Quarterly Portfolio Update

Pioneer Funds – Emerging Markets Equity
30 December 2011

Equity

Review

The Portfolio was up by 3.03% (Class A, non-distributing, EUR units) over the quarter, behind its benchmark, the MSCI Emerging Markets Index, which returned 7.93%.

Markets Remain Hostage to Eurozone News Flow

Despite a flat/slightly negative December and the fact that investors were very nervous of risk, equities, developed and developing, 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 co-ordinated 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 co-ordinated 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.

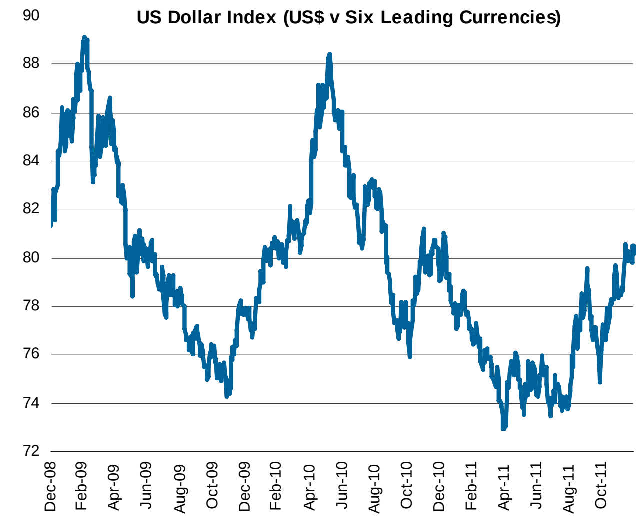
Emerging Markets Underperform Developed Markets in 2011

Emerging-market equities had one of their worst years in the past decade in 2011, with a return of -20.4% in US dollars, which was exacerbated by the strength of the greenback (-14.9% in local currency). In contrast, developed equities lost 7.6% (in US$ and local currency). Over the fourth quarter EM equities were up by 4.1% (US$), due to a strong 13% rally in October, compared to 7.1% for developed markets (10.3% in October).

Over the quarter, Latin America (7.8% in US$) was the clear winner, with Asia (3.2%) and EMEA (2.5%) lagging the global index. In Asia, India and Chinese local (A) shares were down over 6%, with Taiwanese equities also falling. Conversely, Chinese H shares, Thailand and Malaysia saw gains of over 10%, with slightly less in the Philippines. In EMEA, Turkish equities declined by over 14% with Russia slightly outperforming. In Latin America, Mexico and Brazil drove the outperformance for the region, with Colombia and Argentina recording small losses.

Currencies: US-Dollar Continues to Advance

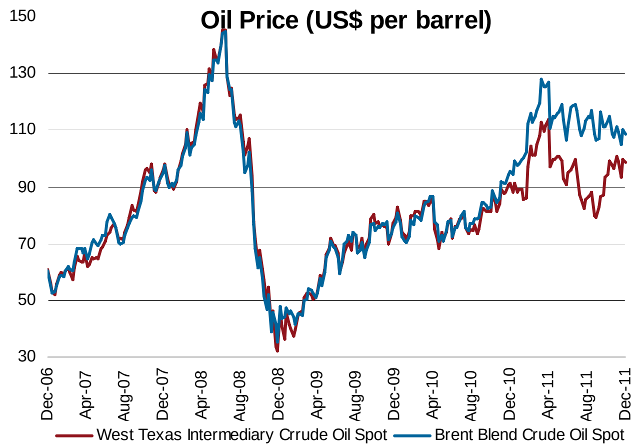
It was a tale of two halves (well almost) for the US dollar in 2011. After a very weak start, it bottomed out in early May (-7.7% ytd), traded slightly up through the summer and then enjoyed a strong rally from September as risk-aversion spiked. Over the year, the US Dollar Index was up by 1.5%, with 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/Jefferies 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

