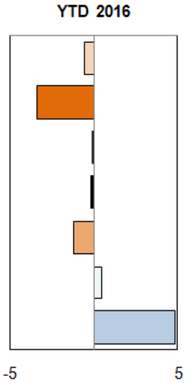
# Portfolio review

- The mandate outperformed its benchmark by 30bps over the third quarter with broadly equal contributions from all investment styles. Portfolio construction and successful stock selection in Consumer Discretionary, Financials and IT contributed to outperformance.

## Dorset County Pension Fund: Absolute and Relative Performance to 30 September 2016



## Relative performance of investment style vs MSCI World over the last 9 months




| | Jan-16 | Feb-16 | Mar-16 | Apr-16 | May-16 | Jun-16 | Jul-16 | Aug-16 | Sep-16 | Q1 16 | Q2 16 | Q3 16 | YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Value | -1.8 | 0.3 | 1.1 | -0.4 | -0.6 | -2.9 | 1.7 | 2.5 | -0.3 | -0.5 | -3.8 | 3.9 | -0.6 |
| Growth | -0.7 | -0.9 | 0.1 | -0.9 | 0.4 | -0.4 | 0.0 | -1.7 | 0.6 | -1.5 | -0.9 | -1.1 | -3.4 |
| Revisions | 0.8 | -0.8 | 0.0 | -0.3 | 0.7 | 2.1 | -0.7 | -2.6 | 1.0 | 0.0 | 2.4 | -2.4 | 0.0 |
| Momentum | 0.7 | -0.6 | -0.6 | -1.0 | 1.5 | 3.3 | -1.8 | -2.2 | 0.6 | -0.5 | 3.8 | -3.3 | -0.2 |
| Quality | 1.0 | -0.9 | 0.1 | -1.2 | 1.2 | 0.6 | -1.1 | -0.7 | -0.2 | 0.2 | 0.6 | -2.0 | -1.2 |
| Risk | -4.9 | 1.0 | 1.3 | 2.4 | -0.7 | -2.0 | 2.4 | 1.2 | -0.2 | -2.7 | -0.3 | 3.5 | 0.4 |
| Size | -0.3 | 0.9 | 1.4 | 1.3 | -0.5 | -0.7 | 1.2 | 0.8 | 0.6 | 2.0 | 0.1 | 2.6 | 4.8 |

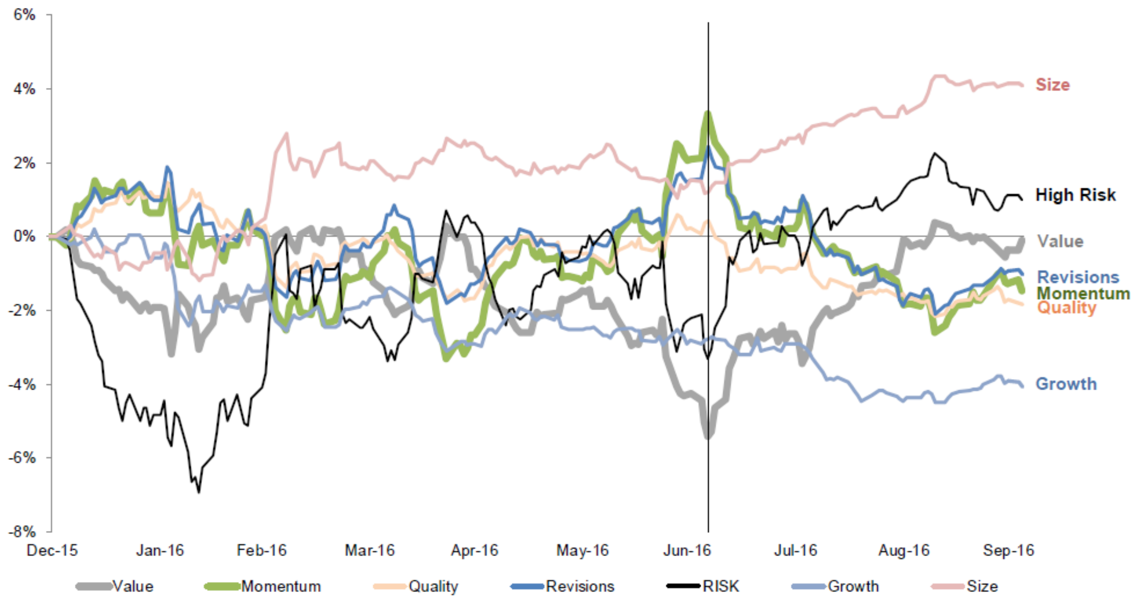
Performance of long-only, region and sector neutral style mimicking equal overweighted portfolios against MSCI World.
Source: Allianz Global Investors as of 30/09/2016.

