Quarterly Portfolio Update

Pioneer Funds – Emerging Markets Bond
30 December 2011

Bond

Review

Markets Remain Hostage to Eurozone News Flow

Despite the backdrop of risk aversion, emerging-market bonds made decent returns in the fourth quarter. Markets remained hostage to news flow and developments in the eurozone and, to a lesser degree, worries over global growth. Most of the negativity occurred at the end of October and through November: MF global collapsed, the Greek Prime Minister called for a vote of confidence on his regime and a referendum on the new aid package, Italian 10-year yields broke through 6% (and hit a low of 7.26% on 25 November). These events caused pessimism about a solution to European debt problems.

A tough stance from the EU against Greece led to the resignation of Prime Minister Papandreou and the appointment of ex ECB vice president Lucas Papademos. In Italy, Berlusconi became the second eurozone PM to resign in November (he was replaced by ex EU commissioner Mario Monti). The fact that Greece and Italy are now being run by technocrats should be seen as a positive with regard to implementing austerity measures. Spain was the third European country to see a new leader: following an election victory by the conservative Popular Party, Mariano Rajoy took over as prime minister.

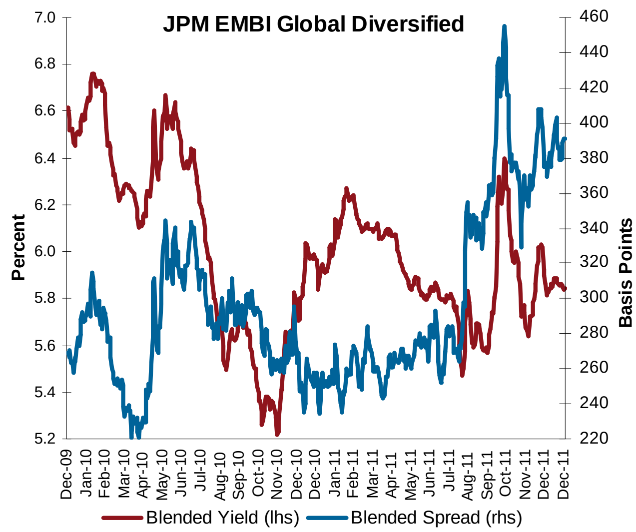
On a more positive note, economic data generally surprised on the upside, especially in the US. Although US Q3 GDP was revised down to 1.5% (annualised), several analysts have been upgrading fourth-quarter expectations. There was better US data on jobs, house sales, consumer spending, employment, manufacturing and business activity (Chicago PMI). Additionally, the unemployment rate fell to 8.6%, a 2.5-year low and there were upward revisions for non-farm payrolls in September and October.

One of the key positive developments over the quarter, that led to a big rally at the end of November, was coordinated action from six central banks (US, EU, UK, Canada, Japan and Switzerland) to cut the cost of US-dollar funding via swaps by 50 bps (to US$ OIS + 50 bps). With the growing danger of a liquidity crisis, this type of coordinated action is key to reducing pressures in the Banking sector and boosting confidence. However, while this will help short-term pressures, focus will soon move back to the fundamentals of the European debt problems.

Emerging-Market Bonds Recover: Corporate Underperforms

The predominantly sovereign JPM EMBI Global Diversified Index (in US$) returned 4.7% (in US$) over the fourth quarter, ahead of the corporate CEMBI Broad diversified (4.1%). Over the full year, the EMBI (7.3%) also outperformed the CEMBI (2.3%). Within the EMBI, high yield (4.73%) slightly outperformed investment grade (4.6%) in Q4, with B names (5.88) ahead of BB (3.88%), which was a reversal of the 2011 return (BB: 7.29%, B: 0.55%).

The yield on the JPM EMBI Global Diversified Index decreased over the quarter from 6.26% to 5.84%, with the blended spread tightening out from 428 bps to 391 bps. The move was mainly due to EM performance rather than Treasury yields, with the 10-year bond tightening by 4 bps to 1.88%.



