

Update Magazine



Active is: **Allianz Global Investors**

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Active is ...

Dear Readers,

In keeping with our new branding, "Active is", in the latest issue of Update I am pleased to share with you our opinions and analyses in relation to some highly relevant investment topics.

To start with, our capital markets expert Hans-Jörg Naumer sheds some light on the hot topic of sustainable investment. He examines why this issue has grown from a niche area to reach the mainstream. The incorporation of environmental, social and governance factors in capital investment has gained considerable momentum for investors, not least due to the EU's new, far-reaching regulatory proposal on implementation of the Sustainable Finance Action Plan.¹

As a global investor, we keep an eye on all international investment opportunities for our clients. Neil Dwane, Global Investment Strategist, summarises the key trends in the growth region of Asia that were presented by our investment professionals at the 10th Asia Conference in Berlin. It is fascinating to note how both structural changes and political reforms can affect important markets such as China and Japan. With economic growth and rising prosperity, Asia is also seeing an increased emphasis on the desire for greater environmental quality and quality of life.

In the current low-interest-rate environment, all investors are seeking attractive investment alternatives. Dietmar Schubert, from our portfolio management team for privately placed corporate loans, and Theoman Kaplan, our expert on investment strategy for insurers, demonstrate the added value that promissory note loans and registered bonds can provide.

So, you believe that passively-managed funds are cheap and always deliver good investment performance? Our Global Head of Distribution and Head of EMEA, Tobias Pross, gives you four important reasons why we are convinced that our 100% active investment approach delivers better portfolio results.

In the 'Allianz Global Investors Today' column, our fixed income specialist Thomas Knigge presents our US Fixed Income Strategy.

Finally, in this issue of Update we introduce you to the new AllianzGI branding that I mentioned earlier: "Active is". In an interview our CEO, Andreas Utermann, discusses the value proposition behind the new brand positioning.

I hope you enjoy reading this issue.

Yours, Steffen Hörter



Dr. Steffen Hörter, Global Head of ESG,
Allianz Global Investors

Spotlights



Brand positioning

Active is: Allianz Global Investors

In the coming months you will see a new look to the branding and messaging of our range of investment products. We have distilled the AllianzGI philosophy into two ideas that are at the very heart of our business: "Active is" and "Value. Shared."

We have always believed in solving, not selling, and in adding value for our clients. Therefore, we invest for the long term, employing our innovative investment expertise and global resources. Our goal is to ensure a superior experience for our clients, wherever they are based and whatever their investment needs. Because at AllianzGI we believe that by enhancing every aspect of the relationship, we can create the best value: Value. Shared.

Our websites adopted our new look back in May. Similarly, our key marketing materials have been updated to the new guidelines. As you can see, Update Magazine has also undergone a facelift. Factsheets and other material should be converted by the end of June.



MORE AT
www.updatemagazineonline.com/branding



Outlook

A Rising Region: the most important outcomes of our 10th Asia Conference

Our 10th Asia Conference took place in Berlin in May. At this annual event, clients, business partners and investment specialists from Allianz Global Investors meet and exchange opinions about the most dynamic region in the world. We have summarised the conference's most important outcomes for you.



MORE AT
www.updatemagazineonline.com/asiacommference2018



Award

Greenwich Quality Leader for the second time in Europe

Allianz Global Investors has been named a Greenwich Quality Leader for institutional investment management in Europe this year, for the second time. Moreover, AllianzGI has been named Greenwich Quality Leader for the eighth consecutive time in Germany.

AllianzGI's quality ranks consistently Q1 across all major markets, driven by its strong service quality. The study also found that AllianzGI has established itself as a leading supplier of active asset management in Continental Europe. Our positive recognition made especially significant progress in the alternatives investment sector.



MORE AT
www.updatemagazineonline.com/greenwich2018



ESG

Using ESG² to help protect investors from downside risk

The start of 2018 has seen a re-emergence of market volatility in the credit markets, rising incidence of idiosyncratic risks, and an increased dispersion in investor appetite. In such a market environment, the focus on ESG is a core part of the armoury in protecting portfolios against downside risk. More about the ESG topic in the article on pages 6–13 of this issue.



➤ MORE AT
www.updatemagazineonline.com/esg



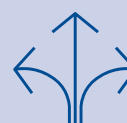
Half-time report

Half-time report: Global trade under threat

The first half of 2018 was marked by rising geopolitical tensions, major fiscal and political changes, and diverging monetary policy. These factors created a rise in volatility that was made more pronounced by the global economy nearing the end of its “Goldilocks” period – a time of sustained growth and low inflation. As it happens, the mid-year point of 2018 matched up with the FIFA World Cup in Russia, where dozens of countries engaged in friendly competition for football’s ultimate prize. So how are these economies likely to fare in 2018’s second half?



➤ MORE AT
www.updatemagazineonline.com/outlook



Infrastructure investments

AllianzGI completes 50th Infrastructure Debt deal

AllianzGI has completed its 50th infrastructure debt deal, providing financing of €200mn towards Paris-Sud University’s new Biology-Pharmacy-Chemistry centre.

This milestone comes less than six years after the AllianzGI infrastructure debt platform was launched, pioneering a new asset class that provides long-term, stable cash flows to institutional investors. The total of 50 deals includes the first three transactions from AllianzGI’s new Resilient Credit strategy. The Resilient Credit strategy complements our core infrastructure debt business, pursuing investment opportunities that have similarly favourable credit characteristics, but are more suited to shorter investment horizons.



➤ MORE AT
www.updatemagazineonline.com/infrastructuredebt/deal

ESG – “plus” for sustainability, “plus” for performance?

AUTHOR: HANS-JÖRG NAUMER

This article illustrates the considerable growth in the importance of CSR³ and ESG for companies and investors. The added value consists not only of a “plus” for sustainability, but may also result in a “plus” for performance, as documented by academic studies.



1/ Strong gain in importance over recent years

ESG-related investments have long outgrown an investment niche. This is demonstrated not only by the rising volume of capital that is managed on these principles, but also by the intensified research into this form of investment. Capital that is managed according to the United Nations' Principles for Responsible Investment (PRI) now amounts to about USD 60 trillion – half of the institutional funds managed globally.

This leads one to ask whether it is ultimately worthwhile investing on a sustainable basis. Ideally, sustainable investing would not be a disadvantage but a “plus” for the capital investment. (See **Figure A/**)

2/What impact does ESG have on investments?

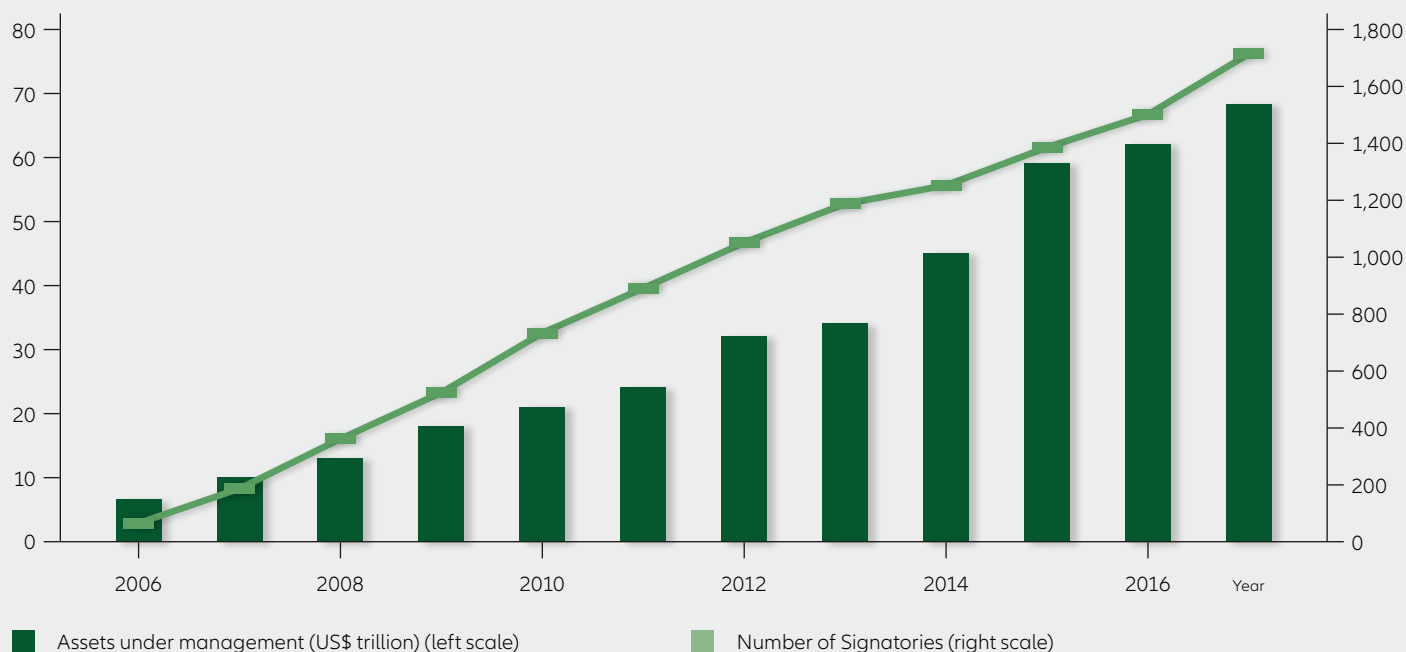
But how does ESG affect capital investments? The abundance of studies devoted to CSR/ESG can be roughly divided into those that research CSR's impact from the company's point of view, and those that look into the potential performance impact for investors.