- The third quarter turned out to be decisively risk-on, which helped higher beta investment styles like value and small caps. The investment style value, our most prominent investment style, outperformed the index strongly by 3.9%, making a significant contribution to the portfolio's relative performance. This risk-on environment was detrimental for lower beta investment styles like high quality and stable growth, and also for trend following investment styles like price momentum or earnings revisions that currently exhibit a lower beta profile. Performance of value and trend-following strategies in Q3 was essentially the opposite of the performance seen in Q2.

- Trend following investment styles like price momentum strategies, earnings revisions strategies and stable growth strategies have struggled in Q3, which whilst they detracted from performance did not offset the gains from investment style value , making Q3 a positive quarter for the mandate.

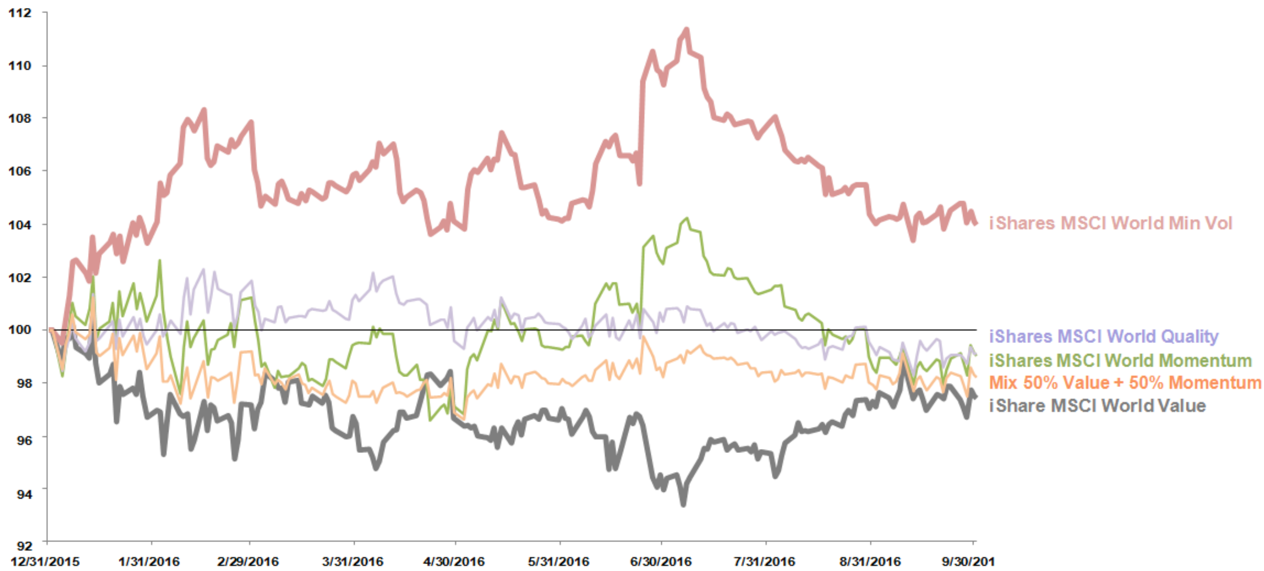
- 2016 has been a challenging year for global style investors. This can be seen in the relative performance of global investment styles vs the MSCI Index, as well as in the returns of the MSCI factors themselves.

## Relative performance of global investment styles vs MSCI World Index




Source: Allianz Global Investors as of 5 October 2016. Calculations are performed by the portfolio management team. Not independently verified.

## Relative performance of iShares MSCI World Factor ETFs year to date 2016




Source: Allianz Global Investors, MSCI, Bloomberg. Figures as of Sept 30th, 2016. Past performance is not indicative of future results.

