

Global Markets Strategy Report

September 2010

Rank: From weakest to strongest in ascending order:

Strong Underweight Underweight Slight Underweight Neutral Slight Overweight Overweight Strong Overweight

Please note that the rank is indicative and may not balance when summed.

Central Banks' Commitment to Loose Policies Supports Risky Assets

- Economic growth in major developed economies is back to trend rates in the year to the second quarter with the help of very loose policies. As the support of stimulus measures wanes, weaker economic data may fuel concerns about an impending slowdown, but central banks are committed to leaving key interest rates near zero to prevent a double dip scenario.
- Mixed evidence from the economic data should be offset by buoyant corporate data. Low interest rates can be afforded by subdued core inflation, which in turn is held in check by a lack of wage pressures. This is a favourable backdrop for corporate earnings, which can grow steadily in spite of a slow recovery on the macroeconomic side.
- Earnings growth should be sustained not only by lower costs but also by increased sales revenues, which are curbed by consumers' penchant for more savings. However, the slow growth of domestic demand in developed economies can be offset by buoyant global growth led by fast-developing regions. The outlook for companies with strong foreign sales remains sanguine.
- The US Federal Reserve is warning about low inflation in order to retain its unconventional policies and fulfil its other target of maximum employment. The European Central Bank is more committed to fighting inflation than promoting economic growth, but it may refrain from raising policy rates as long as banks' balance sheets are not thoroughly repaired and capital ratios need to improve.
- This is a legacy of a hard recession but not the presage to a double dip or to a deflationary environment as record-low government bond yields in the US and Germany may be suggesting. Corporate bond markets retain attractive yield spreads and good risk/reward ratios at current levels, having weathered a risk averse scenario amid the debt crisis of some euro peripheral governments.
- In this environment we reiterate our preference for cyclical (also known as risky) assets, beginning with credit markets. Within corporate bonds, we prefer the US where spreads remain high compared to declining default rates, and the unstable Financial sector accounts for less than in Europe. Government bonds are generally expensive in core markets and supported by central banks' purchases.
- Within equities, we retain some regional biases, notably towards countries or areas with stronger domestic growth potential such as most of Emerging Asia and Latin America. Europe and Japan stand at the other side, although European markets have become cheap on several counts and hold some upside if economic growth is upgraded.

Recovery in earnings per share and no fears of inflation favour cyclical assets

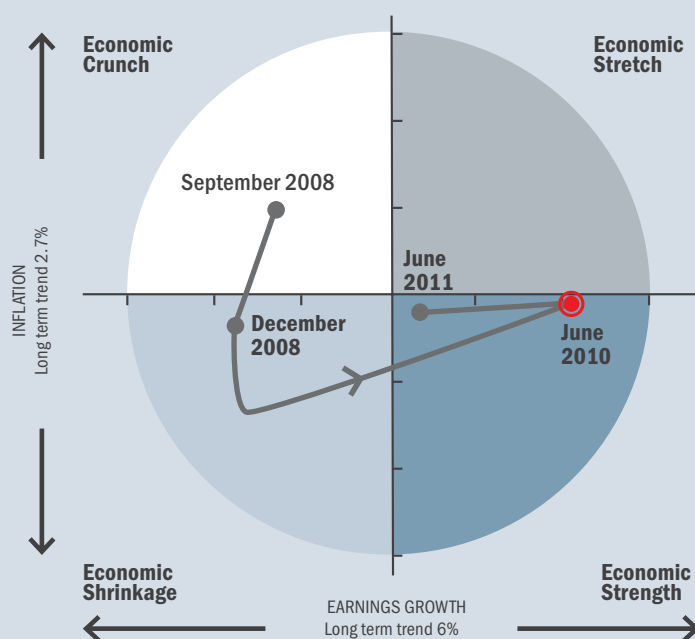
Economic Strength

The stabilisation and the progressive improvement of the Financial sector, which began in the second half of 2009, is broadly confirmed by the latest available data from the United States. Inflation is not yet a threat in spite of GDP going back to trend growth, due to a lack of wage pressures. Upward price pressures are most visible in major emerging regions but inflation is not yet a matter of concern.

Profit Recovery

Earnings growth is again in focus. Sales revenues add to cost cutting but top-line growth is not yet sustained. This should happen as the macroeconomic scenario also improves in developed countries, while demand from fast-developing emerging markets has been a key support at this stage.

The Investment Phazer



(*) Data on US Earnings Growth and US Inflation are analysed by a proprietary statistical model to get four different economic phases. Source: Pioneer Investments Asset Allocation Research as of 30 June 2010

Implied Strategy

We name 'Economic Strength' a phase of the cycle with above-trend operating earnings and below-trend inflation expectations. Over the last 30 years this environment has called for risky assets. The current stance leads to an overweight of global equities and investment-grade corporate bonds.