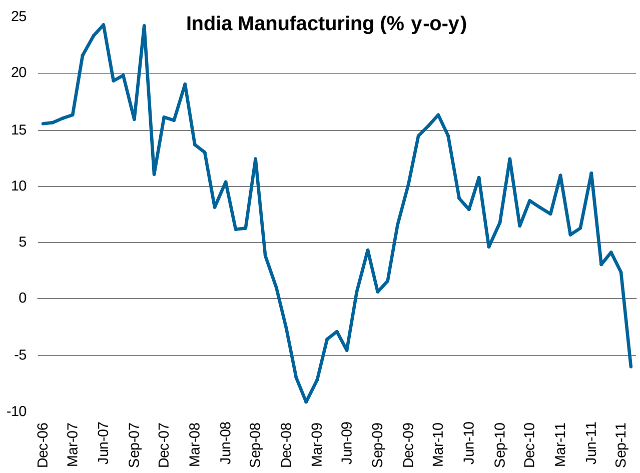
China: Inflation Continues to Fall – and Authorities' Attention Turns to Growth

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.

Performance Analysis

The key reason for the underperformance was a defensive strategy at the start of the quarter in October's strong rally. We outperformed by 137 bps during November and December. More than half of the underperformance was due to stock selection in China. The other main negatives were our holding in IAMGOLD, which cost us 52 bps, and Korea, where -61 bps was due to our large overweight in biopharmaceutical producer Celltrion, which we sold in October. There were smaller losses in Mexico, Malaysia, Russia and South Africa. Conversely, we added value in Thailand, Poland, Indonesia and Colombia.

In China, the main negative was our large overweight (trimmed in October and November) in China Mobile. We lost ground due to investments in three defensive utility companies: CLP, Guangdong (also water and other infrastructure) and Power Assets. Other negatives included being underweight in the banks, which rallied strongly, and our holding in casino operator Sands China.

On a sector perspective, we outperformed in two out of the ten areas, Industrials and IT. The main negatives were our overweights in the defensive Health Care, Utilities and Telecoms areas, along with selection in Financials and Consumer Discretionary.

Portfolio Strategy

We ended the year with Brazil as our main overweight country (316 bps). We have smaller overweights in China (110 bps), Canada (107 bps - IAMGOLD), Luxembourg (107 bps - Millicom Cellular is a mobile-telecom business with operations in Latin America and Africa) and the UK (102 bps - Rio Tinto is a leading global miner with a portfolio of businesses across many emerging countries). Conversely, the key underweights are South Africa (207 bps), Malaysia (189 bps), Korea (143 bps), Poland (138 bps) and Mexico. Portfolio activity was relatively high in the fourth quarter, with our focus being on raising the beta back towards a market level from a very defensive stance that we took in the third quarter. We trimmed some of the defensive holdings that had performed well and added stocks that could perform better in up markets, which is what hurt our performance in the October rally. Our country bets are also much tighter, with only two countries having a delta of more than 200 bps. The biggest changes on a country perspective were moving South Africa from the largest overweight to the main underweight, and Taiwan from the largest underweight to roughly neutral.

We also reduced underweights in Russia, Malaysia and Korea, and moved underweight in Turkey. Valuations in Russia look very compelling and we are likely to move overweight soon.

New stocks added the Portfolio included Lenovo (a Chinese computer manufacturer that bought the PC/Laptop division from IBM a few years ago), Gazprom (Russian gas), Hyundai Motor (Korean car manufacturer), Itau Unibanco (Brazilian bank), Infosys (Indian IT services), Posco (Korean Steel manufacturer) and Hon Hai (Taiwan electronic manufacturing services). Conversely, we exited stocks including BIM (Turkish supermarkets), Korea Aerospace, E-Mart (Korean retailer), Lupin (Indian pharmaceuticals), Redecard (Brazilian credit-card services), Shoprite (South African retailer) and Tata Consultancy (Indian IT services).