Studies focusing on corporate success analyse the issue of financial performance. To wit, does CSR lead to better corporate financial performance (CFP) and contradict the assumption that this involves only costly measures that could eat into corporate profits? The portfolio-based analyses use the performance of ESG-based investments, hence the direct outcome for the investor.

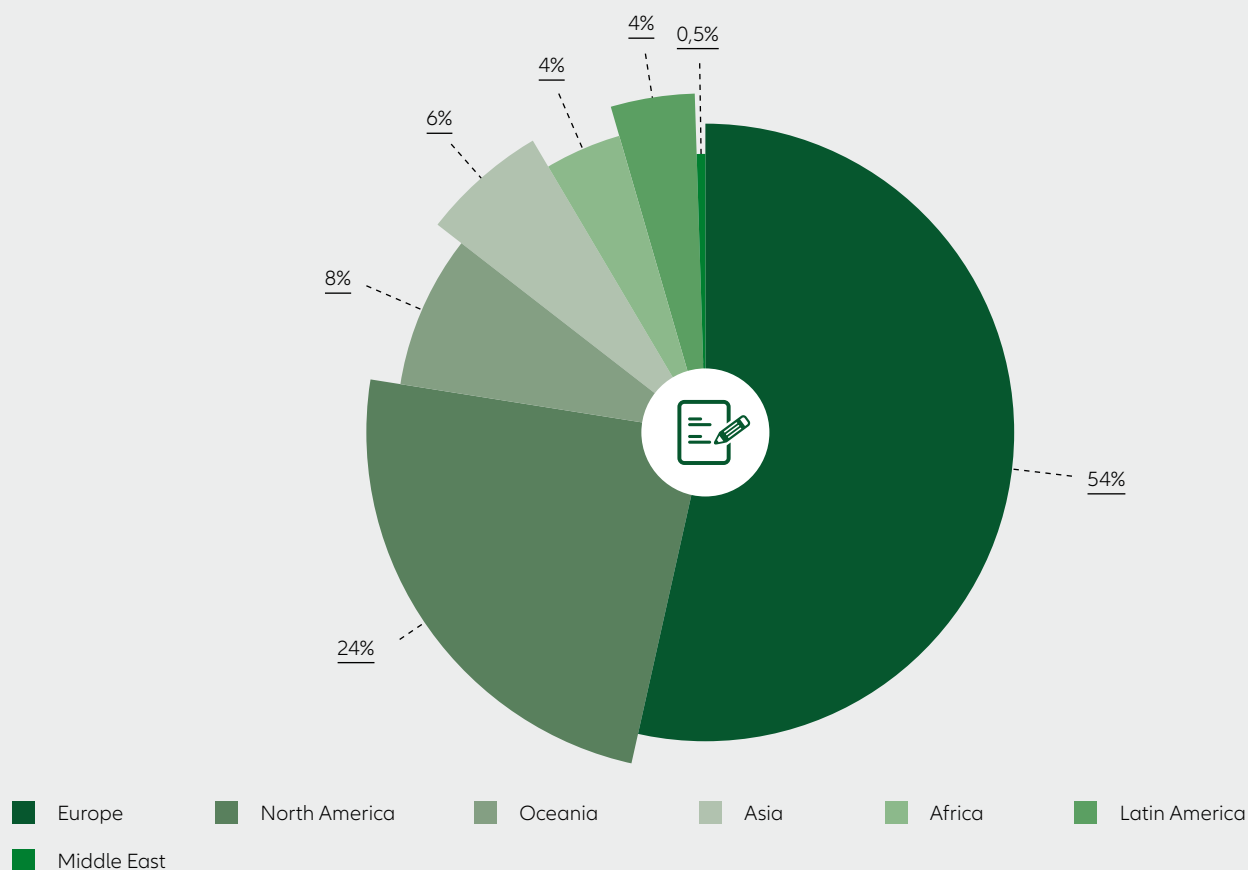


A/ THE PRI INITIATIVE HAS GROWN CONSISTENTLY SINCE IT BEGAN IN 2006. THE PRINCIPLES FOR RESPONSIBLE INVESTMENT IS A VOLUNTARY SET OF SIX INVESTMENT PRINCIPLES BASED ON ESG CRITERIA.

Over 1,700 signatories representing \$68 trillion of assets



Signatories by region



Source: unpri.org. Data as of 23 May 2018.

“Nowadays the market value of an increasing number of firms can be explained by intangible factors – R&D strength and product innovation, process patents, expertise of their employees, brand power, consumer trust, etc. The Environmental, Social and Governance (ESG) dimensions are an integral part of these value drivers. Companies are attractive to investors if they recognise the ESG factors relevant to their enterprise, invest in them, see them as a business opportunity and manage them well. Conversely, companies that are poorly managed and ignore the ESG factors that are important to their future success are an especially risky investment.”

Dr. Steffen Hörter, Global Head of ESG, Allianz Global Investors

B/ ESG: ENVIRONMENTAL – SOCIAL – GOVERNANCE

Classification according to the Sustainability Standards Accounting Board (SASB)

Environment	Social	Governance
GHG emissions	Human rights	Systematic risk management
Air quality	Community relations	Accident & safety management
Energy management	Customer welfare	Business ethics
Fuel management	Data security & customer privacy	Incentive structures
Water and wastewater management	Fair disclosure & labelling	Reporting & audit practices
Biodiversity impact	Labour relations	Competitive behaviour
Lifecycle impacts of products & services	Fair labour practices	Regulatory capture
Environmental, social impacts on assets & operations	Labour standards in the supply chain	Political influence
Product packaging	Employee health, safety & wellbeing	Materials sourcing
	Diversity & inclusion	Supply chain management
	Compensation & benefits	
	Recruitment, development & retention	

Source: www.sasb.org

3/ From the company's perspective: CSR and CFP

Apparently the widest – and easily the most current – study on the correlation between ESG and companies' financial results was carried out by Friede et al.⁴. This meta-analysis reviewed 2,200 studies from the 1970s to today, including the primary and secondary data of these studies, and found that in the overwhelming number of cases (about 90% of the studies) a non-negative correlation. Around 60% of the studies found a clearly positive relationship between CSR and CSP, i.e. a positive influence on corporate results. Fewer than 10% of all studies found a negative correlation.⁵ (see **Figure C/**)

Friede et al. made a distinction between so-called "vote-count studies", in which the meta-studies they referred to counted only the results of primary studies ("positive", "negative" and "neutral") and meta-analyses that referred to the primary studies' underlying econometric estimates, and aggregated these into an overall analysis. However, both analysis approaches came to the same conclusion, with deviations between individual asset classes.⁶ The vote-count studies found a significantly higher positive correlation between ESG factors and financial performance in bonds and real estate than in equities, but the analysis was dominated by equities.⁷



4/ The weaker the legal framework, the higher the importance of ESG

Broken down by country, emerging economies showed by far the most positive correlation between ESG and CSP. This is to be expected, as the protection of investor rights is weaker in emerging economies than industrialised economies, and hence voluntary ESG measures make the biggest contribution to lowering investor risks. This

matches the finding by Friede et al. that governance is the most prominent component in ESG. Also noteworthy in this context is the fact that most scientific studies found a positive contribution in emerging economies.^{8 9} (see **Figure D/)**