Alternative Scenario

'Economic Shrinkage' is the main alternative scenario.

Asset class	Shrinkage	Crunch	Strength	Stretch
Equity			Buy	Buy
Government Bond		Buy	Sell	
Corporate Bond			Buy	
Cash	Buy		Hold	

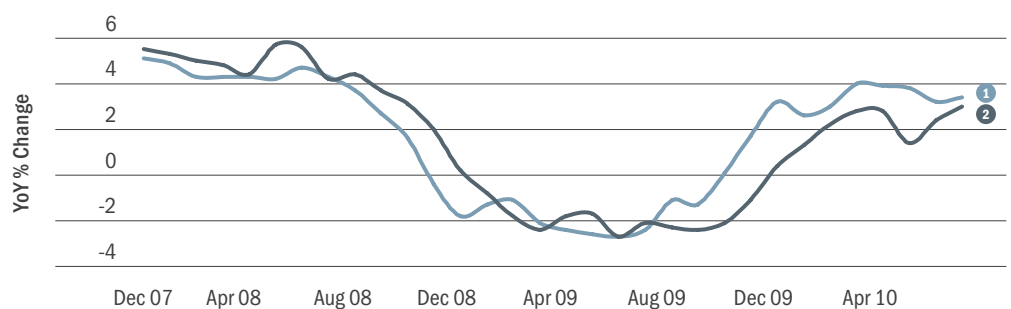
Putting a slowdown into the right perspective

US GDP growth is back to 3% in the year to the second quarter, and therefore back to pre-recession levels. This is a remarkable feat, if we remember the pervasive gloom of a year ago about a deep and long recession or even a return to the Great Depression scenario. In order to get there, however, some help was needed, notably in the form of massive stimulus policies that lifted the economy out of the worst of the recession and sped up the return to a normal growth rate at least on headline figures. That this kind of help was short-lived and its beneficial impact would not be sustainable in the long run was accepted by most analysts and investors. What looked important, in spite of these caveats, was that a path of growth was nonetheless resumed as the steady recovery of US personal income and spending shows. So the recent concerns amid very weak data on US home sales, as well as ongoing evidence of low employment growth, should not prompt calls for a dramatic slowdown or even a double dip.

This may be happening because the eurozone debt crisis has not yet disappeared from investors' minds and is unlikely to do so for some time. Keeping loose economic policies in place is seen as key for a long-term economic revival and the prospect of budget tightening by deficit-stricken governments cannot be reassuring. However, there is little impending risk that these policies are being wound down on a global scale. This goes not only for the US but also for major emerging countries, whose demand has lifted many developed regions out of recession. Inflation is rising at a moderate pace in China and other BRIC countries so that the current containment plan may work without making the case for hard monetary tightening. For its part, the US Federal Reserve can afford to keep interest rates near-zero and roll over such unconventional policies as quantitative easing, as long as wage growth and core inflation remain subdued.

When we set our global allocation strategy and decide how much money to put into equities, we should also keep in mind that corporate earnings may continue to grow nicely in spite of a mild macroeconomic slowdown next year. Unlike the aftermath of the shallow (in macro terms) recession of 2002 that followed the tech bubble, corporate balance sheets are much healthier and can allow well-managed companies to weather many stress tests including an economic slowdown (we rule out a double dip). Moreover, the reliance on foreign orders makes companies based in struggling economies less dependent on domestic earnings growth. This looks especially true for German and other European industrial firms, whose order book is primarily driven by fast-developing regions such as China.

The US Housing Market Dips Again, Not so Other Reliable Indicators



1 US Personal Consumption Expenditures Nominal Dollars YoY SA 2 US Personal Income YoY SA

Source US Bureau of Economic Analysis, Bloomberg as of 17 September 2010

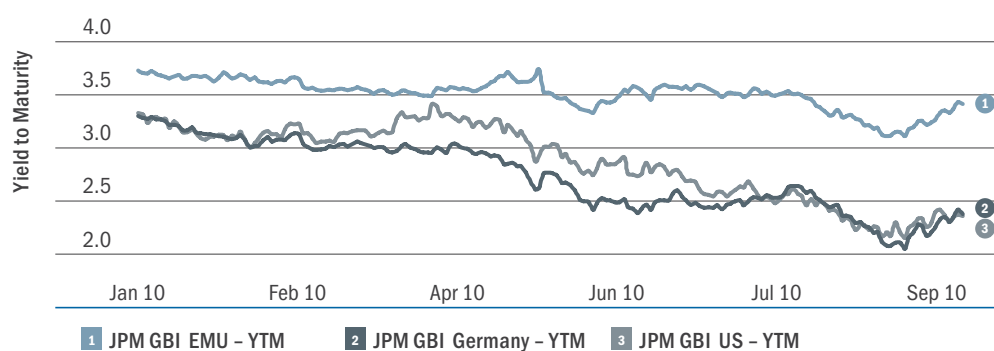
Although partly retraced of late, the dramatic decline of government bond yields in core markets (Germany, USA) suggests that investors are wary of a possible Japan-style deflation but that sounds overly pessimistic. In our view, the main message of record-low yields is an enhanced investment case for risky (cyclical) primary asset classes, such as equities and corporate bonds.