## Why has performance been weak and what action have we taken?

## Relative performance of global investment styles vs MSCI World over the year to date

| 2016 relative performance of investment styles | | | | | |
|---|---|---|---|---|---|
| *Relative performance vs. MSCI Indexes* | YTD 2016 Europe | Japan | US | World | Emerging Markets |
| **Value** | -2.0% | 3.8% | -0.9% | -0.1% | 5.3% |
| **Growth** | -2.7% | -7.2% | -6.9% | -4.5% | -4.5% |
| **Revisions** | -1.3% | -5.3% | -2.0% | -1.9% | -1.8% |
| **Momentum** | 1.0% | -5.0% | -2.2% | -2.0% | -4.0% |
| **Quality** | -0.6% | 0.4% | -3.6% | -1.7% | -2.4% |

| Long term relative performance of investment styles | | | | | |
|---|---|---|---|---|---|
| *Relative performance vs. MSCI Indexes* | Since 31/12/1986 Europe | Japan | US | World | Emerging Markets |
| **Value** | 2.9% | 3.7% | 1.6% | 3.7% | 5.1% |
| **Growth** | 2.1% | 0.0% | 0.2% | 1.2% | 0.2% |
| **Revisions** | 3.0% | 0.0% | 1.2% | 2.6% | 0.0% |
| **Momentum** | 2.5% | -0.8% | 1.1% | 1.2% | 0.9% |
| **Quality** | 2.3% | 0.8% | 0.6% | 1.2% | -0.5% |

- Most traditional investment styles have been struggling in 2016 as a result of strong outperformance by lowest risk stocks, driven by the ultra-low interest rate policy of global central banks. Central bank policy has been triggering flows from fixed income into bond-like equities, i.e. lowest risk stocks with some dividends

- Lowest risk stocks offer neither value, growth nor earnings upgrades hence flows are driving outperformance of non-value, non-growth or non-revision stocks to the detriment of our key investment styles value, growth and revisions

- In our view, ultra-low interest rate policy has established 'lowest risk stocks' as a new risk factor within equities, on equal terms with established risk factors like sector or regions or market beta.

- Within our risk management overlay we have implemented additional constraints to ensure the relative performance of the portfolio is not impacted further by the relative performance of lowest risk stocks vs highest risk stocks.

# Portfolio outlook

## We see equity markets driven by the following factors:

### Structural trends

- Deleveraging in industrialized countries is likely to last and has led to lower trend growth compared to before the great financial crisis. Support from monetary policy and negative real interest rates are likely to stay for longer even with the Federal Reserve having entered the rate hiking cycle. Monetary policy will remain supportive for valuation levels of risky assets as the Bank of Japan (BoJ) as well as the European Central Bank (ECB) might further ease monetary policy in order to stimulate growth and inflation. Hence, we don't see a change to the global macro picture – the long low-growth cycle continues to drag on. A severe slowdown of growth seems equally unlikely as a notable acceleration of growth.

### Cyclical swings

- Global leading indicators have peaked in autumn 2014 and have retreated for about 18 months to reach levels in 2016 that are now signalling an uncomfortable high probability of a recession. However, more recently, indicators have improved slightly and growth concerns have abated.

- GDP growth most likely rebounded in the second quarter of this year, to around 2.7% on a q/q annualised basis on preliminary data. This was largely due to pick-up in growth in China while aggregate growth in developed economies has slowed steadily since mid-2015, reflecting a series of disappointing GDP numbers from the US. More forward looking, global composite PMI did move higher to 51.7, the highest level since January - but it is effectively range-bound between 50 and 55 since 2011. Over the last years, growth has been a scarcity with companies not being able to increase earnings on average. However, analysts are now looking much more positive at company earnings with the number of earnings upgrades being on a five year high. Encouragingly, revenue forecasts have also started to rise for the first time in recent years meaning that companies increasingly don't need to rely solely on cost cutting to drive bottom-line earnings growth.

### Regional perspective

- In the US, business surveys rebounded from the late summer dent, both for the industrial sector and for the (more important) service sector, with ISM service indicators even soaring to its highest level since October last year. Hence, the US services sector continues to remain strong, while the US industrial sector has recovered with the drag on investment and exports from the past slump in oil prices and rise of the dollar easing. Despite declining in October, the University of Michigan measure of consumer confidence remains at a fairly high level and consistent with a decent rate of consumption growth of more than 3% annualized. Overall, US growth is likely to have picked up again in Q3 after some weaker data during late summer.

