

SMid Investing

An Alternative or Complement to Small-Cap Equities

Over the last few decades, small-cap equities have established their place within investment portfolios, and in many cases this asset allocation decision has served investors well. More recently, investors have moved slightly up market to the SMid-cap (small- to mid-cap) universe, in pursuit of superior risk-adjusted returns, improved diversification and access to top investment teams.

While the definition of the SMid-cap universe varies, the primary benchmark is typically the Russell 2500 Index. The benchmark includes all of the Russell 2000 Index, as well as the smallest 500 stocks of the Russell 1000 Index, and its components had a market cap range of \$24.2 million to \$9.7 billion as of the end of 2010. With such a wide range of market caps, it is no surprise that the types of companies among the investable universe for SMID managers can be very different from the small-cap universe. The Russell 2500 Index includes companies that are at their earliest stages of growth and innovation as well as more mature, established companies that have a long track record and well-defined business model. This diversity offers the potential for a more eclectic portfolio that may perform well in most market environments while allowing active managers to choose from companies in a variety of stages in their respective business cycles. It is also one of many reasons that we believe that SMid-cap equities deserve a place in investor portfolios.

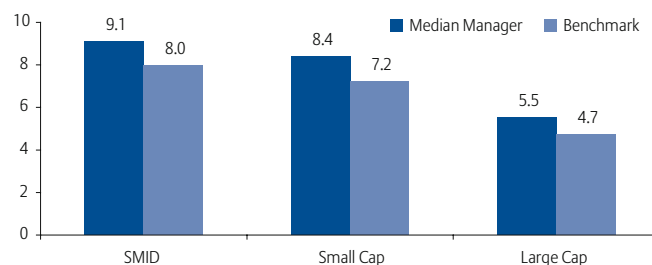
Historical Outperformance

Exhibit 1 compares the average return of the median active manager in the SMid, small- and large-cap eVestment Alliance universes over rolling 5-year periods: Over the last ten years and across multiple market cycles, SMid-cap managers have achieved the highest average returns over rolling periods. Additionally, active managers have proven a superior ability to outperform the SMid and small-cap asset classes, relative to large caps.

As shown in Exhibit 2, the average Sharpe Ratio, a measure of risk-adjusted performance, the median SMid-cap manager was higher than that of the median small-cap and large-cap managers.

Past performance is not indicative of future results. See important disclosures at the end of this presentation.

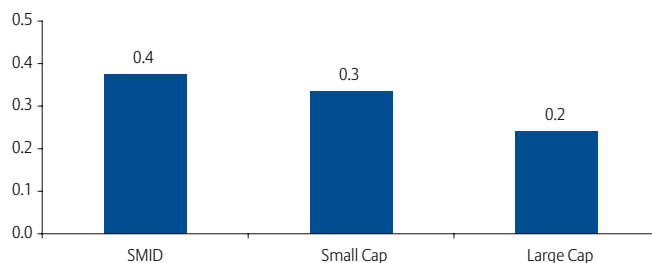
Exhibit 1: Average 5-year Return of Median Manager



Data as of December 31, 2010. Average of rolling 5-year periods, measured quarterly, over 10 years. Median manager represents median performer within respective eVestment Alliance manager universe. The index and universe information shown were obtained from eVestment Alliance. A fee was paid to eVestment Alliance for access to and use of the analysis. Past performance is not indicative of future results.

Not only did SMid-cap managers exhibit higher total returns over this period, but they were also able to achieve a superior Sharpe Ratio. The Sharpe Ratio measures risk-adjusted returns by dividing the excess return of a portfolio compared to the risk-free rate by the standard deviation of the portfolio's returns.

Exhibit 2: Average 5-year Sharpe Ratio of Median Manager



Data as of December 31, 2010. Average of rolling 5-year periods, measured quarterly, over 10 years. Median manager represents median performer within respective eVestment Alliance manager universe. The index and universe information shown were obtained from eVestment Alliance. A fee was paid to eVestment Alliance for access to and use of the analysis. Past performance is not indicative of future results.