Government Bonds

Record-low yields underscore risk of deflation

Core government bond markets, such as the US and Germany, have moved of late as if the risk of a Japan-style deflation was real. Before nudging up in early September, benchmark US 10-year yields fell to levels last seen when the recession was at its worst in March 2009. The Federal Reserve's move to extend the bond-purchase programme and roll over its policy of quantitative easing has provided a clear bid for US Treasuries, coupled with fresh evidence of weak economic growth. Unless consumer prices show renewed pressures, the extension of these unconventional policies aimed at boosting money supply is unlikely to spark concerns over inflation. Nonetheless current yields are so low that a slow-growth scenario seems well entrenched and a sharp decline in prices may follow better-than-expected evidence about the economy. For their part German Bund yields have even touched record lows also because of their perceived safe-haven status in the euro debt crisis. This support may be more lasting. The theme of sovereign credit risk may not be making headlines as in May and June but spreads are still pretty close to those peaks. Compared to the end of June, credit default swap rates are about the same for Greece and Italy, and higher for Portugal and especially Ireland, whose finances can be further strained by a weak Banking sector. The safe-haven quality inside Europe may not shelter German Bunds from US influence if the expected slowdown is not sharp. Yields in the 2.80%-3% range are closer to fair value and that means about 50 basis points higher than current levels.

Core Government Yields at Lows as Euro Zone Divergence Persists



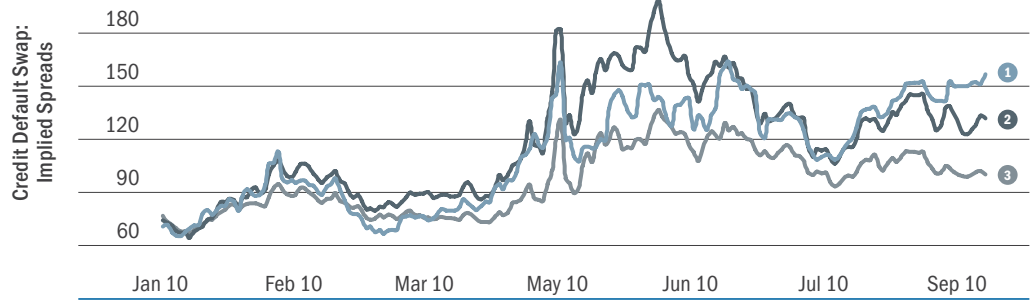
Source JP Morgan, Bloomberg as of 17 September 2010

Credit Markets

Healthy balance sheets point to safe credit risk

The euro government debt crisis increased credit spreads in most investment-grade bonds. For the euro market this was not only an instance of risk aversion, as bank issues account for a good half of it and losses on government bonds held on their balance sheets are not negligible. However, for the broad market the pull of higher yields on peripheral countries' debt was much less evident. The risk implied in CDS prices trades some 50 basis points less for euro corporate bonds than for Western Europe's sovereign bonds, and the correlation between the two is much lower than between sovereign and financials. US corporate spreads show a similar pattern and are reasonably close to this year's lows. Nonetheless, an improving economy should reduce defaults more than current valuations imply and therefore this market still looks cheap.

European Corporate Spreads Weathering the Storm of the Greek Crisis



1 MARKIT ITRX SOVX WE 12/14 2 MARKIT ITRX EUR SNR FIN 12/14 3 MARKIT ITRX EUROPE 12/14

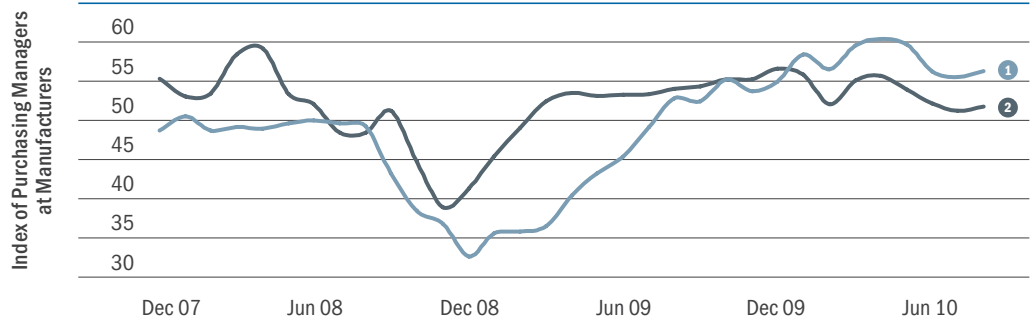
Source Markit, Bloomberg as of 17 September 2010