- In the Eurozone, the backdrop of a growing, but not very dynamic, Eurozone economy amid low inflation pressure is unlikely to change. The economy has shown no obvious ill effects from the UK's vote to leave the European Union. Eurozone business surveys have rebounded from their declines of previous months, but the underlying trends have been sideways since early 2015. The economy-wide Economic Sentiment Indicator (ESI) edged up from 103.5 to 104.9, better than the consensus expectation of an unchanged reading driven by a sharp increase in industrial sentiment to a five-year high, while sentiment in the service sector remained unchanged.

- In Japan, the improved PMI reading went hand-in-hand with y/y industrial production growth jumping to 4.6%, the highest level since March 2014, and the upward revisions to Q2 GDP growth. The government has passed a large fiscal stimulus package a few weeks ago which will support growth momentum going into 2017.

- In China, growth has been stable since early 2015, as the ramping up of policy support has helped contain downward pressures on the economy over the past year. And we expect growth to accelerate over the second half of this year as the lagged effects of previous policy stimulus feed through. However, we expect China to slow again in 2017/18 as policy stimulus is withdrawn and an overhang of debt starts to drag on growth. Authorities have already imposed curbs on property prices that are running hot. More fundamentally, we believe that China's potential growth rate has dropped to around 4.5% and that it will continue to decline without significant structural reform.

## Risks

- Potential risks are coming from a potential Trump win at the US presidential election. There is not much consensus regarding how markets will ultimately react should Donald Trump win the presidential elections as the outlook for the US would be much more uncertain due to the reason that it is unclear how many of his sometimes radical plans he would be able to implement.

- At a European level, the Brexit vote might further fuel a further rise in anti-EU sentiment across the region and reignites doubts over the future of the currency union. A defeat of PM Renzi at the constitutional referendum in Italia in autumn might result in a general election and a potential EU referendum, which might trigger a new Euro crisis.

- Furthers risks are coming from a slowdown in China as the effect of the policy stimulus fades out, or a stronger than anticipated rise in interest rates in the US.

- In our base scenario, we expect equities to grind higher on the back of a ongoing economic recovery, still accommodative monetary policy and reasonable valuations. Global equities currently trade on a trailing Price/Earnings-Ratio of 17x, in line with the long-run median. Historically, there is little evidence that current valuation levels may hinder risky assets from appreciating any further. On the contrary, history clearly shows that as long as monetary policy is highly accommodative and rates remain below "neutral" levels, i.e. a level at which the economy is running at around trend growth, risky assets tend to do well and outperform bonds.

## Four different scenarios for the US election

| | | |
|---|---|---|
| ***Trump* wins the General Elections** | ***Republicans* keep the majority in the Senate** | **Scenario 1**<br>the worst scenario<br>with highest uncertainty for the US economy and highest volatility for the financial markets |
| | ***Democrats* win the majority in the Senate** | **Scenario 2**<br>least worst scenario<br>as the majority of Democrats in the Senate would make the enforcement of the more controversial points on Trump's agenda less likely<br>(e.g. on health care, energy, finance services, etc.) |
| ***Clinton* wins the General Elections** | ***Republicans* keep the majority in the Senate** | **Scenario 3**<br>the best scenario<br>- Clinton is viewed as a candidate representing continuity<br>- a majority for the Republicans in the Congress would not allow disruptive reforms |
| | ***Democrats* win the majority in the Senate** | **Scenario 4**<br>a less agreeable scenario than # 3<br>as there will be a room for major Democratic (leftish) reforms |