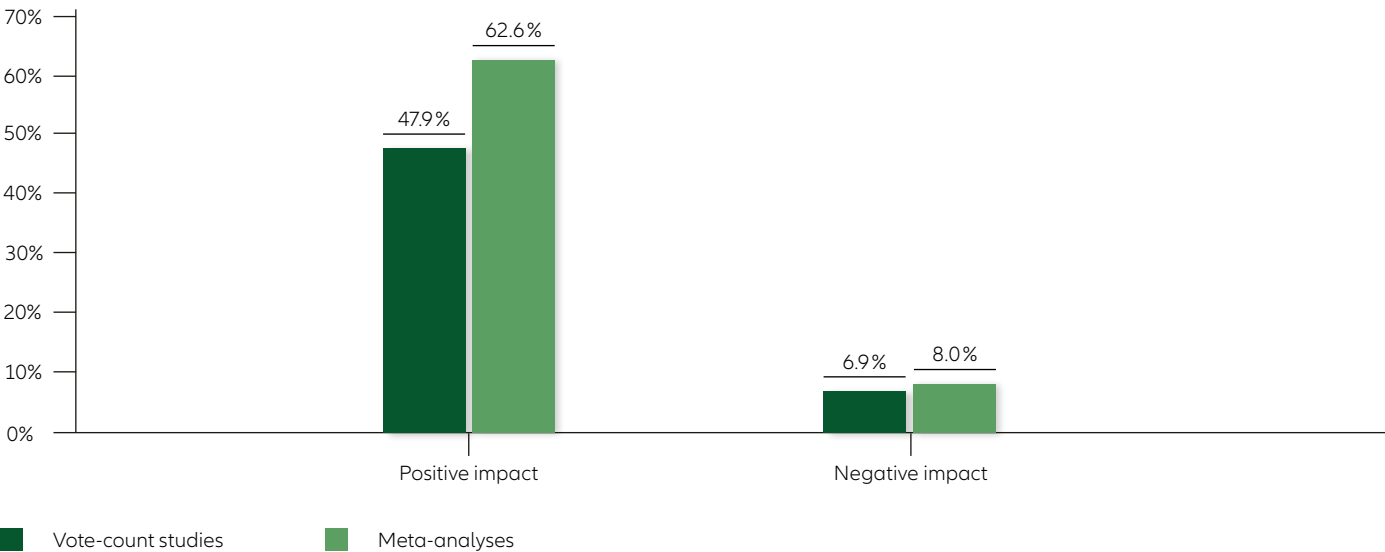
“Incorporating performance-relevant ESG factors into the wider investment universe helps generate better results. Not only equity portfolios, but also corporate and government bond portfolios and alternative investments can benefit.”

Dr. Steffen Hörter, Global Head of ESG, Allianz Global Investors

C/ ESG FACTORS CAN HAVE A MATERIAL IMPACT ON INVESTMENT PERFORMANCE

ESG-CFP relation, synthetic overview

Figures in %

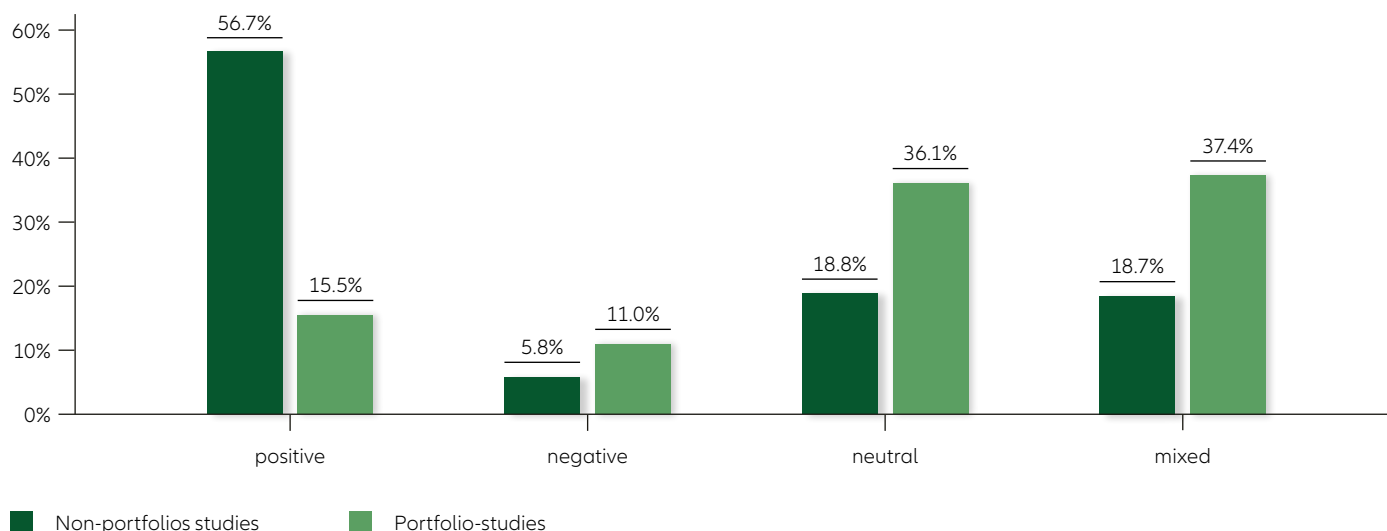


Source: Gunnar Friede, Timo Busch & Alexander Bassen (2015): “ESG and financial performance: aggregated evidence from more than 2,000 empirical studies”, Journal of Sustainable Finance & Investment, 5:4, 210–233.

D/ DO ESG PORTFOLIOS DEMONSTRATE SIGNIFICANT OUT- OR UNDERPERFORMANCE?

ESG & CFP in dependence of portfolio and non-portfolio sample (frequency of correlation in vote-count studies)

Figures in %



Source: Gunnar Friede, Timo Busch & Alexander Bassen (2015): "ESG and financial performance: aggregated evidence from more than 2,000 empirical studies", *Journal of Sustainable Finance & Investment*, 5:4, 210–233.

5/ From the investor's point of view

From the investor's point of view, the research review by Friede et al. comes to a somewhat less impressive but still positive conclusion. Addressing the issue of whether ESG factors also enhance investment returns for investors, they report that only about 10% of studies found a negative correlation between CSR and investment performance. However, the number of studies finding a neutral or mixed outcome is higher than in the studies undertaken from the companies' point of view. The number of studies that conclude unequivocally that there is a positive relationship is lower, at about 16% of portfolio-based studies. It should be noted, however, that the findings are skewed by the fact that the portfolios are allocated on the basis of widely different investment approaches.

All in all, Friede et al. conclude from their comprehensive assessment of ESG-related studies that long-term responsible investing is important for all "rational investors" in meeting their fiduciary duties.

Allocation with reference to ESG criteria when stock-picking shows that doing good and generating returns does not have to be a contradiction. On the contrary.

Dr. Steffen Hörter, Global Head of ESG, Allianz Global Investors, commented: "For an active asset manager, integration of ESG factors is critical for success. They must

be managed proactively, weighing up the potential risk/return of the portfolio. A pure ESG overlay, which takes ESG research data from third-party providers and applies it to portfolio strategies indiscriminately via filters or exclusion lists, is not effective. A more correct approach is to form one's own opinion based on proprietary fundamental research, and treat performance-relevant ESG factors, analysed with the proper expertise, as a further investment signal. It is vital to get a clear understanding of a specific investment case if one is to avoid ESG "torpedoes", and exploit ESG investment opportunities. In a low-interest-rate environment, every basis point of investment performance counts!"



Hans-Jörg Naumer, Global Head of Capital Markets & Thematic Research, Allianz Global Investors

Four industry trends are arguments in favour of active asset management

AUTHOR: TOBIAS C. PROSS

Firm believers in active asset management do not always have it easy in the public debate. Yet they have also had it tougher. This is because, in the long-standing controversy about active versus passive fund management, the debate is gradually becoming objective – and thankfully so. Each of these approaches has its *raison d'être*; neither is the only true path. Nonetheless, there are good reasons for asset managers to adopt a clear position. We have done so and remain committed: Allianz Global Investors (AllianzGI) is an active manager. We refer to four globally observable trends in the industry to illustrate this.



1/ Divergence has advantages

The first trend – to take the bull by the horns, so to speak: the popularity of passive strategies provides an opportunity for real active management. In the bond sector, the advantages of a deliberate deviation from the index are obvious, as the largest borrower (not always the most solid one) holds the largest weighting in the index. This applies to German equities, too: since the low point in the spring of 2009, investors have been able to make up a lot of ground against the DAX just by underweighting utilities and banks. The prices of these two sectors are still below the level of March 2009, while over the same period the DAX has more than tripled. Even more opportunities are provided by multi-asset funds, which have held first place by a wide margin in European sales statistics over the last 15 years: an analysis by AllianzGI indicates that European private investors have entrusted around EUR 870 billion to this asset class since 2002. The built-in diversification and flexibility, i.e. the opportunity for active reallocation, are the trump cards that the asset class can use to its best advantage.