United States

The case for maintaining loose economic policies

Concerns over a stimulus-led recovery have become more widespread as the latest figures on home sales suffered a sharp decline. This should not come as a surprise after the tax breaks on a first-home purchase expired at the end of April and those people who were entitled rushed to buy right up until the very last day before the deadline. Nevertheless the latest data were impressive for the scale of the fall, with the seasonally-adjusted annual rate of existing home sales breaking through the 4-million mark, which is a record low for this survey released by real-estate agents. Other gauges of the housing market have not been as gloomy, with the S&P Case Shiller Index of home prices in the 20 major cities still rising year-on-year and only slightly down from the May peak. In the broader economy, retail sales have held up reasonably well following the end of government incentives on the purchase of cars and other durable goods, suggesting that these measures may support household spending in the longer run even amid evidence of a weak jobs market keeping consumer confidence down. The demand for temporary workers continues to rise, while the overall non-farm payroll in the private sector is up by less than a million from last December's low having lost about 8.5 million jobs during the recession. When the Federal Reserve policy council extended the bond-purchase programme on 10 August it reiterated the risks to growth but many investors reacted as if it issued a growth alert. Most analysts have moderately downgraded GDP growth expectations for this year and next. We have also cut our 2010 estimate to 2.7% but we used to be more upbeat than consensus and still retain a scenario of solid economic growth with little risk of a double dip. Although domestic spending is unlikely to provide the same contribution as before the downturn, we believe that other sources will have an enhanced role, starting with foreign demand. The closely watched ISM Index of Manufacturing is still above the 50 mark, indicating expansion, along with a similar index for China suggesting that demand for industrial goods is not waning in the world's second-largest economy with positive effects on US growth.

US and China are Closely Intertwined by Manufacturing



1 ISM Manufacturing PMI SA 2 China Manufacturing PMI SA

Source Institute of Supply Management, Bloomberg as of 17 September 2010

US Equities

Buoyant corporate results have offset mostly weak economic data and allowed the S&P 500 Index to erase year-to-date losses since the beginning of September. While we have revised our GDP growth estimate down to 2.7% in 2010 (from 3%), we reiterate our positive view on US equities, although politics may add to market volatility. In the run-up to November's mid-term congressional elections, the government is proposing an additional fiscal package that is likely to prove inadequate and that may curb consumer confidence. Nevertheless, the downside risk for domestic sales revenues is offset by the exposure to foreign demand. We expect foreign sales to grow 10% in the next 12 months and should keep in mind that about 46% of total revenues by S&P 500 companies come from overseas. The comparison between dividend and bond yield also makes equities look cheap.