## Clinton vs Trump

## Implications for stock market segment

| Stock Market Segment | Clinton | Trump |
|---|---|---|
| Energy | Favours alternative energy over traditional energy. | Favours traditional energy over alternative energy. |
| Banks | Higher taxes and more regulation in banks/hedge funds | Higher taxes and more regulation on banks/hedge funds |
| Defense | At least maintaining current spending on defense | More spending on defense |
| Health Care | Affordable Care Act will be maintained, more regulation on health care costs will put margin pressure on pharma/biotech stocks and health care service providers | Affordable Care Act will be abolished which will result in far less generous subsidies and fewer people insured which would hurt hospitals and managed care companies. |
| Construction | More spending on public infrastructure | ? |
| Companies with many low paid workers | Increase in nation-wide min wage will hurt companies with many low paid workers like restaurants or retailers | Does not support a federal minimum wage |
| Large Multi-Nationals vs smaller domestic stocks | - TTIP might not be ratified, which will hurt international trade but might benefit smaller domestic names<br>- Tax incentives to bring back jobs to the U.S will hurt international trade | - TTIP will not be ratified, which will hurt international trade but might benefit smaller domestic names<br>- Introduction of tariffs will risk a trade war<br>- Tax incentives to bring back jobs to the U.S will hurt international trade but might benefit smaller domestic names |

## AllianzGI strategist Kristina Hooper on the US Elections

- Stock market likes predictability, it does not like change. Hillary Clinton's presidency would be perceived as something of a continuation of President Obama's administration. While that administration is not viewed as having business-friendly policies, there is perhaps some slight upside with a Clinton victory if she is able to move closer to the centre politically than Obama.

- Clinton's pledge to minimum wages from $8.50 to $15 is a concern for companies like restaurants or retailers with a high proportion of lowly skilled, lowly paid workers.

- Clinton is generally thought to have tougher stances on regulation in big finance and health care.

- The market has not priced in fully the potential for a Trump victory. From the Brexit vote and the Colombian elections, it is possible that polls are wrong – specifically, voters will not be honest with pollsters if they perceive their position to be unpopular. Therefore, the possibility of a Trump victory needs to be hedged.

- A Trump presidency would likely see less financial services regulation and there is also the possibility that Trump's Fed will raise rates more quickly.

- Trump has promised more defense spending, so Defense stocks are likely to perform well in case of an unexpected Trump victory.

- Infrastructure is a beneficiary – both debt and equity, as both candidates have infrastructure as a key priority.

- Trump wants to roll back the Affordable Care Act, which would hurt hospitals, and he would be unlikely to regulate pharmaceuticals / biotechnology.

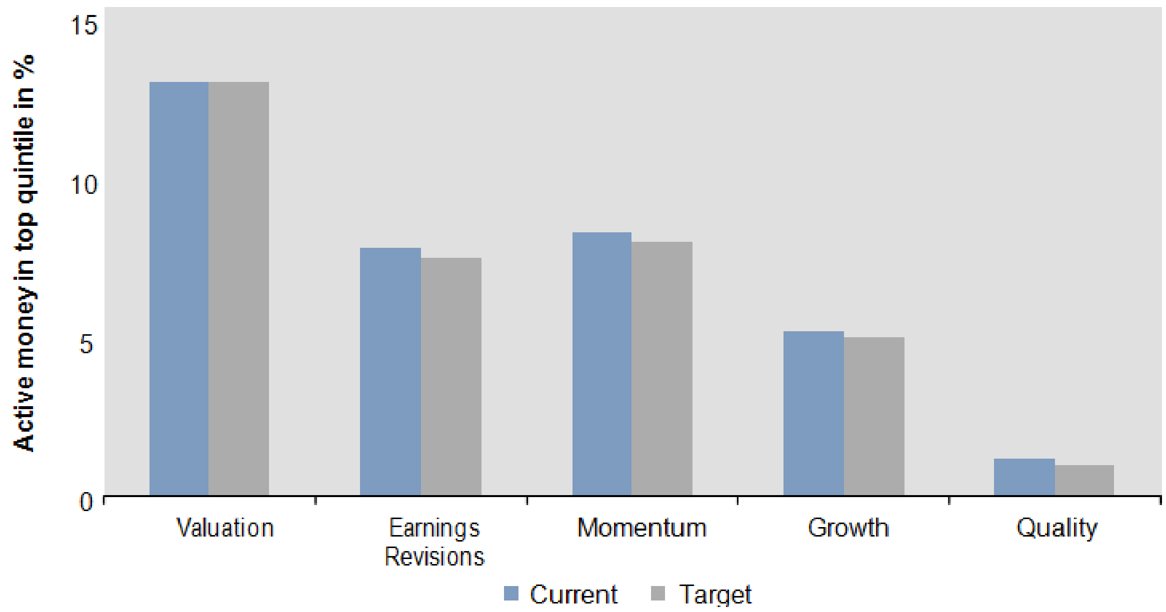
- A Trump victory would result in concerns of a trade war – hurting multinationals, but benefiting companies deriving a significant portion of revenues from the US.