All this shows that even in a world in which the market return – beta – can be achieved cheaply via passive products, there is a need for active strategies and active management. Even in the implementation of an investment strategy consisting entirely of passive instruments, most customers need “active” support. In addition, it is a myth that investors always receive exactly the performance of the associated index with an ETF. The DAX, for example, is a performance index, which includes the dividends that are paid out. Since taxes are payable on dividends, however, a DAX ETF is systematically lower than the index. In the case of ETFs on less liquid market segments, such as high-yield bonds, index and ETF perform differently in difficult market situations, because some of the securities included in the index are no longer tradable. We last saw this situation in February, and as the ECB exits the corporate bond market, we will probably experience it more often. This suggests at least a more complex balance between active and passive management than we usually find.

2/ Myth of exact tracking

A second globally observable trend is the increasing importance of alternative investments. When the expected yield for supposedly safe investments (government bonds with the highest credit ratings) is almost zero or is negative, not least with serious repercussions for the portfolios of pension institutions, more depends on additional income – alpha. The charm of alternatives is not only that they have return potential, but that this is also uncorrelated with other asset classes. In addition, the market for illiquid alternatives such as infrastructure or private financing is growing immensely: capital supply has its counterpart in fast-growing capital demand. As an example, this is reflected in the growth of Alternative Investments at AllianzGI. Between

2013 and 2018, the assets under management in that sector have increased thirty-fold through organic and inorganic growth – from the original EUR 2 billion to more than EUR 60 billion now. Actually, the term “alternatives”, as a catch-all for strategies that are not plain vanilla equity, bond or multi-asset investments, has not lived up to the importance of this asset class for quite a long time. It is often overlooked that the assets managed within this strategy have, according to the Boston Consulting Group, grown just as strongly as the more passive investment strategies in the last 15 years. This trend will continue. And alternatives are pure active management.

All this shows that even in a world in which the market return – beta – can be achieved cheaply via passive products, there is a need for active strategies and active management.



3/ Sustainability becoming more important

The third global trend is the increasing importance of ESG aspects when making capital investments. The Global Sustainable Investment Alliance (GSIA), a worldwide association of organisations for promoting sustainable investing, reports that the total volume of responsibly managed investments rose by a quarter between 2014 and 2016 alone, to nearly USD 23 trillion. More than half of this amount (USD 12 trillion) is managed in Europe. An important note in this context is that investing while taking into account environmental (E), social (S) or governance (G) aspects does not automatically mean exclusion criteria and investment bans. A number of clients are looking for exactly this, or are interested in impact investing, i.e. investments that explicitly promote well-defined ecological or social causes. For some other clients, on the other hand, this is not

what they are looking for. So precisely for these clients, there is a third way: integrated ESG research. This is AllianzGI's alternative for those who are not seeking direct SRI products, but who would like to make sure that the main ESG risks are taken into account in the investment process. The objective in doing so is to identify and avoid "ESG torpedoes" in the research process, i.e. ESG risks that may seriously threaten the share price. At the same time, however, investment opportunities should also be used actively, resulting from the fact that companies redefine their strategy on the basis of dialogue with critical analysts and portfolio managers. In the US especially, integrated ESG research already plays a major role, according to GSIA figures. This alternative approach still has some potential for catching up in Europe.

4/ Client focus put into practice

Lastly, the fourth trend is based on the recognition that the justification for the existence of active asset management is not based solely in achieving an outperformance of any type. It is based rather more on a trusting and added value-creating client relationship. This starts with advisory services, but can go much further. As the highest level of the cooperation known from fiduciary management (this would include the preparation of strategic asset allocation, the development of the investment strategy, selection of portfolio managers, risk management, reporting), the investment value chain is fully outsourced to delegated/outsourced CIO services. This means that both the decision-making authority and responsibility are delegated to the asset manager. This requires a very special close relationship of trust between client and asset manager. The partnership is raised to a new level. Common values can only emerge over the long term if they are shared, i.e.

"Shared Value". Consequently, critical factors in the success of an asset manager are, above all, genuine client focus put into practice, in addition to extensive expertise (both geographical and asset class-related) and proven risk management qualities.

Active advice essential

Our many discussions with clients reveal that these four trends, observable worldwide, are on investors' minds. Many appreciate comprehensive and active asset management, not least because experience shows that investment objectives are primarily missed due to investment strategies that have been established or implemented inadequately. As a result, active advice and active management will continue to be essential in the future, in order to create value together with clients and on their behalf.



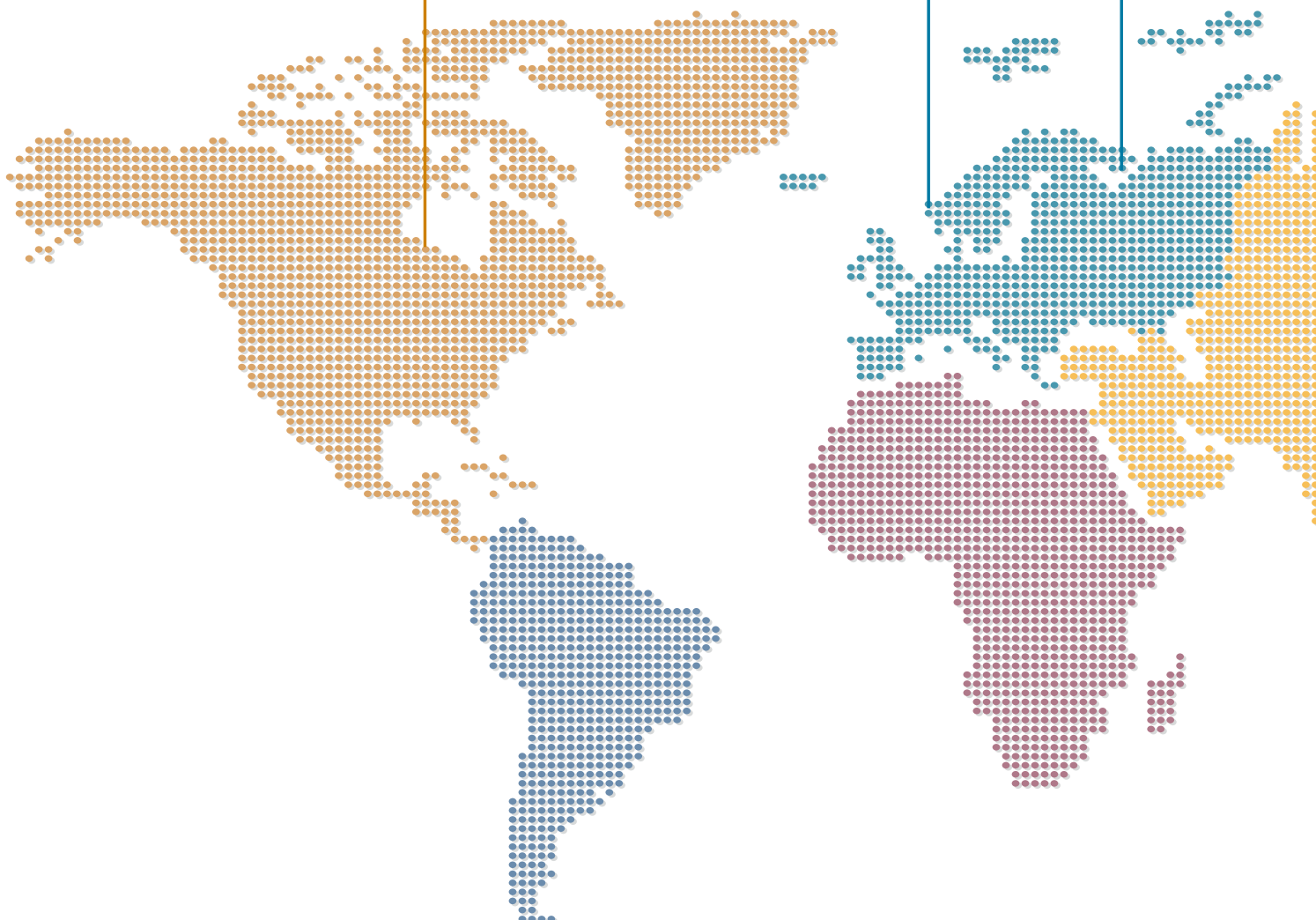
Tobias C. Pross, Global Head of Distribution and Head of EMEA, Allianz Global Investors

Capital market implications 2018

Our capital market outlook provides you with a concise overview of the current fundamental macroeconomic factors. In addition, it will tell you in what direction we expect the capital markets to move by the end of 2018.