Diversification Benefits

Historically, small- and large-cap equities have demonstrated wide dispersion of returns in various market environments. As such, many investors have controlled their portfolio's overall volatility by allocating to both asset classes. Because this diversification is an important risk management tool for many investors, it is important to note that SMid-cap stocks are highly correlated with small-cap stocks, while both demonstrate similarly low correlation with large-cap stocks (Exhibit 3). As a result, investors may elect to utilize a SMid-cap manager in place of or as a complement to a small-cap allocation without materially affecting correlation characteristics and the resulting diversification benefits.

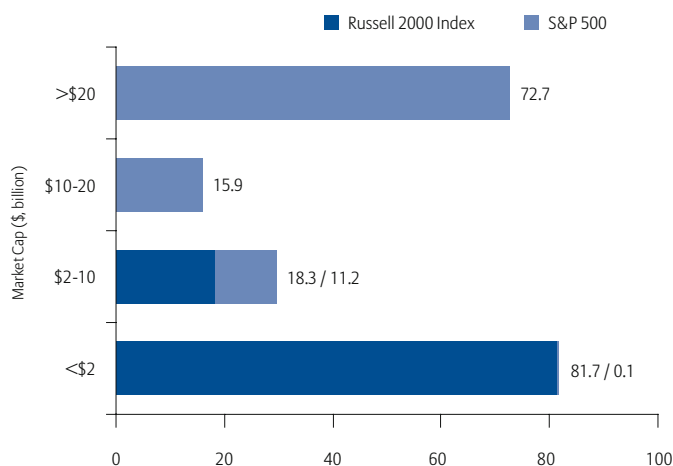
Exhibit 3: Historical Correlation Matrix – 20 years through December 31, 2010

	S&P 500	Russell 2000 Index	Russell 2500 Index
S&P 500	1	0.79	0.85
Russell 2000 Index	0.79	1	0.99
Russell 2500 Index	0.85	0.99	1

Data as of December 31, 2010. Measured quarterly. Source: FactSet.

Furthermore, an investor may see even greater diversification from a combined allocation to SMid- and large-cap equities because it includes a broader opportunity set than an allocation to only small- and large-cap equities. A combination of the S&P 500 and Russell 2500 Index captures a large swath of mid-cap names that are excluded from both the S&P 500 and Russell 2000 indexes (Exhibit 4).

Exhibit 4: Universe Coverage

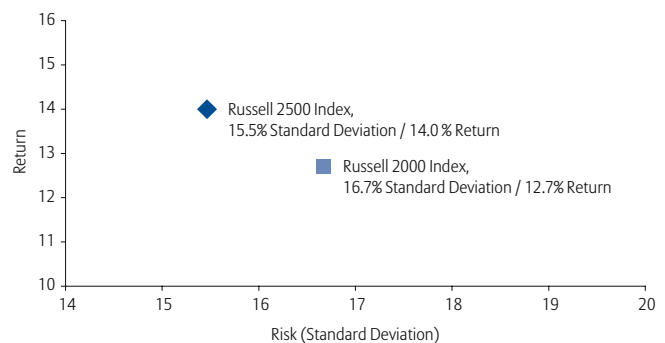


Data as of December 31, 2010. Past performance is not indicative of future results. Source: FactSet.

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But why would you invest in SMid over small? One reason is that many of the best small-cap funds are closed to new investors, and it can be difficult to find available capacity among these managers. In fact, of all the funds in the three Morningstar Small Cap universes with five-star overall ratings, more than 49% by assets, are closed to new investors. Fortunately, most SMid-cap strategies are managed by teams that also manage small-cap strategies, allowing investors to access funds with nearly identical investment processes that do not have such restrictive capacity controls. Further, SMid-cap equities can offer a better risk/return profile with similar diversification benefits. SMid-cap stocks, as shown in Exhibit 5, have produced stronger average returns with less volatility than small-cap stocks. As such, investors seeking to allocate to a talented small-cap manager may benefit from an allocation to a SMid-cap fund.