Stock Valuations Made Cheaper by Low Government Bond Yields

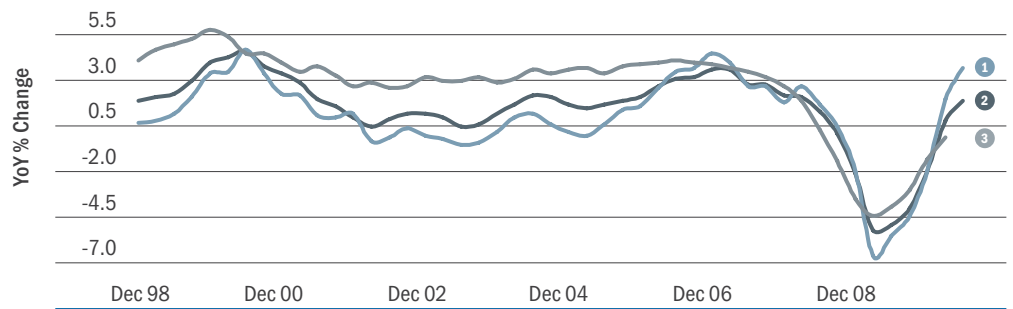


Europe

Unequal growth confirmed by official GDP data

Analysts' predictions of increasingly unequal growth patterns in the euro area were definitely confirmed by GDP data released in mid-August. Euro-wide growth was 1.9% in the year to the second quarter, but Germany performed well above the average with a 2.2% quarterly gain lifting year-on-year growth to 3.7% and therefore almost regaining the rate before the crisis. Some peripheral countries are far from recouping the same levels, with Spain still in recession territory. The underperforming countries are basically the same ones that are plagued by excessive budget deficits and have suffered a dramatic widening of credit spreads to Germany, especially over the last six months. Spain, Portugal, Greece and Ireland are tightening their belts in order to reduce the shortfall and Italy is also committed to spending cuts. These efforts may bring bear fruit and help regain the confidence of financial markets, but government finances can be structurally improved by stronger economic growth boosting tax revenues and lessening the case for welfare spending. Most of the deficit-stricken countries, however, seem incapable of moving to a faster track because of low productivity and uncompetitive businesses. Increasingly diverging bond markets, with spreads closer to emerging countries than to Germany, therefore seem consistent with real-growth patterns. The last European Central Bank (ECB) policy council sounded more upbeat about overall growth in the eurozone but it also extended the financial support to troubled banks by providing unlimited funds at benchmark rates. The ECB met on 2 September just after Sweden's central bank raised its benchmark to head off inflationary pressures. This gradual normalisation of monetary policy is unlikely in the eurozone for the foreseeable future as the gap between Northern and Southern Europe widens further.

Unequal Economic Recovery in the Euro Zone



- 1 Eurostat GDP constant prices Germany YoY
- 2 Eurostat GDP constant prices Eurozone YoY
- 3 Eurostat GDP constant prices Spain YoY

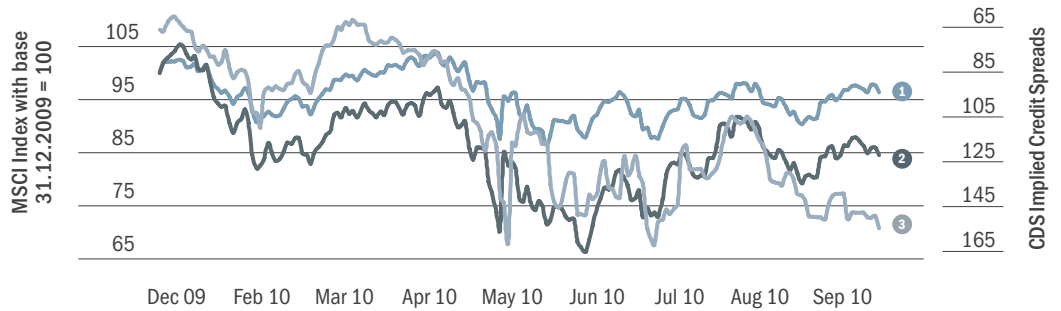
Source Eurostat, Bloomberg as of 17 September 2010

European Equities

Upside potential but domestic economic outlook still cloudy

The outlook for corporate earnings has long been very supportive for export-driven industry groups (which account for a larger percentage of market capitalisation than in the United States), offsetting a weak macroeconomic picture also because of euro depreciation. We have indeed upgraded our GDP growth estimate for the euro area to 1.7% in 2010 (from 1%). However, unequal economic growth prospects, between Northern and Southern European countries, call for a selective approach before unconditionally buying into this market. If economic growth improves, there is probably more upside for European equities than other markets with valuations well below 12-month fair value. The outlook is more cloudy for Financials, which are still trailing the broad market year-to-date and are also more volatile since feeling the heat of the sovereign debt crisis. Recent gains are explained by the slow enactment of the new regulatory capital ratios, which puts less pressure on banks to raise money through rights issues. However, this breathing space will not exempt major banks from meeting stricter requirements to also improve the capital base in the near future, as the risk of further asset write-downs on holdings of government bonds is not negligible.

Euro bank Stocks Rebound in Spite of Wide Sovereign Credit Spreads



- 1 MSCI EMU
- 2 MSCI EMU BANKS
- 3 MARKIT ITRX SOVX WE 12/14

Source MARKIT, Bloomberg as of 17 September 2010

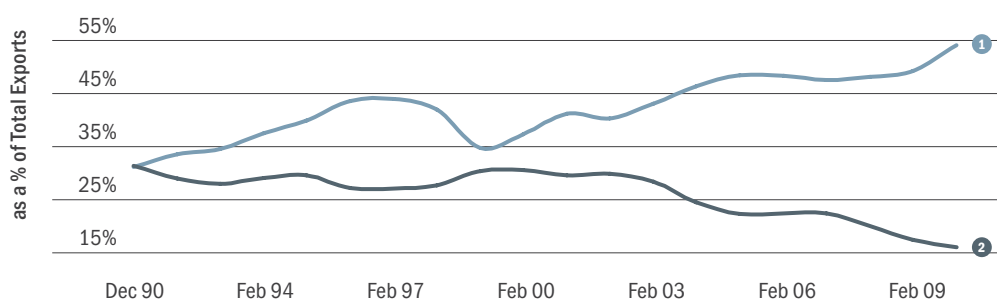
Japan

Currency intervention follows the leadership contest

The strong yen has often been a nightmare for Japan's politicians, although the government, led by the Democratic Party, showed some scepticism about direct intervention in currency markets compared to its predecessors. The political scenario was made uncertain this summer by a leadership contest. However, the current Prime Minister eventually won the contest and the central bank moved shortly thereafter on behalf of the government to buy US dollars and show some action in an effort to revive the economy. Exports have consistently led Japan's economic growth since the early