US	2018
S&P 500	2,650
10y UST	3.35%
FFR	2.00–2.25%

UK	2018	EUROZONE	2018
FTSE	8,000	EURO STOXX 50	3,900
10y Gilt	2.00%	DAX	14,250
\$/£	1.35	10y Bund	1.25%
		€/£	1.27



CHINA	2018	JAPAN	2018
HSCEI	11,000	Nikkei 225	23,500
PBOC	4.35%	10y JGB	0.15%
¥/\$	6.50	¥/\$	110

MACROECONOMIC BASE SCENARIO

1/ ECONOMIC TREND

Loss of economic momentum – late cycle reflation phase. Ongoing labor market tightening will entail a further narrowing of the global output gap. Biggest risk: global trade war.

2/ PRICE DEVELOPMENT

We expect core and headline inflation to rise in coming months. We are already receiving signals for price pressure at the producer level.

3/ MONETARY POLICY

Expansive overall, but growing signs of an end to global monetary policy dominance and forthcoming peak in central bank liquidity. Risk of tighter than anticipated Fed policy.

4/ FISCAL POLICY

Increasing pressure to take the baton from monetary policy, but only limited leeway and willingness for fiscal stimulus globally, except for some countries like the US and Japan.

Source: AllianzGI Economics and Strategy. Data as of June 2018.

The statements contained herein may include statements of future expectations and other forward-looking statements that are based on management's current views and assumptions, and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. We assume no obligation to update any forward-looking statement.





Private Lending

AUTHORS: **TEOMAN KAPLAN** AND **DIETMAR SCHUBERT**

The promissory note loan (Schuldscheindarlehen, SSD) continues to be used increasingly by corporates as a financing instrument. Even outside the banking market, the instrument is gaining importance for investors via private lending. As a result, a classic form of investment used by insurance companies could possibly be on the brink of re-invention as an alternative asset class.

1/ Capital investment by insurance companies – regulated for more diversification

From a historical viewpoint, insurance companies were very conservative investors, especially life insurers. They invested the money received from their policyholders mainly in long-term government bonds or local quasi-government issuers. Safety, liquidity and profitability were prioritised (Section 54 of the German Insurance Supervision Act [Versicherungsaufsichtsgesetz, VAG] [old version] Investment principles for restricted assets).

On the other hand, insurance companies have developed and re-defined themselves and their capital investments to cope with changes in the conditions in capital markets. In doing so, they have taken new and sometimes innovative paths to fulfill their product claim, i.e. to generate the guaranteed rate of return for their customers, the policyholders, and ideally a respectable surplus return.

This can be clearly followed in the development of the Regulation on the Investment of the Restricted Assets of Insurance Companies (Investment Regulation: Anlageverordnung, AnlV) in Germany in the context of the Insurance Supervision Act (VAG) and the supplementary circulars published by the Federal Insurance Supervisory Office (Bundesaufsichtsamt für das Versicherungswesen, BAV) and, since May 2002, by the Federal Financial Supervisory Authority (BaFin). The latter throw even more light on the changes in the general conditions for capital investments by insurance companies, as they are constantly revised, adapted or replaced.

Under the “former Solvency I” regime, there were “precisely” defined quantitative limits as to how much was permitted to be invested in specific asset classes to cover the

guarantee assets. These limits were laid down in the Investment Regulation, and further specified in the relevant circulars and, in some areas, also extended.

The volatility of capital markets over the last two decades, and the low interest rate environment since the financial crisis, compelled insurance companies to broaden their range of investments in order to derive even more benefit from diversification. The trends in the capital markets, in particular the performance of derivatives and structured products, opened up many new investment opportunities. Insurance companies made use of these opportunities to service their liabilities, which are very long term in some cases, or to generate additional income.

In order to address these developments, Circular R 3/1999 (Information on investing in structured products) and Circular R 3/2000 (Information on preemption and use of derivative financial instruments) were implemented at that time. Due to the introduction of financial innovations such as asset-backed securities (ABS) and credit-linked notes (CLN), Circular R 1/2002 (Investments in asset-backed securities and credit-linked notes) was brought in. With the aim of offering insurance companies even more options for diversification, the Circular on hedge funds, R 7/2004, was introduced in 2004. In the course of time, other asset classes such as private equity were also adopted in the Investment Regulation, even if only under strict adherence to defined risk ratios. The requirements in the Investment Regulation were then specified in another Circular, with the latest version published last December (Circular R 11/2017, previously R 15/2005, R 4/2011).

The volatility of capital markets over the last two decades, and the low interest rate environment since the financial crisis, compelled insurance companies to broaden their range of investments in order to derive even more benefit from diversification.





2/ Solvency II and the interest-rate differential at the reinvestment stage

With the introduction of Solvency II, all these requirements no longer apply. They make room for risk-based solvency rules for the capital resources of insurance companies, and qualitative requirements for the risk management of insurance firms in Europe. However, this “old Investment Regulation” may still apply at many insurance companies in Germany, although in a slightly modified version, in their internal investment guidelines.

During this prolonged low-interest-rate environment, innovative ideas are more than ever in demand for investing new money, or reinvesting the capital from expiring securities that usually pay higher interest. For the purposes of the additional interest reserve in particular, many securities had to be sold to raise undisclosed reserves and, by doing so, to finance the additional interest reserve.

So where to place the money? In recent years, new buzzwords have frequently been thrown into the discussion: private debt, private placements, loans, infrastructure, etc. All of this could be regarded as a new “alternative” asset class. The objective of these asset classes in the current environment is, firstly, to diversify the investment and, at the same time, to generate additional returns.

So where to place the money? In recent years, new buzzwords have frequently been thrown into the discussion: private debt, private placements, loans, infrastructure, etc. All of this could be regarded as a new “alternative” asset class. The objective of these asset classes in the current environment is, firstly, to diversify the investment and, at the same time, to generate additional returns.

However, these “alternatives” often need to be introduced internally as a new asset class. Yet that is not all. Under the new Solvency II regime, they incur a “capital charge”, i.e. these forms of investment “cost” equity capital. This is the first major hurdle for many alternative investments, as the capital requirements for the (in some cases unrated) investments are very high. In addition, it is also expected in Pillar 2 that a thorough in-house risk assessment (ORSA, Own Risk and Solvency Assessment) will be drawn up for the investments. This could present many insurers with an almost insoluble problem for these asset classes. In our opinion, this asset class generates a “complexity premium” rather than an illiquidity premium. This is why these investments are outsourced to asset managers for the most part.

In principle, diversification into “alternative” asset classes is to be welcomed, because they also offer the potential to generate higher returns in the current environment. Most of the investments in this context are highly illiquid. Nevertheless, this should not deter life insurers in particular from investing: due to their long-term investment horizon, they pursue a buy-and-hold strategy for the most part.

In this article, we would like to look at an asset class that can be described as “alternative”: promissory note loans (SSD) and registered bonds (Namensschuldverschreibungen, NSV) from corporate issuers¹⁰. Why is this investment referred to as “alternative”? On the one hand, this asset class is unique to Germany, while on the other, most of the issuers in the past were federal states, cities and banks. In this article we intend to focus on promissory notes issued by corporates, which represent a logical extension to the range of promissory notes. This type of promissory note is not yet quite as common for some investors, partly because these notes are more time-consuming to source and require very complex due diligence, especially in the case of unrated issuers, in addition to the company’s own risk analysis that is necessary under Solvency II. If you look at the balance sheet of a German (life) insurer, the proportion of promissory note loans and registered bonds can in some cases be up to 50%, even though public-sector issuers and banks account for most of this.

3/ Historical development of the promissory note loan

The origins of the promissory note loan can be traced back to the last century, when life insurance companies provided various municipalities with capital not only through the purchase of municipal bonds, but also by granting them loans against the issue of a promissory note¹¹. Since then, the promissory note loan has passed through several high points. The first such phase was in the Third Reich, when insurance companies were forced to buy new batches of Reich bonds from the Reich Ministry of Finance. Alternatively, however, they could also issue promissory note loans earmarked for a specific purpose to public-sector entities, up to a certain level.¹²

The second real boom was in the post-war period. Even shortly after the currency reform in 1948, large sums of money regularly flowed to insurance companies through premium payments. These funds had to be invested to earn interest over quite a long term. On the capital-seeking side stood utilities and (industrial) companies. At that time they were unable to fully cover their enormous need for capital through other capital market instruments, as the equity and bond markets were still being developed right into the 1950s.¹³ Subsequently, promissory note loans led a shadowy existence for very many years, until they experienced a renaissance at the beginning of the new century.