- Trump pledge to deport illegal immigrants as well as his focus on seeing interest rates rise Therefore, Housing is a risky sector for an unexpected Trump victory.

## Strategy outlook - Allocation to investment styles Q4 2016

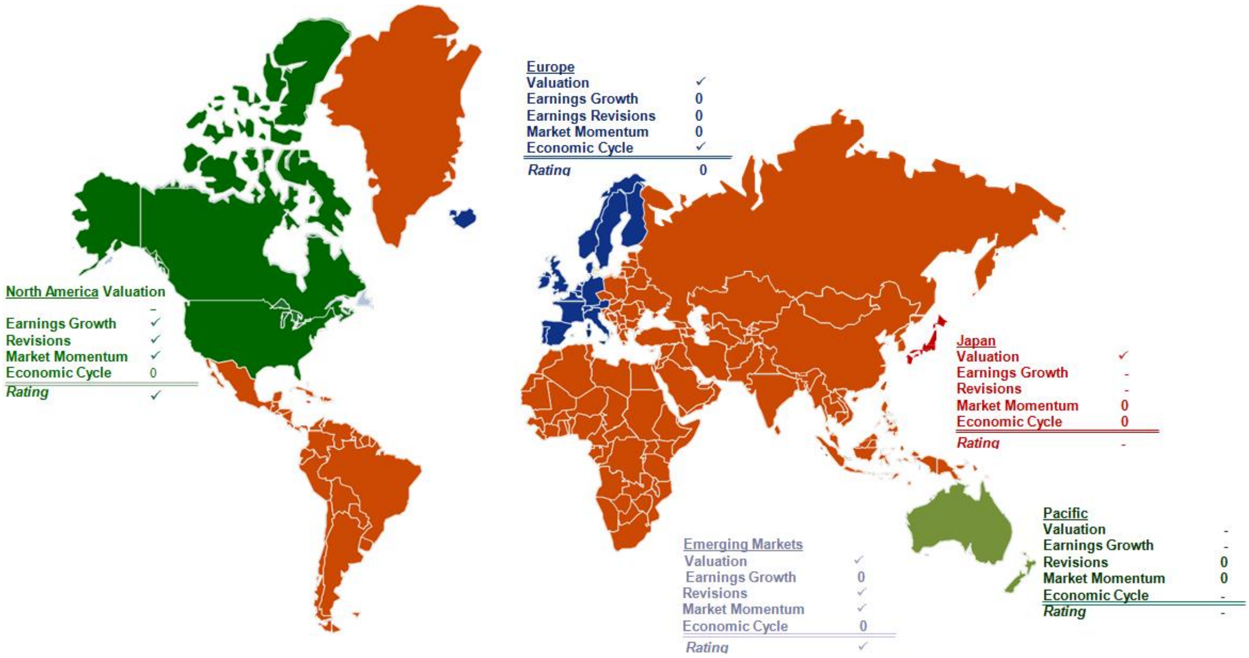
- Overweight in stocks with attractive valuation and positive momentum/positive revisions, in line with the long-term investment style allocation of Best Styles.
- Analysis of performance of this investment style mix has delivered very stable outperformance over the last 25 years. Outperformance proved to be largely independent from the general economic environment and market conditions
- Historically this investment style mix has done well in the anticipated macro economic environment - some stabilization of leading indicators.