1990s and an uncompetitive currency hurts most industrial companies, notably in the key Auto and Consumer Electronics sectors. With the US market still providing an outlet for goods made in Japan, evidence of softer growth in America is another concern that may have tipped the balance in favour of intervention even though the reliance on the US as a trading partner has steadily decreased over the last 20 years in favour of the surrounding Asian region. A strong currency seems inconsistent with an economy again hit by deflation and benchmark interest rates near-zero, but the effectiveness of a one-sided intervention is doubtful and is easily offset by private flows. Moreover, a zero-rate policy is now shared by the US Federal Reserve.

Japanese Exports' Growing Reliance on Asia



1 Japan Exports to Asia 2 Japan Exports To US

Source Japan Ministry of Finance, Bloomberg as of 17 September 2010

Japanese Equities

The benchmark TOPIX Index has lagged the MSCI World Index year-to-date with the (relative) loss concentrated in the second half of the year. The correlation between a falling stockmarket average and a very strong yen does not look coincidental, as leading companies have long been overly reliant on exports. Valuations have become cheaper and the price-to-book ratio stands again at an all-time low around par. This measure used to be attractive for foreign investors but this time the volatile currency markets may keep them from buying with confidence. The outlook for key industry groups, such as makers of cars and electric appliances, is also made cloudy by their reliance on strong consumer spending in the United States, which is unlikely to be sustained going forward. Companies getting most of their revenues from sales to fast-developing regions look better placed, although leading manufacturers of industrial equipment and other machinery are very sensitive to news of a possible slowdown in Chinese orders and have been down sharply of late.

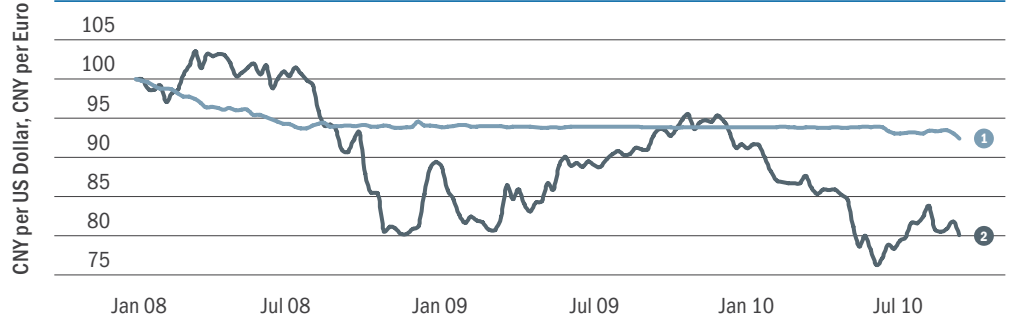
Asia and Emerging Economies

Upbeat data from China

For Asia's largest economy the worst-case scenario has not been a double dip but an aggressive policy tightening in an effort to kill inflationary pressures: resorting to that could eventually put the brakes on economic growth both domestically and abroad. The excessive growth in bank lending has been under close scrutiny by the central bank (People's Bank of China (PBOC)) because of a possible rise of non-performing loans. By combining moral persuasion with other credit curbs, such as higher reserve requirements, the PBOC has managed to lower year-on-year growth rates to about 20% (from 35% in late 2009). New lending unexpectedly rebounded in August along with money supply, but that may be explained by genuinely strong demand for credit from the business sector rather than from speculators in the housing market. Strong data on industrial activity in August seem consistent with looser financial conditions and

should not be anticipating a rise in inflation. China's apparent willingness to let the currency strengthen against the US dollar is unlikely to herald a change in its traditional (export-based) model of growth. The currency has appreciated by some 1.5% since June but this could also be explained by China's fears that trade becomes an issue in the run-up to November's US mid-term congressional elections.