4/ Market development

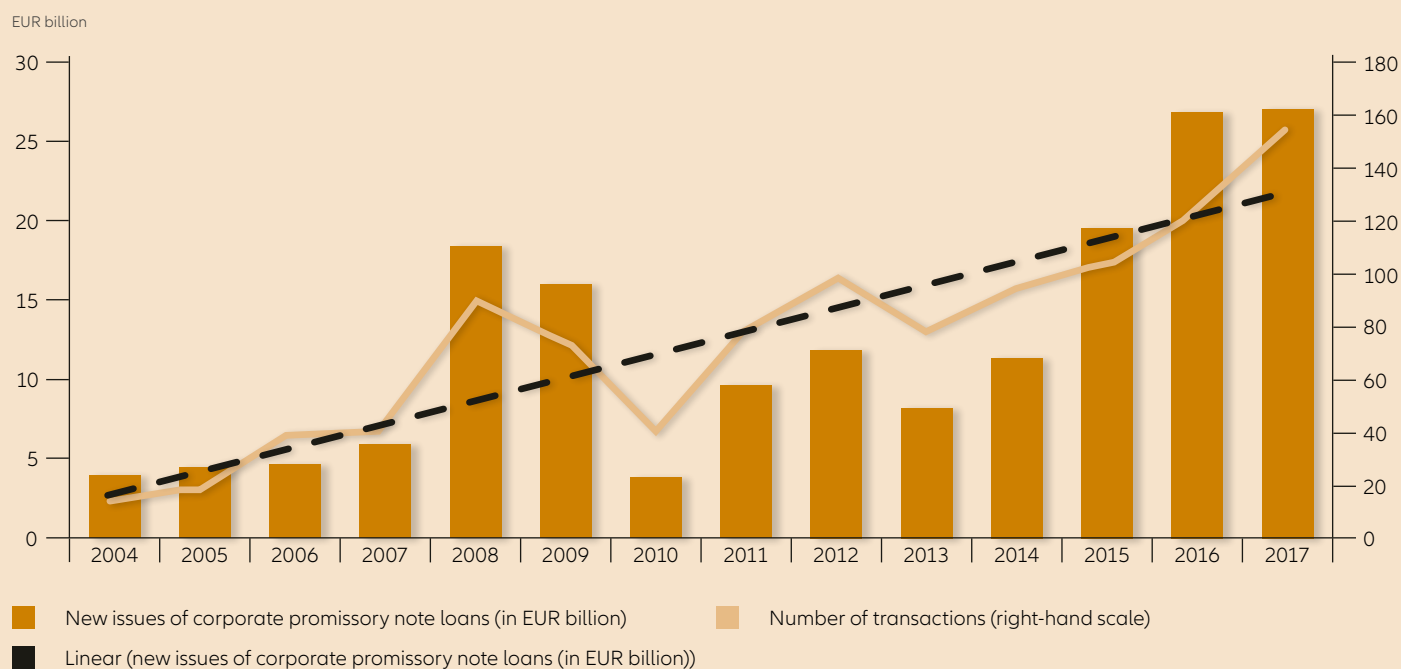
The volume of promissory note loans issued by corporates, EUR 3 billion as estimated at the beginning of 2000, reached a new all-time high of more than EUR 27 billion in 2017 (see chart). In the case of these securities, however, it must be taken into account that, in issues from companies with a term of more than 10 years, the registered bond format is added to promissory note loans issues. It is also important to note that the number of issues and the issue volume could in fact be higher. This is because the promissory note loan is also used as a “genuine” private placement, and consequently no corresponding figures are published by the arranging banks.

In 2017, for example, several hundred million euros’ worth of these private placements were arranged by us alone, without the involvement of a bank (direct lending) and put on the books of various insurance companies in the Group.

It is not possible to forecast reliably whether the trend will continue in this form. Factors such as increasing credit defaults or difficulties of current promissory note loan issuers or declining quality of the promissory note market may, on the one hand, discourage issuers from continuing to use promissory notes as a means of financing. On the other hand, investors could also become more cautious.

The granularity of the capital-raising companies is very high. For example, a wide range of issuers are among the more than 160 transactions in 2017, from DAX-listed companies through family-run small and medium-sized enterprises to special-purpose associations organised on public law lines.

A/ TREND IN THE ISSUE VOLUME OF CORPORATE PROMISSORY NOTE LOANS SINCE 2004



5/ Diversification within the promissory note market

In the last calendar year, our own estimates suggest that approx. 65% of the issuers of this typically German financing instrument are from Germany. This was followed by issuers from Austria with around 15%, and from Switzerland with about 10%. The granularity of the capital-raising companies is very high. For example, a wide range of issuers are among the more than 160 transactions in 2017, from DAX-listed companies through family-run small and medium-sized enterprises to special-purpose associations organised on public law lines.

The investor base has also expanded in previous years: in addition to various investors from Germany (banks, insurance companies, pension funds, etc.), buyers are also increasingly coming from other countries, both near and far.



6/ Issuer market

In recent years, we can refer to an issuer market for various reasons, where the price structuring and contract design have moved steadily in favour of the capital-seeking side. For example, the last few years have seen a strong narrowing of risk premiums (spreads), which is difficult to follow in some cases. Even if the high demand coupled with often significant oversubscriptions puts pressure on the price, thus confirming the arrangers' pricing, it is quite legitimate to question the pricing of individual transactions. For example, maturity-independent spreads (i.e. that the risk premium is identical for different maturities) do not adequately reflect the associated risks from the investor's perspective, because contrary to all probability and experience, it is assumed in this case that the credit risk is independent of the maturity. Likewise, the pricing should also take into account that, unlike a traded instrument, a promissory note loan should include a maturity-dependent illiquidity premium, because the investor cannot usually sell a subscribed promissory note loan tranche at short notice, in contrast with a bond.

In contract design, the strong position of companies seeking to raise capital is also shown. In the last few years, for example, financial ratios were agreed in the contract for only very few issuers, in which breach of these ratios could result in a margin step-up or cancellation by the buyer. While the trend in financial ratios is still transparent in some aspects, situations are increasingly arising that are not acceptable to promissory note loan investors in all conscience. It is not clear, for example, why investors should casually accept the following "disparities" in contract design that have recently occurred more and more:

Structural subordination:

This situation arises when, in addition to the issuers, other group companies (are permitted to) borrow funds, in a bad case even to an unlimited extent. The situation is even more investor-unfriendly if the issuers themselves have not set up any (major/realisable) assets.

"De facto" subordination:

An escalation occurs when, within the raising of loans at the level of the issuer or other companies in the group, the funds raised can also be secured. The latter is possible if the negative pledge in the documentation refers only to the issuers. In this case, there is even a combination of a structural and de facto subordination ("double subordination").

Asset disposal:

The lack of a clause on the possible or unrestricted sale of assets may result in a major change in the basis on which the investment decision had been made. This may also lead to an "erosion" of the issuers.

However, there are certainly options acceptable to both sides that could lead to a reduction in investor risks of this nature. In these contract designs, for example, the position of the investors could be improved somewhat through joint liability of other companies, while at the same time restricting the transfer of assets to these companies and/or their borrowing. In practice, however, this is very rarely taken into account for arranged promissory note loans.

7/ From the banking market to private lending partnerships?

Under these general conditions, the market for promissory note loan issuers is very attractive, regardless of their company size. On the one hand, large issuers with corresponding capital requirements can collect issue volumes of more than EUR 1 billion. On the other hand, smaller issuers can reach new investors or expand their funding base. It also helps issuers that the number of arranging banks has grown strongly, with the result that they are in competition with one another for the marketing of the issue. Accordingly, they want to get in a good position with the issuer in relation to the “selling power” (placement with investors) and the risk premium, as well as the documentation.

The 2017 financial year has undoubtedly seen sufficiently interesting opportunities to invest in the promissory note loan market arranged by banks, even for investors with the highest quality standards. These options have nevertheless decreased significantly compared to previous years. Due to the trend described above, these investors were pushed more and more to enter the private placement business (in the form of direct lending). Large investors such as investment companies or asset managers with the necessary expertise and track record should also have opportunities in this respect to make this available to third-party investors who do not have the expertise or the

capacity for a credit check. The aim would be to use these additional funds for even larger issues, which would not be possible on a stand-alone basis. This could also enable third-party investors to accommodate the options relating to equity capital offsetting under Solvency II, as currently discussed by the EIOPA. A particularly fascinating aspect is the extent to which the corporate promissory note loan, either rated or unrated, is categorised as a worthwhile asset class for insurance companies, and the extent to which it provides relief for capital adequacy requirements.