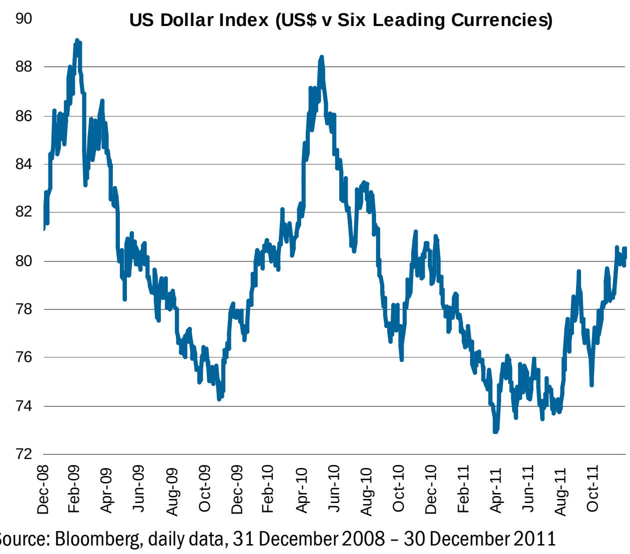
Source: Bloomberg, daily data, 31 December 2009 – 30 December 2011

Of the markets with an index weight of at least 100 bps, the best performers in the fourth quarter were Venezuela (14.32%), Uruguay (12.74%), Argentina (8.96%), Peru (8.44%), Panama (6.43%), Indonesia (6.36%) and Brazil (5.81%). Conversely, the weakest countries were Hungary (-3.98%), Ukraine (0.44%), Turkey (0.69%), Lithuania

(1.88%), Lebanon (2.12%), China (2.14%), Poland (2.66%) and South Africa (2.77%).

Currencies: US-Dollar Continues to Advance

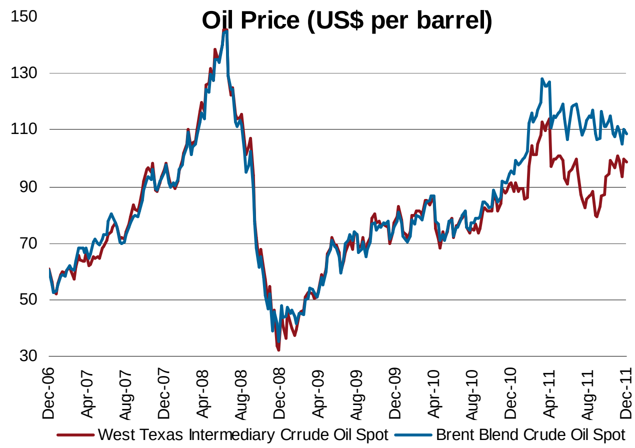
It was a tale of two halves (well almost) for the US dollar in 2011. After a very weak start, it bottomed out in early May (-7.7% ytd), traded slightly up through the summer and then enjoyed a strong rally from September as risk-aversion spiked. Over the year, the US Dollar Index was up by 1.5%, with a 2.1% gain in the fourth quarter (2.3% in December). The greenback appreciated against all major EM currencies in 2011 except the Peruvian new sol (-3.9%) and the Chinese renminbi (-4.7%). The weakest EM currencies in 2011 were the Turkish lira (US$ +22.5%), South African rand (22%), Indian rupee (18.7%), Hungarian forint (16.8%) and Polish zloty (16.3%). Over the fourth quarter, the weakest EM currencies, by some margin, were the Hungarian forint (US$ +10.9%) and the Indian rupee (8.4%). The Hungarian forint dropped 7% against the US dollar in December alone as investors became concerned about changes to the constitution, including the independence of the central bank, and S&P downgraded the country's debt to junk status (BBB- to BB+). Conversely, the greenback was down against the Peruvian new sol (-2.7%), Korean won (-2.2%), Chinese renminbi (-1.4%), Taiwan dollar (-0.7%), Brazilian real (-0.7%) and Malaysian ringgit (-0.7%) in the final quarter.



Source: Bloomberg, daily data, 31 December 2008 – 30 December 2011

Commodities Advance but Gold declines

Commodities were generally higher over the fourth quarter, with the notable exceptions of gold (-3.7% to US$1,564) and sugar (-7.9%). The Thomson Reuters/Jeffries CRB Index was up by 2.4%, although the S&P GSCI TR CME Index, another broad measure, advanced by 9%. By far the best returns were from West Texas Oil (24.8%), which closed the price differential with European Brent (2.3%) to around US$10 from almost US$30 in September.