## Allocation to Investment Styles Q3 2016/Q4 2016



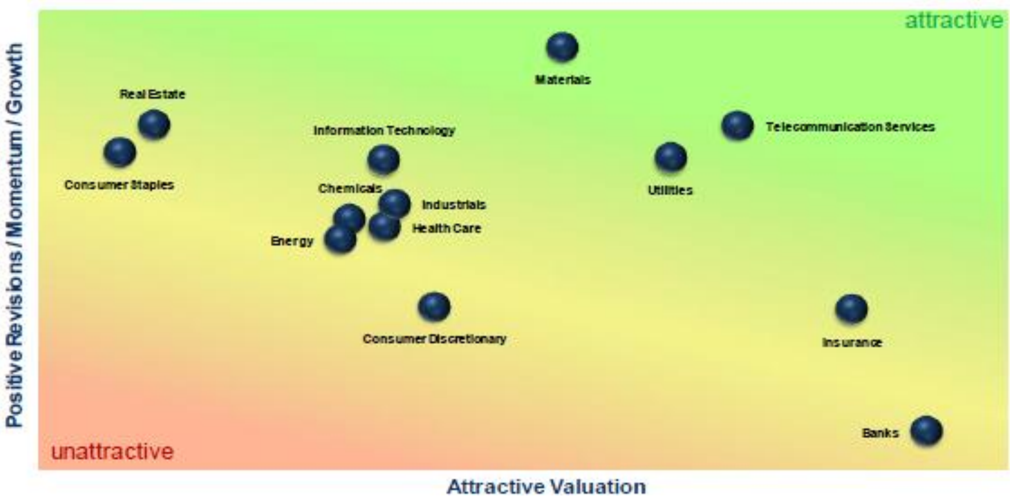

Source: AllianzGI, 2016.

## Investment style attractiveness of regions Q4 2016




- Utilities and Telecommunication Services are the most favoured defensive sectors combining attractive valuation with strong price momentum, however, both sectors have fallen recently.
- Materials have become significantly more attractive during recent months, and are currently the most preferred cyclical sector offering a combination of strong momentum at a slightly better than average valuation. Most other cyclical sectors are similar and trade at comparable Valuation levels, but Consumer Discretionary significantly lost momentum.
- Financials have seen their readings weaken over the last months due to falling earnings revisions and price momentum.
- In our portfolio, we seek a balanced exposure to cyclical and defensive sectors targeting a performance profile that is largely independent of the economic cycle.

## Investment style attractiveness of global sectors in Q4 2016



# Market outlook

- The world economy should remain on a moderate growth path during the fourth quarter. Growth in the US is still robust and benefiting from the expansionary monetary policy and a better economic environment, which boosts corporate profits. In the euro area, the improving labour market situation should prop up household consumption.

- Moreover, the international central banks' expansionary monetary policy is an argument in favour of equity investments, as bond investments are increasingly becoming less attractive. However, the elbowroom of the central banks is narrowing. Despite the risks, which doubtless exist (political uncertainties, weak corporate earnings growth, uncertainty about the monetary policy stance of the Federal Reserve, liquidity risks, valuations in some regions), equities appear to offer good opportunities in the long run.

- Most traditional investment styles have been struggling in 2016. This is broadly in line with our past experience of weakish performance of most traditional investment styles in the context of leading indicators that are uncomfortably close to recessionary levels.

- The weak backdrop for most traditional investment styles is further exacerbated by the ultra-low interest rate policy, which is triggering the shift of flows from fixed income investors to equities, and more specifically to bond-like equities, i.e. low risk stocks with some dividends. Such stocks offer neither value, growth nor earnings upgrades, hence these flows are driving the outperformance of non-value stocks, non-growth stocks and non-revision stocks, to the detriment of our key investment styles of value, growth and revisions.

- In our view, the ultra-low interest rate policy has established lowest risk vs highest risk stocks as a new risk factor within equities, on equal terms with established risk factors like sector or regions or market beta. Therefore, in our risk management overlay we have implemented additional constraints to make sure that the relative performance of the portfolio is indeed not further impacted by the relative performance of lowest risk stocks vs highest risk stocks.

- Best Styles will continue to be overweight in stocks with attractive valuation and stocks with positive momentum and positive revisions, in line with the longer term strategic investment style mix of Best Styles Global.

# Appendix

# Investment guidelines

## Investment Restrictions and Limitations

- The Manager shall comply with and adhere to the investment restrictions and limitations provided below.

## Permitted Investments and Prohibited Investments

- Investments shall be restricted to constituents of the "MSCI World Investable Market Index (IMI)" and Bloomberg ticker MXWOIM Index ("Investment Universe").
- Investments in securities outside the Investment Universe which, e.g., may arise from stocks leaving Investment Universe or from corporate actions, shall be sold as soon as reasonably possible.