It should not be forgotten that the increased implementation of private placement as direct lending is a result of various discussions with (potential) issuers. As the maturity increases, the issuers appreciate aspects such as investor security (reliability, creditworthiness, reputation) and are also willing to reward these accordingly, through the price or documentation. Since the investment continues for many years or even decades, both parties also speak of a “partnership” in this context. This may be extended during the business relationship by increasing the exposure, or it may be continued after repayment of the loan. As an arranging investor, it is always important to find a fair solution for all parties. This includes: a fair risk premium with appropriate issuer documentation for a reliable, highly creditworthy, strategically-oriented “buy-and-hold” investor.



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A region on the rise: key conclusions from our Asia Conference

AUTHOR: NEIL DWANE

Our clients and investment professionals recently met in Berlin for our 10th annual Asia Conference. Here are some of the highlights from two days of discussions about the world's most dynamic region.



1/ ESG investing is on the rise

While Asia once lagged Europe in many environmental, social and governance (ESG) issues, an increasing number of governments and corporations in Asia are paying close attention to ESG factors. We expect that this shift will gain momentum as the region's markets continue to develop.

- In Japan, Prime Minister Shinzo Abe's government and major pension funds are pressing for improved diversity, shareholder representation and management accountability.
- China is changing its "growth at any cost" model of the last 25 years; President Xi Jinping knows the importance of delivering better living standards and a cleaner environment.
- South Korea is also making progress on its ESG journey, making efforts to address all-too-common management scandals and bribery issues.
- India still relies on domestic coal, but is keenly aware of the unpopular costs of growth at the expense of the environment, particularly given the country's large farming population.

2/ Politicians are driving significant reforms

Politicians know that the best way to get and stay popular is through sustained economic growth. Many Asian governments are focused on adapting their economic business models. They recognise that supplying goods to tapped-out US and European consumers will not work for much longer.

China is leading the region's reform efforts, aiming to rebalance its economy away from exports and manufacturing towards consumption and services. Indeed, China's spending on consumer needs and essentials is already falling, leaving more room for discretionary spending.

In India, Prime Minister Narendra Modi is moving his country forward along similar lines, restructuring the country's banks and inefficient monetary system through an aggressive "demonetisation" plan. A better biometric-based identification system called Aadhaar should make government services, such as welfare, more targeted and less susceptible to fraud.



Key takeaways

- 1/ Standards for corporate governance and behaviour are rising rapidly across Asia amid a greater focus on ESG factors.
- 2/ For investors, Asian politics are less worrisome than US or European politics; Brexit negotiations and Italy's discontent with the EU may be more pressing.
- 3/ Global trade is still important to Asia, but as every year passes, the region's growth becomes more and more self-sustained – especially with “One Belt, One Road” projects.
- 4/ Built on strong long-term fundamentals, Asian equities and bonds offer investors the potential for solid returns and risk diversification.
- 5/ Asian governments are adapting their economic business models: supplying goods to tapped-out US and European consumers won't work for much longer.
- 6/ Trade wars help no one, but denying Asia access to US technology could simply fuel the need for local Asian tech.

With general elections due in 2019, India does, however, face significant electoral unknowns. But greater political uncertainty exists in the European Union, which is grappling with Brexit and with Italy's threats to flout the EU's rules – or even withdraw from the monetary union.

Politicians know that the best way to get and stay popular is through sustained economic growth.

3/ Trade troubles won't derail Asia's high-tech shift

In recent months, trade friction between Asia and the United States created a steady flow of worrisome headlines, for good reason. Trade wars help no one, particularly big exporters such as Japan, China and South Korea. Although US President Donald Trump seems to have softened his initially hard-line stance towards China, it is unclear whether new tariffs are officially off the table – particularly with regard to technology. Asia's regionally efficient supply chains mean the negative effects of tariffs can quickly spread; consider how the technology sectors in the US and China are inextricably linked with South Korea, Taiwan and other countries.

Yet Asia's tech sector is on a good trajectory. At some point in the next few years, Asia appears set to become the largest investor in research and development (R&D) globally, intensifying a high-tech race with the US. Moreover, denying Asia's economies access to US technology could simply fuel the need for local Asian tech.

4/ Green tech and infrastructure are spurring development

As Asian economies grow, they will come under the same pressure as their US and European counterparts to make that growth sustainable from an environmental perspective. The good news is that many leading economies – in Asia and elsewhere – may now be able to grow even as they decrease the negative environmental impact of that growth. China is leading the way with a strong emphasis on developing green technologies such as solar power and electric vehicles, as well as sustainable food sources through better R&D and agricultural practices.

Infrastructure is also a major development theme for the region. India, Vietnam and Indonesia are addressing their huge infrastructure deficits in the hope of sustaining strong, open and competitive economies. Asia as a whole is also supported by China's huge "One Belt, One Road" plan, which is primarily an infrastructure project, but could have a halo effect on employment and services development – particularly in Sri Lanka, Vietnam, Pakistan and Bangladesh.

As Asian economies grow, they will come under the same pressure as their US and European counterparts to make that growth sustainable from an environmental perspective.



6/ Growth and income are top investment themes

Asia's compelling structural growth story provides investors with a host of access points:

- Asia's millennials are reshaping their economies and driving the adoption of new technologies and services. Asia's focus on R&D is also giving the US a run for its money with big data and artificial intelligence.
- The prospect of less trade with the US and Europe could push Asian companies to focus more on the new emerging-markets consumer, many of whom may at first only be able to afford regional brands, rather than those of global multinationals.
- Equity investors will find that many Asian companies boast less debt and better longer-term fundamentals than their Western counterparts – in addition to solid earnings and dividend growth potential.

For fixed-income investors, Asia also offers the ability to boost return potential and diversification – particularly for portfolios overexposed to US high yield, or overly sensitive to Federal Reserve policy. Thanks to its growing markets and rising domestic investment by local investors, Asia should be whipsawed less by US investors in years to come. Instead, the region will be powered by sound economic policy, strong fundamentals and exciting investment opportunities from both equities and bonds.

5/ China is opening up its equity markets

China has been taking measured steps to open up its currency, bond and equity markets to international investors, even as it carefully controls the flight of capital out of the country. Yet despite an abundance of caution, China's market reforms are working well – and being expanded. This is turning Chinese equities from an asset class that many investors ignored into one that is being taken seriously, particularly with China A-shares set to be included in the MSCI Emerging Market index this summer. (For more insights into China, read "China's Year of the Dog bounds into view" and "10 key facts about China A-shares".)



Neil Dwane, Global Strategist, Allianz Global Investors

Allianz Global Investors expands Regional US Fixed Income capabilities with addition of US Portfolio Management Team

Security selection on the corporate bond markets and sector rotation in the secured bond segment are the key strengths of our new US Fixed Income team.

The team's expertise, backed by many years of experience, and its ability to generate consistent outperformance will soon be available to our European institutional clients.

Allianz Global Investors announced in January that it has further built out its Fixed Income capabilities by hiring an entire US Fixed Income team. The team consists of 12 members, and is headed by Carl W. Pappo Jr., CIO US Fixed Income, who has 25 years of investment experience. The firm welcomes the team responsible for portfolio management, trading and research to AllianzGI. The team will launch active traditional strategies in US Core, Core Plus, Liability Driven Investing (LDI) and Preferred Securities, filling a critical gap for AllianzGI in the US market.

The investment team is highly experienced, with an average of approximately 19 years of experience. The broad team has worked together for 10 years, with some working relationships going back 20 years. They have an impressive track record in managing US Fixed Income, outperforming the broad market mainly through security selection and sector rotation. Their investment process is based on dedicated bottom-up fundamental research, and is well designed to exploit the significant and repeatable valuation inefficiencies in the US fixed income market, to the benefit of our clients.

The team conducts fundamental research. They utilise in-house financial models to investigate the full financial statement and forecasts, as well as stress-testing the projections. The team produces proprietary internal credit assessments, and performs risk vs. reward analysis of issuers. Their fundamental research analyses amongst other things the capital structure and the quality of collateral, combined

with relative value analysis to identify alpha-generating opportunities. This approach has proven to lead to great consistency of potential excess return.

A great example of how the team can enhance the portfolio's alpha-generating potential is the aftermath of the "Tax Cut and Jobs Act" signed by Mr. Trump on 22nd Dec. 2017. Key elements of this tax reform include reducing tax rates for businesses, but also reducing deductibility of interest, as well as repatriation of foreign earnings. Most analysts estimate that this tax reform can bring around \$600-700 bn in savings for US corporations. But not all corporates benefit equally. There are major differences in the consequences for corporate earnings and credit metrics alike, including cash flow, leverage and interest coverage ratio. Hence, constantly re-evaluating and selecting the right security is crucial.