China's Currency Slowly Appreciating Ahead of US Mid-term Vote



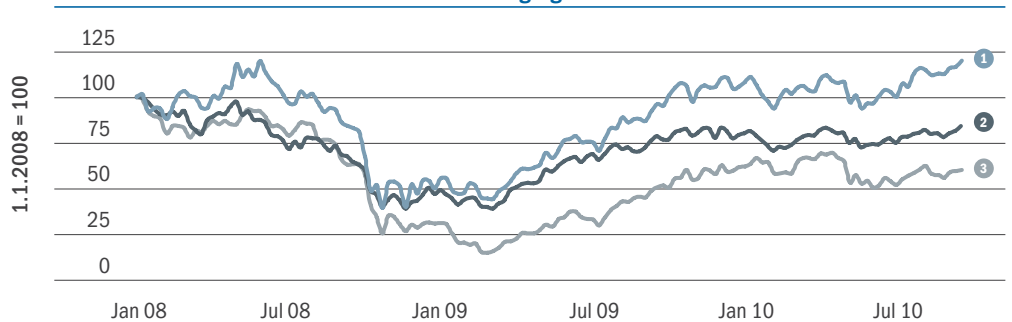
1 CHINA RENMINBI SPOT 2 EUR-CNY X-RATE

Source Bloomberg as of 17 September 2010

Emerging Equities

The strong growth potential of the emerging area as a whole masks some material differences. Countries in Eastern Europe are affected by Western Europe, whose growth prospects are lacklustre. The case for investing in this asset class is mostly made by a remarkable domestic growth potential, and in Europe only Russia and Turkey appear to meet this requirement. There are more opportunities in other regions, starting with Asia where the main risk comes from aggressive policy tightening (especially on the monetary side) to contain inflationary pressures even at the cost of slowing down the economy. The healthy condition of major banks both in Asia and in Latin America is another positive, leaving plenty of room for expanding the consumer credit business. This is where profit growth is expected to be stronger.

The Health of Banks' Balance Sheets in Emerging Markets



1 MSCI EM LAT AM/FINANCE 2 MSCI EM ASIA/FINANCIALS 3 MSCI EM EAST EUR/FINANCE

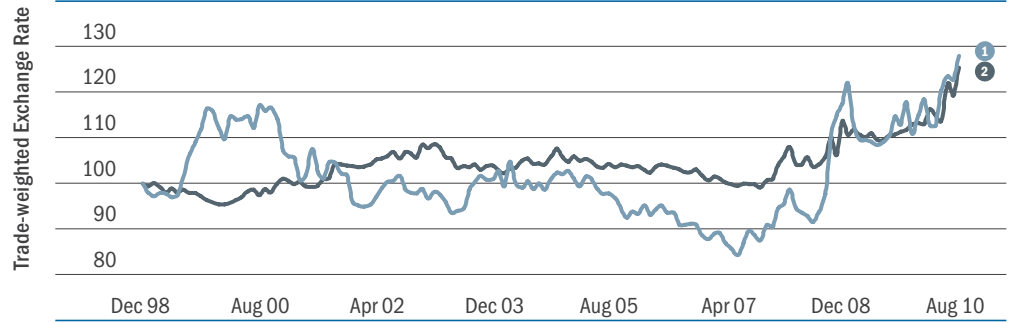
Source Bloomberg as of 17 September 2010

Currencies

Focus on Asia

Japan's one-sided intervention to support the US dollar is shifting most of the attention to Asian exchange rates. The yen weakened just a bit from 15-year highs against the US dollar and the Chinese currency's crawling revaluation may cause renewed pressure. The lack of joint action is unlikely to fend off speculators, all the more so as the Japanese government quotes specific values to trigger intervention. However, we believe that deteriorating growth prospects for the Japanese economy may prevail over the demand for safe assets in a risk-averse scenario and the yen looks set to weaken over time. This climate is also felt elsewhere in the currency market, with the Swiss Franc reaching new highs against the euro amid persistently elevated sovereign credit spreads in the euro area.

The Currencies of Japan and Switzerland Never so Strong



1 BOE Calculated Effective Exchange Rates Japan 2 BOE Calculated Effective Exchange Rates Switzerland

Source Bank of England, Bloomberg as of 17 September 2010

Tactical Asset Allocation Summary

Global Equities: Neutral

The case for cyclical assets remains intact, in spite of an expected slowdown in major developed economies. Our main indicator still points to a scenario of 'Economic Strength' with a minor risk of 'Shrinkage' (double dip). Corporate earnings growth is not overly affected by macroeconomic issues, as companies getting most of the revenues from foreign sales stand to benefit from strong growth prospects in fast developing regions.

USA: Overweight

The recovery in consumer spending helped GDP regain a normal growth trend but there are reasons to believe that the 3% rate is not sustainable. Most stimulus measures have expired and the labour market is showing few signs of improvement. We confirm our positive call in spite of a more uncertain macroeconomic outlook as the Federal Reserve is committed to maintaining exceptionally low interest rates for the foreseeable future and leave unconventional policies in place, thanks to subdued wage growth and low core inflation.