Exhibit 5: Average Annual Return – 20 years

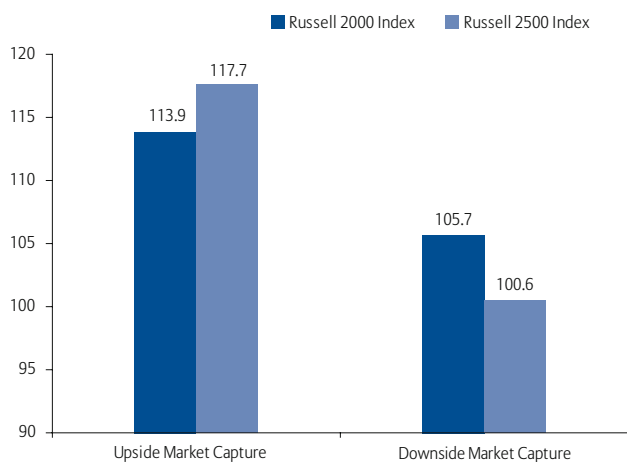


Data as of December 31, 2010. Average of 20 calendar year returns and standard deviation, measured quarterly. Source: FactSet.

Big Upside – Little Downside

It's no surprise that a pure SMid- or small-cap investment, over time, is more volatile than an investment in a large-cap or broad market index such as the S&P 500. In markets where volatility is at elevated levels, the fluctuations of stocks from smaller companies are much more pronounced than those of larger companies. The easiest way to observe this phenomenon is through up and down market capture ratios. Over the last 20 years, on average, the Russell 2000 Index has captured 114% of the S&P 500's upside, and 106% of its downside. When looking at the same metric using the Russell 2500 Index, we see enhanced upside capture at 118% and more limited downside at only 101%, leading to a highly favorable market capture ratio, and a slightly smoother journey along the way.

Exhibit 6: Upside / Downside Capture (as % of S&P 500)



Data as of December 31, 2010. Average of 20 calendar year returns and standard deviation, measured quarterly. Source: FactSet.

Muted Analyst Coverage

One of the biggest advantages of small-cap investing centers around a lack of Wall Street coverage that creates inefficiencies in the market. On the whole, less analyst coverage offers managers a greater opportunity to generate excess returns through fundamental research. As Exhibit 7 demonstrates, companies within the Russell 1000 Index are covered by an average of more than 14 analysts; conversely, small-cap companies, those that constitute the Russell 2000 Index, are covered by an average of less than 6 analysts. The increase in coverage for SMid-cap companies, as represented by the Russell 2500 Index, is minimal at an average of less than 7 analysts. As such, the relatively high level of market inefficiency remains intact for the SMid-cap space, creating increased potential for long-term outperformance by active managers.

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Exhibit 7: Analyst Coverage

	Average # of Analysts
Russell 1000 Index	14.6
Russell 2500 Index	6.9
Russell 2000 Index	5.8

Data as of December 31, 2010. Source: FactSet.

However, because small-cap managers are in many cases forced to exit positions due to market cap constraints, the upside may be limited just as a company starts to enter a phase of rapid growth. This problem is far more muted in SMid-cap portfolios, as many managers will allow certain positions to reach \$10 billion or more in market cap size. Furthermore, because SMid-cap managers are able to hold small-cap winners into the mid-cap realm, they may be able to reduce turnover and lower transaction costs, enhancing total returns as a result.

Summary

A SMid-cap allocation, in the context of a diversified portfolio, affords investors several benefits including:

- Potential for outperformance compared to small caps
- Lower average volatility, resulting in an enhanced risk/reward profile
- Access to capacity-constrained small-cap management teams
- Correlation characteristics that make SMid-cap equities suitable for inclusion in diversified portfolios
- More flexibility to hold stocks irrespective of market cap, leading to lower expenses and higher total return
- Reduced levels of analyst coverage that enable managers to take advantage of increased inefficiencies
- Timely allocation during an extended period of moderate economic growth

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