Source: Bloomberg, weekly data, 29 December 2006 – 30 December 2011

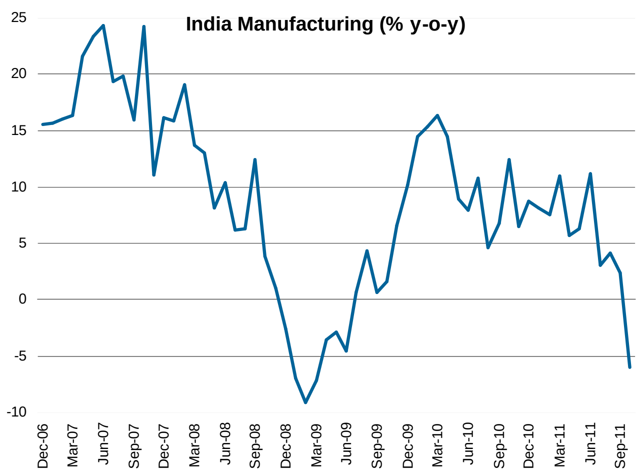
China: Inflation Continues to Fall – and Authorities' Attention Turns to Growth

Worries over a hard landing in China have abated, but growth has slowed, albeit modestly, due to problems in the developed world and Chinese authorities' attempts to control inflation and property prices. Third-quarter GDP was 9.1% (y-o-y), down from 9.5% in the previous quarter. Growth has been on a downward trend since Q1 2010 (11.9%), but the government is keen to promote a more balanced growth model with a greater contribution from consumption. Expectations are that growth may slow a bit more over the coming year but we would expect it to stay comfortably above 8% unless there is further deterioration in the global economy. A rebound above 50 in China's PMI Manufacturing survey in December should help alleviate growth worries. Lower inflation over recent months (4.2% y-o-y in November, down from 5.5% in the previous month and 6.5% in July) has enabled the authorities to turn their attention to sustaining growth rather than controlling prices. The People's Bank of China surprised the markets when it announced a 0.5% reduction in banks' reserve ratios (to 21% for large banks) on the last day of November. There was further evidence that China is relaxing its policy stance to sustain growth when loan growth in October was about 15% higher than expectations. The yield curve graph below highlights the huge shift that occurred from 17 November, the day the loan data was released.

Source: Bloomberg, daily data, 31 December 2008 – 30 December 2011

India: Inflation and Interest Rates Continue to Rise

The trajectory of inflation and monetary policy in India has been out of step with other emerging economies over recent months. In October, the Reserve Bank of India (RBI) raised interest rates (to 8.5%) for the 13th time since March 2010 in an effort to control stubbornly high inflation (9% y-o-y in November). Tighter monetary policy and slower global growth led the RBI to cut current-year growth expectations to 7.6%: Q3 GDP was 6.9% (y-o-y), the slowest rate of growth since the second quarter of 2009, with manufacturing particularly weak. The RBI predicted that inflation will start to moderate from December, falling to around 7% by March, giving it scope to loosen monetary policy in an effort to boost growth.



Source: Bloomberg, monthly data, December 2006 –October 2011

Trend of Lower Interest Rates and Growth Continues, but not Everywhere

While several EM countries loosened overall monetary policy (reserve ratios, liquidity etc), only three cut interest rates in Q4 - Brazil, Indonesia and Russia – with the same number tightening - India, Hungary and Colombia. Several countries, including Malaysia, Colombia, the Philippines, Thailand (massive flooding has severely depressed recent activity), Taiwan, Hungary, Mexico and Brazil, lowered growth expectations.

Indonesia followed October's 25 bps reduction with a further 50 bps cut, taking policy rates to 6%. Economic growth in Indonesia has remained strong through the third quarter (6.54% y-o-y, slightly ahead of Q2) but inflation is heading lower. The monetary policy stance is indicative of the general change that has occurred over recent months from fighting inflation to protecting growth. In contrast, Colombia hiked rates by 25 bps to 4.75%, despite lowering its economic forecast for 2012 by 0.5% to between 4% and 6%. Growth has actually been improving in Russia, where third-quarter GDP came in at 4.8% (y-o-y), up from 3.4% in the previous quarter. Malaysia also announced that Q3 GDP is likely to improve, while Poland enjoyed a higher-than expected, albeit slightly lower, 4.2% (y-o-y) expansion in Q3.