Europe: Neutral

The outlook for Europe's economy remains fragile with the government debt crisis urging several countries to tighten budget policies, which may hurt domestic consumer spending. A weak euro will help exporters but not all countries look set to exploit this opportunity. Germany stands to benefit more than the average and a strong industrial component can extend the overperformance of its stockmarket. Valuations have become cheap in other sectors that are mostly reliant on domestic spending but this upside potential needs clear evidence of stronger economic growth.

Japan: Neutral

As in most of Europe foreign demand makes up for weakness in domestic spending. With the yen trading close to 15-year highs against the US dollar, official intervention may provide temporary relief if it remains one-sided. With the risk of increased volatility in currencies, the return of price-to-book ratios to record lows around par is unlikely to make the market newly attractive.

Pacific ex Japan: Underweight

Markets overly reliant on China's growth may be concerned about early policy tightening aimed at keeping the economy from overheating. Moreover, commodity-related sectors play a key role in this region and their valuations still look demanding.

Emerging Markets: Overweight

Most of these regions retain a strong potential for domestic growth, with Asia in the first tier followed by Latin America. The risk of overly restrictive policies to hold inflation in check is worth monitoring closely, though we believe that China's containment policies may prevent an overheating. A radical change in China's exchange rate policy would be of help, but the US dollar has been allowed to depreciate too slowly (for US tastes) since the June announcement about more flexibility.

Global Bonds: Underweight

Government bond yields in core markets, such as Germany and the US, are close to cyclical lows in spite of a global economic upturn, which makes them basically unattractive. Regional crises may prompt investors to look for safety in German bonds but awarding the same status to US Treasuries looks far-fetched amid renewed attention on structural budget deficits.

Euro Government: Underweight

Domestic household spending has rarely driven GDP growth in the euro area and the debt crisis may spur tighter fiscal policies, which will curb spending further and keep inflation at bay. Core markets, such as Germany, may retain a safe-haven status as long as volatility among peripheral markets persists. Nonetheless current yields are so low that a slow-growth scenario seems well entrenched and a sharp decline in prices may follow better-than-expected evidence about the economy.

Euro Corporate: Neutral

Most companies have cut costs in an effort to regain profitability. Compared to some profligate governments now grappling with heavy budget deficits, they have had their risk premiums duly lowered. However, bank names account for a large part of the euro corporate market and their holdings of government debt may put the balance sheets at risk of further asset write-downs.

US Government: Underweight

Recent evidence of weak economic growth in the second half of the year is making US Treasuries attractive again, as core inflation is held under control by subdued wage growth. Central bank purchases provide further support, but current yields are close to record lows as if the economy suffered a double-dip recession. Moreover, this level of yields does not compensate adequately for very large budget deficits.

US Corporate: Overweight

Global risk aversion tends to rise as a result of an extended period of uncertainty in euro government bonds and that puts upward pressure on credit risk premiums even for companies with healthy balance sheets. That provides renewed opportunities with cheaper valuations, adequately hedging the risk of a rising default rate.

Emerging Markets: Neutral

Economic policies have structurally improved in most emerging countries where opportunities exist in both hard and local currencies, with the latter often cheaper and with a reasonable risk/reward ratio. When risk aversion rises, as during the recent euro debt crisis, valuations are definitely more attractive.

Tactical Asset Allocation Summary

Global Summary Table

Asset Class	Recommendation
Equity	Neutral
Government Bonds	Underweight
Corporate Bonds	Overweight
Liquidity	Overweight

Regional Summary Table

Asset Class	Recommendation
Euro Cash	Underweight
2yr Euro Corp	Overweight
Total Liquid Assets	Overweight
Euro Bond	Underweight
US Bond	Underweight
Japan Bond	Underweight
Government Bonds	Underweight
US Corporate	Overweight
US High Yield	Neutral
Euro Corporate	Neutral
Euro High Yield	Neutral
Emerging Market Bonds	Neutral
Corporate Bonds	Overweight
North America Equity	Overweight
Europe Equity	Neutral
Japan Equity	Neutral
Global Emerging Mkts	Overweight
Pacific Ex Japan	Underweight
Equity	Neutral

Foreign Currency Exposure

US Dollar	Overweight
Euro	Underweight
Yen	Underweight
Other	Neutral

FROM WEAKEST TO STRONGEST IN ASCENDING ORDER:

Strong Underweight Underweight Slight Underweight Neutral Slight Overweight Overweight Strong Overweight

Please note that the rank is indicative and may not balance when summed.

Important Information

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