Sector Positioning

There were some big changes to our sector positioning over the fourth quarter, particularly in December as we continued to rebalance away from the defensive stance. Consumer Staples remains the largest overweight (497 bps) but this was down from 1059 bps at the start of the quarter. The other main overweights from September – Telecoms, Health Care and Utilities - are now roughly neutral weighted. We increased the underweight in Consumer Discretionary to 407 bps, boosted Energy to almost neutral from 483 bps underweight and moved IT from 404 bps underweight to 187 bps overweight (although a 4% position in MSCI Taiwan, which is heavily biased towards IT companies, means we have a higher IT exposure).

Outlook

The three key drivers for emerging-market performance are Growth, Valuations and Sentiment. Growth and Valuations are both fundamental measures that influence the majority of our decisions on a country, sector and stock level. Sentiment encompasses the short-term environment for emerging markets; it can influence entry/exit points for Portfolio changes and guide tactical decisions as when to add/decrease risk.

We remain positive on the medium- and long-term outlook for emerging markets, despite their underperformance over the past fifteen months. The structural case for investing in emerging markets compared to developed markets remains intact, with superior growth, better government finances and higher reserves, supported by a sustained period of low interest rates globally. In particular, emerging markets have much lower government debt levels, which is an issue that is currently in the spotlight and is likely to remain so over several years. A healthier fiscal position and stronger domestic demand should drive superior growth in emerging markets for a multi-year period. Conversely, developed-market growth is likely to remain sub-par for the next two or three years as countries go through a deleveraging cycle.

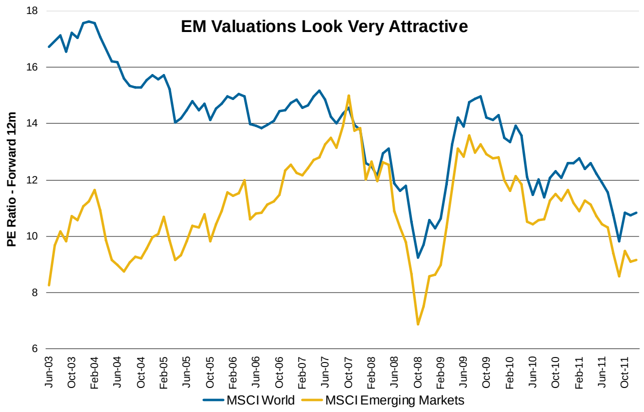
2011 was a tough year for emerging markets but we believe that 2012 should be significantly better. Risk aversion has dominated since last May, with investors pulling capital out of emerging-market equities into safer-haven assets, which have performed well but are looking expensive. This has led to valuations of EM equities falling well below long-term averages and presenting a very attractive entry point for medium-term investors. We believe that emerging markets have a good chance of outperforming developed markets over the next 18 month, with returns of 25% to 30% a real possibility.

The short-term outlook is far more difficult to predict and is likely to be dominated in the first quarter by European issues, particularly the huge amount of debt that needs to be rolled over. Therefore, it is difficult to predict if emerging markets have bottomed or whether there will be another European-induced sell off. The potential risk of further outsized market shocks looks to be more likely in the first quarter than the rest of the year.

From an emerging-market perspective, the headwinds of high inflation and policy tightening are either over or ending. Brazil is lowering rates and reversing capital controls, and China is starting to implement growth policies, such as cutting banks' reserve requirements. However, there are key elections in Russia and Taiwan in the first quarter that could cause volatility.

Earnings, particularly expected earnings growth, are a key factor in valuations. EM earnings grew at 30% in 2010. In 2011, expectations were for 18%, but the actual figure is likely to be under 10%. In 2012 and 2013, expectations are for growth of 9% and 10% respectively. However, the pace of downgrades is slowing and it is likely that analysts may start upgrading 2013 earnings expectations in the second half of the year.

Valuations look increasingly attractive on either a relative or a historical perspective. At the end of December, the forward PE for the MSCI Emerging Markets Index was 9.14 compared to 10.82 for the MSCI World Index. This 15.5% discount is the widest (on month end data) since February 2009. With the exception of this November and September, the current absolute PE level is also the lowest since February 2009.



Source: Bloomberg, monthly data, 30 June 2003 – 30 December 2011

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