Russia: Positive Momentum in Consumer Area

There was a continuation of the trend of positive macro data in Russia in the fourth quarter, including a 25 bps cut in interest rates to 8% in December. Unlike the majority of other countries, Russia's income is exceeding its expenditure. As at the end of November, the budget surplus was around 3.2% of GDP (US$46bn) and it is likely to stay positive for the full year despite an expected pre-election increase in spending in December. A weak ruble and resilient oil prices have both helped budget revenues. Retail sales remained strong in October and December (9% and 8.6% y-o-y), well above the average this year. Unemployment was 6.3% in November and has been steady at between 6% and 6.5% since May. Inflation in December was down to 6.1% (y-o-y), a 17-month low, which should result in a similar figure for 2011 as a whole, which would be the best ever result in modern Russia (food inflation was 5.3% y-o-y in December, down from 13%-15% in the first half of the year). Real wages were up 7.1% (y-o-y) in November and real disposable income has remained in positive (y-o-y) territory since June, with the past three months each seeing at least 1% (m-o-m) improvements.

Unlike many other countries, growth accelerated in Russia in the third quarter. The initial estimate of third-quarter GDP was 4.8% (y-o-y), up from 3.4% in Q2. There is also a chance that this figure will be revised higher. The economics Ministry is predicting 4.1% growth in 2011 but we believe that this is too low and could be between 4.5%

and 5%. Growth should stay relatively strong in 2012, at around 4%.

Performance Analysis

Pioneer Funds – Emerging Markets Bond (Class A, non-distributing, EUR units) was up by 6.74% over the quarter, behind its benchmark (JPM EMBI Global Diversified Index 95% and JPM Cash 1 Month Euro 5%), which returned 7.77%. We outperformed in a strong December (5.48% vs. 4.63%).

The underperformance was primarily due to our overweight in corporate credit, which underperformed government bonds. The main negatives were Russia, the Philippines, Peru, Uruguay, Colombia, Indonesia, Panama, Lithuania and Poland. Conversely, we performed very well in China, which added 97 bps to relative returns; Venezuela, Argentina, Kazakhstan and Brazil were also strong.

We have not changed our overall views or strategy and are positioned to recover relative performance when the market environment stabilises. Key to this is a resolution to the European debt problems. We believe that European policymakers are conscious of the gravity of the situation and that notwithstanding the protracted political cycle, the debate is moving forward to find the right policy tools to protect and defend the eurozone. Once in place, these policies should reduce market volatility and the sovereign-risk premium implicit in EM spreads.

Strategy

We have a considerable overweight in corporate bonds, which make up around 80% of the Portfolio (compared to 17% in the Index), 19% in sovereign/local authority/supranational and 8% cash. We have other investments in CDS (index and single name), TRS, FX and interest-rate derivatives. We remain short on duration (5.53 years vs. 6.3).

On a country perspective, our key overweights are Kazakhstan, Argentina, Brazil, China, Venezuela, Nigeria and Croatia. Conversely, our main underweights are Lebanon, Colombia, Poland, Panama, Peru, South Africa, Malaysia, Lithuania and Chile.

October Activity

Market activity was still subdued in October despite the rising prices. The key theme in October was to reduce exposure to some of our more overweight countries, such as Croatia and Argentina, thus boosting our cash levels. In China, we reduced our position in China South City and added a new 2016 senior-secured holding in rival property developer Hopson, which had an 11.75% coupon. On the primary market, we participated in a new senior-secured 10-year bond from Brazilian electricity utility Electrobras.

November Activity

Most of our buying activity was on the primary market in November, where we took part in three new issues. Two placings were senior-unsecured 10-year bonds rated BB+: Instituto Costarricense de Electricidad is an electricity producer in Costa Rica with a 6.95% yield; Corp Lindley (6.75%) is a Peruvian soft-drinks manufacturer and the exclusive bottler of coca cola in Peru. The third new issue was from National Road Operating & Constructing Company, a road-construction firm in Jamaica – the bond is rated B-, paying 9.375% over 13 years and is supported by the Jamaican state. In the secondary market, we added a new position in Hyva (senior-secured 8.625%, March 2016, B+), a global manufacturer of commercial-vehicle components (mainly used in hydraulic loading and unloading) based in the Netherlands but with operations in emerging markets including China, Brazil and India.

December Activity

Markets were quiet in December. We participated in two new issues from Latin American oil companies. Pacific Rubiales (10yr 7.25%, BB) is fast growing crude oil and natural gas exploration & production company based in Columbia, with a low cost base. It operates in the Colombian and Peruvian offshore regions. We also added a position in Empresa Nacional del Petroleo (10yr, 4.75%, BBB+). Conversely, we reduced exposure to Argentina, by trimming our holding in Provincia de Buenos Aires, and exited a 9.5% coupon Philippines government bond following a strong rally that reduced its yield to less than 5%. We also reduced exposure to China Shanshui Cement and sold out of Digicel, a Jamaica-based mobile-phone company that operates across the Caribbean and Central America.