Franck Dixmier, Global Head of Fixed Income, said: "US Core Fixed Income and LDI have been missing pieces in our global fixed income offering, and I am very pleased that Carl and his team will be able to develop this important capability which meets a critical client need both in the US and globally, and complements our other capabilities in fixed income."

We plan to launch selected US strategies in Europe in the Autumn. Please contact your local sales representative for further detail.



Andreas Utermann, CEO and Global CIO, Allianz Global Investors, talks to **Kerstin Keller**, Head of Institutional Marketing and Editor-in-Chief Update Magazine, Allianz Global Investors

“Active is” doesn’t just reflect our commitment to active asset management. Being active is part of our DNA.

Allianz Global Investors has sharpened its value proposition and brand positioning, with “Active is” becoming the key statement. What does ‘active’ mean to you?

Andreas Utermann: First, “Active is” reflects our commitment to active asset management. Too often, active management is seen solely as a job of selecting securities and measuring performance against a benchmark index. While that’s a core part of what we do, we think active management involves a broader partnership built around identifying clients’ needs.

We can use a diversified toolkit of strategies to meet those needs, and adjust the approach as required over the long term. Our toolkit includes expert capabilities within and across asset classes, that help us guide clients in a way that is truly product-agnostic.

Whatever the arguments for active management, however, active managers need to show that they represent fair value. Our innovative pricing model

is one way in which we seek to build a common understanding with clients of where and how we add value.

Over the past year, with our “Active is” positioning, we have refined our positioning to accentuate our commitment to active, and set ourselves apart in the marketplace.

But “Active is” doesn’t just reflect our commitment to active asset management. Being active is part of our DNA: it means leading change, taking ownership, working flexibly and challenging ourselves – among other aspects.

All of these commitments come together in our brand promise – “Value. Shared.” – which underscores our mission to work with clients to address their challenges for the long run.

Why is active management important right now, and what difference does it make for clients?

Andreas Utermann: Asset management is still a fast-growing industry, yet it faces continued scrutiny from investors and regulators alike.

Asset managers' profit margins are tightening, and we anticipate more industry consolidation as a result. We expect the number of leading asset management firms to reduce from the current 200 or so to less than 50 players in the near future. Meanwhile, trust in the industry remains low, and clients' expectations continue to increase.

And, while passive investment vehicles have grown popular against the backdrop of a prolonged bull market, they may not position investors well when conditions – and opportunities – change. Faced with a more muted return outlook over the next five to 10 years, investors will need ways to work their money harder.

Many investors are looking for alternative types of investment that may deliver uncorrelated returns.

Investors are demanding greater transparency from their advisers: they want to know that the fees they pay reflect the performance they are achieving.

Against this backdrop, we are focused on several key projects that support our vision to be a global active asset management leader. For example, we're simplifying our operational backbone, and creating a global, state-of-the-art and flexible enterprise architecture.

We continue to expand our active conviction and alternatives investment offering. We're extending and diversifying our distribution footprint, and we're accelerating our digital transformation. And, of course, we're strengthening our brand to emphasise the value we can add.

We hope that clients rely on us to be a trusted and valued partner who puts their needs first.

With “Value. Shared.”, we want to show that asset management generates long-lasting value, not just for our clients but for all of our stakeholders. We also have a broader social role to play.

You said that your “Value. Shared.” brand promise underscores your commitment. What does “Value. Shared.” stand for?

Andreas Utermann: We are one of the few truly global asset managers dedicated to active management, managing more than EUR 500 billion in assets for individuals, families and institutions.

With “Value. Shared.”, we want to show that asset management generates long-lasting value, not just for our clients but for all of our stakeholders. We also have a broader social role to play.

Reflecting investors’ increasing desire to influence companies and society, we are integrating environmental, social and governance (ESG) factors into our investment process. Not only does this enable us to identify material risks, it allows us to engage with companies to enhance governance and drive improved performance.

Other examples of our commitment to “Value. Shared.” include our ability to co-invest in the products that we recommend to clients. Many clients find this attractive, especially for our illiquid offering. From our perspective, co-

investing gives us an even deeper understanding of the outcomes that clients are looking to achieve.

We also develop products in partnership with our clients, to find the solutions that work best for them. This involves very engaging and productive discussions to understand their needs.

And our ability to deliver on these objectives is helped greatly by our internal culture of partnership and collaboration. We build teams and projects that cut across functional lines to maximise idea-generation and move quickly from planning to action.

Our “Value. Shared.” commitment manifests itself in many ways, but ultimately it’s sharing our clients’ journeys for the long run, adding value in a cost-efficient way – including through innovative fee structures – and staying focused on where the next big opportunities are coming from.



Kerstin Keller, Head of Institutional Marketing and Editor-in-Chief Update Magazine, Allianz Global Investors

All sources and background information

Editorial

- 1 Page 3:** https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance_en

Spotlights

- 2 Page 5:** The acronym “ESG” stands for Environmental, Social and Governance (the latter meaning corporate governance). The term and concepts for ESG criteria were first introduced in 2004 by the United Nations’ Global Compact initiative, in order to provide analysts and investors with a set of standards based on the United Nations’ “Six Principles for Responsible Investment”.

ESG

- 3 Page 6:** Corporate Social Responsibility.
- 4 Page 11:** Cf. G. Friede, T. Busch, A. Bassen: ESG and financial performance. Aggregated evidence from more than 2,000 empirical studies, in: Journal of Sustainable Finance & Investment, 5. Jg. (2015), H. 4, p. 210–233.
- 5 Page 11:** On ESG’s importance for investments, see also: S. Hörter, ESG in Investment Grade Corporate Bonds, Allianz Global Investors, 2016; and S. Hörter, ESG in Equities, Allianz Global Investors, 2015.
- 6 Page 11:** Cf. also: G. Friede, T. Busch, A. Bassen: Impact of ESG factors on the performance of firm investments, in: AbsolutImpact, 01/2016.
- 7 Page 11:** The analysis encompasses 334 studies, including 291 equity, 36 bond, and 7 real-estate studies.
- 8 Page 12:** Cf. R. Laporta, F Lopez-de-Silanes, A. Schleifer & R. Vishny, Legal Determinants of External Finance, in: The Journal of Finance, Vol. LII, No.3, July 1997.
- 9 Page 12:** Cf. K. Gugler, D. C. Mueller, B. B. Yurtoglu: Corporate Governance and Globalisation, in: Oxford Review of Economic Policy, 20. Jg. (2004), H. 1, p. 129–156; cf.: The Impact of Corporate Governance on Investment Returns in Developed and Developing Countries*, in: The Economic Journal, 113. Jg. (2003), H. 491, F511-F539.

Private Lending

- 9 Page 25:** The promissory note loans issued by corporates are regulated in Section 2 Para. 1 No. 4 of the Regulation on the investment of guarantee assets by pension funds, death benefit funds and small insurance firms (Investment Regulation: Anlageverordnung, AnlV) in conjunction with the “Principles for the granting of business loans by insurance companies – promissory note loans”.
- 10 Page 26:** Cf. Hilben, H., Die Kapitalanlagen der deutschen Privatversicherungsgesellschaften und ihre Bedeutung für den deutschen Kapitalmarkt [The capital investments of German private insurance companies and their significance for the German capital market], Jena 1908, p. 109-112; Mueller, R., Anlage und Verwaltung der Kapitalien privater Versicherungsunternehmen [Investment and management of the capital held by private insurance companies], Berlin 1914, p. 90-93.
- 11 Page 26:** Cf. Dr. Staehle, W., Die Schuldscheindarlehen [Promissory note loans], Betriebswirtschaftlicher Verlag Dr. Th. Gabler, Wiesbaden, 1965.
- 12 Page 26:** Cf. Zender/Grunow in Finanzinstrument Schuldschein [The promissory note as financial instrument], Springer Gabler Verlag, Wiesbaden 2018.

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The volatility of fund unit prices may be increased or even strongly increased. Past performance is not a reliable indicator of future results. If the currency in which the past performance is displayed differs from the currency of the country in which the investor resides, then the investor should be aware that due to the exchange rate fluctuations the performance shown may be higher or lower if converted into the investor's local currency.

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Masthead

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ACTIVE IS: ALLIANZ GLOBAL INVESTORS

Active is the most important word in our vocabulary. It doesn't just describe how we manage your money. It defines our entire approach as an asset manager: active is our commitment to creating and sharing value with our clients.

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