## General Restrictions

- The Portfolio shall not borrow cash, securities and/or other assets for leveraging the Portfolio. For the avoidance of doubt, short-term overdrafts which may result from operation difficulties such as "trade fails," "limit orders" or discrepancies in security settlement dates, shall not be deemed a borrowing or acts which leverage the Portfolio.
- The Securities held in the Portfolio may not be lent or be subject to a repurchase transaction.
- The Portfolio may not sell short.
- The investments of the Portfolio shall maintain reasonable liquidity at all times.

## Investment Limitation

- The maximum amount to be invested in the Securities of any one issuer is the higher of (a) 10% of the Value of the Portfolio or (b) 150% of the Benchmark weight.
- Number of different stock issuers should be 20 or more.
- No investment shall be more than 10% of the outstanding Securities of any one (1) issuer in the Portfolio.
- Investment in non-Benchmark countries shall not exceed 20% of the Value of the Portfolio.

## Cash/bank Deposits

- A deposit shall be placed with:

  i) A bank with deposit taking license which has short term credit rating of at least 'A-1' as measured by Standard & Poor's or 'P-1' by Moody's.

  ii) The custodian or its sub-custodian(s) for transaction purposes.

- Deposits with any institution authorised by the Client should not exceed 5% of that institution's issued capital and published reserves and deposits with any single institution should not exceed 5% of the assets of the Portfolio. This limit does not apply to the custodian or its sub-custodian(s).

- Deposits will be in freely convertible currencies.

- Currency transactions, both spot and forward currency contracts, shall be entered into with the Custodian or counterparties which have a credit rating of A3/A- or higher recognized by rating agencies which mean Standard & Poor's, Moody's and Fitch . In the case of a split rating, the middle of the three ratings will be applied. In case that two of the 3 ratings are same, the same rating will be applied and in the event of the issuer being rated by only two agencies, the lower rating is applicable. If there exists only one rating, that rating will be applied.

# Investment management teams

## Portfolio management – Systematic Equity team


Source: Allianz Global Investors; data as at August 2016

## Global research headcount

| | Consumer | Financial | Health Care | Industrial & Resources | Technology & Telecom & Media | ESG & Engagement | Grassroots® | Credit | **Total** |
|---|---|---|---|---|---|---|---|---|---|
| Asia | 3 | 4 | 1 | 4 | 3 | 0 | 1 | 4 | 20 |
| Europe | 4 | 4 | 3 | 9 | 5 | 7 | 2 | 10 | 44 |
| Americas | 3 | 1 | 3 | 4 | 6 | 0 | 3 | 0 | 20 |
| Total | 10 | 9 | 7 | 17 | 14 | 7 | 6 | 14 | **84** |

- An average of 15 years of industry experience
- Innovative and proprietary investment tools
- Analysts manage sector and thematic mandates
- Each analyst conducts circa 100 meetings per year with corporate management
- Research identifies the key drivers of each stock, which frames and focuses the analytical process
- Dedicated sustainability research analysts
- Complemented by Grassroots® Research

**The cornerstone of our investment process – generating information advantage**

Source: Allianz Global Investors, as at 30 June 2016.

# Disclaimer

## Valuation of investments

- Investments within the portfolio are valued as at the close of business on the valuation date using mid-market, bid or last traded prices, depending on the convention of the exchange on which the investment is listed.
- Investments in UK authorised open ended investment companies for which Allianz Global Investors GmbH is the authorised corporate Director are valued at the noon daily dealing price.
- Unlisted or suspended investments are valued on the basis of the best information available to the manager.
- Running yields attributable to equity pooled vehicles and gross redemption yields attributable to fixed interest pooled vehicles are each stated before deduction of management fees.

## Risk warning

- Please remember that past performance is not a guide to future performance. The value of an investment and the income from it can fall as well as rise as a result of market fluctuations and you may not get back the amount originally invested. You should not make any assumptions about the future on the basis of this information.
- Except for products investing exclusively in the UK, currency exposure exists in all funds. These funds will suffer a negative impact if sterling rises in value relative to the currencies in which the investments are made.

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