Outlook

2011 was a year of two halves for emerging-market debt, with strong returns through the first eight months across all sub sets, especially local currency and high yield, before the sell-off from September. Nevertheless, US dollar investors made money in EM government (7.3%) and corporate bonds (3.2%), but weak currencies in the latter months meant that local-government bonds showed a 1.8% loss; increased risk aversion caused a -3.8%, return from high-yield corporates. Overall, this was a relatively good performance in a risk-averse backdrop where EM equities lost 20.4% (capital return), thus highlighting the growing resilience of EM debt as a more mainstream asset class.

Following the rally over the first eight months of last year, we became relatively cautious, due to valuations and the uncertain outlook for the global economy. We are now relatively constructive on the outlook given the extent of recent market falls. Risk assets are factoring in a pretty bleak scenario. With yields of many emerging-market corporates in high single-digit or double-digit territory despite, on the whole, solid fundamentals, we see a good foundation for decent medium-term returns. Valuations are now much more compelling, with lower-grade credits, such as B-rated EM corporates, pricing in a recessionary scenario, which we consider extreme.

Growth in emerging markets has slowed but remained robust, with around 5.5% to 6% expected in 2011. For 2012, growth is likely to slow to between 4.5% and 5%. Downgrades in EM have been much smaller than in the developed world. Indeed, some moderation in growth is not necessarily negative, as it has helped ease inflationary pressures. This is certainly the case in China, where a rebalancing away from fixed-asset investment could lead to slower, more sustainable but still solid growth, with greater contributions from consumption and trade.

European and, to a lesser extent, US debt issues, along with global growth concerns, are likely to remain the key drivers of sentiment for the immediate future. Given the heightened tensions in Europe around debt funding, the European Central Bank will probably reduce rates further in the coming months; the US should keep rates at record lows through 2012 and probably into 2013. We believe that Europe and the US will maintain sub-par growth. While there is a likely chance of a recession in Europe, albeit mild, the US looks likely to avoid a double dip and growth seemed to be improving in Q4. Continued strong (albeit moderating) growth in emerging markets will help buoy developed markets.

There is a possibility of further fiscal stimulus measures in Europe and the US in order to promote stability. Investors are anxiously waiting for further details and clarity on the European debt plans. A credible plan for the debt situation in Europe could be the catalyst that pushes investors back into risk. If systemic concerns abate, markets look cheap and could be driven higher by the wall of money that is waiting on the sidelines. The risks look front-end loaded in 2012, particularly in the first quarter, where volatile trading is likely to continue, driven mainly by European debt problems and bank stresses. Growth could accelerate in the second half. Overall, the backdrop is relatively positive for EM debt. Defaults are likely to rise in EM high yield to around 5.8%; this is much higher than last year but around half of this will be accounted for by the impending BTA restructuring. Investors are defensively positioned with high cash levels and there is likely to be net negative issuance in EM sovereigns. An increase in risk appetite could to see this cash put to work. With all the net issuance expected in the corporate area (US$185bn gross, US$78bn net), combined with more attractive yields, corporates could outperform.

During 2011, EM sovereigns made positive absolute returns due to a substantial compression of US Treasury yields that compensated for wider spreads. With the US seemingly on a recovery trend, 10-year Treasuries may move from 2% towards 2.5%. Given this potential US interest-rate duration pressure, unless growth in EM countries (especially those relying on commodities to manage their current accounts) surprises on the upside, leading to tighten their current spreads, we predict returns of 4% to 6% for the EMBI Global Diversified in 2012.

Investment-grade EM corporates, where quasi sovereigns valuations are very close to their sovereign benchmarks, may experience additional pressures as the need to raise funds for heavy capital-expenditure is more acute in 2012. They will compete for funding with other global investment-grade issuers, both sovereign and corporate, potentially forcing EM corporate issuers to offer higher yields. This may lead to underperformance compared to sovereigns in 2012, with returns around 4%, depending on technical issues.

High-yield EM corporates (28% of the CEMBI Broad Diversified) have higher yields, wider spreads and bombed-out valuations, that will help compensate for higher Treasury Yields. Additionally, high-yield issuance is unlikely to be high in 2012 unless growth picks up, which would make valuations very compelling. With current yields of 10.3%, we predict 2012 returns in the range of 8% to 10%.

Important Information

Unless otherwise stated all information contained in this document is from Pioneer Investments and is as at 30 December 2011.