

## Quality, Growth, and Valuation

*With a global mandate for seeking small-cap growth opportunities and with global resources to draw upon, the Allianz RCM Global Small-Cap Fund feels free to invest anywhere in the world. Ideally, the fund would invest in growth companies in a growing industry. But since we don't live in a perfect world, portfolio manager Tom Ross most often looks for the companies with consistent growth that outperform peers in their competitive environment.*

**Q: What's the overall investment philosophy of the fund?**

**A:** We're a quality growth manager in terms of the individual equity selection. The quality of a company is partly measurable by its underlying financial characteristics and partly by the competitive environment in which it operates. We also focus on quality in the good old-fashioned sense of quality of the product and services that the company delivers.

For us growth is not an absolute number as we're not necessarily confusing a growth company with a growth sector. Ideally, we'd invest in a growth company in a growth sector but we usually look for companies that exhibit certain growth characteristics. Their top line revenue growth as well as the growth in the cash flow and EPS should be at a higher level than the growth of other companies within its direct competitive environment. We're not going to compare a retail growth company in Europe with a technology company in the United States, for example, but we'd look at growth relative to the region where the company is positioned. A European retailer that's growing at 10% or 11% in a lower-growth environment would fall into our working universe of growth stocks.

Philosophically, we do believe that global small-cap markets do have characteris-

tics of inefficiency. To take advantage of that inefficiency, we concentrate on two particular types of companies. The ideal case would be when we can identify a point of improving dynamics for that company over at least 12 – 18 month time horizon. This often refers to some of the cyclical growth companies but such pearls are sometimes harder to find if the economy has progressed.

We're also looking for companies with the ability to execute their business plan and consistency in the growth. That leads us back to the notion of quality growth company. There should be a certain degree of general consistency between growth due to a growing market and due to being a well-managed company that's growing its market share versus its competition. So in terms of the overall investment philosophy, we're looking for quality growth companies operating in efficient markets at valuation levels that we think make sense.

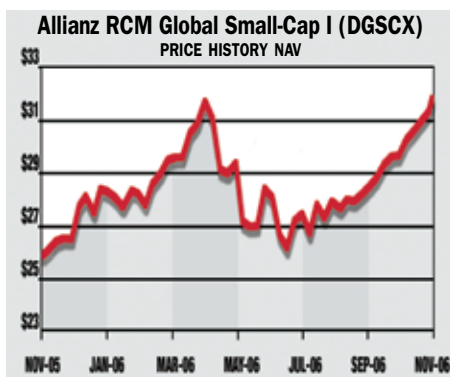
**Q: Do you base your valuation on historic or forward-looking growth? Do you make adjustments to the earnings you use?**

**A:** For the second type of companies, we indeed look at the past growth characteristics of the company, especially if it's pretty much the same management team and the same operating environment. In



**THOMAS ROSS** is a Director and Senior Portfolio Manager on the RCM Capital Management small-cap equity team. He joined RCM in San Francisco in 2001 and has 24 years of investment experience in the U.S. and Europe. Mr. Ross received his undergraduate degree from Cornell College and his Masters of International Management from the American Graduate School of International Management (Thunderbird) in 1980.

**“I believe that one of the greatest risks for growth managers is the risk of stock implosion if we are wrong, so our bias toward the quality side serves us well.”**



terms of individual company analysis, that's specific according to the sector or region. Because we're investing in the US, European, Japan, and emerging markets, we have to deal with different accounting standards. Although they're getting closer to each other, they're not the same, so we make adjustments. We lean towards the underlying quality of the company, its business model, and the growth opportunity with a time horizon of about 18 to 24 months.

We do our research process more on a regional basis and then go through a centralized management decision making process. We look for the so-called best ideas, knowing that the hurdles for growth may be different in different parts of the world. But many of our companies, although some of them operate outside of the region, are regional or country-specific in terms of nature. That's why we've chosen to work region-by-region and then consolidate that information.

**Q: Could you describe your investment strategy and process? For example, do you compare the telecom companies at the sector level or you evaluate them individually?**

**A:** Companies differ from region to region depending on whether the sector in which the company is operating is a global sector. Technology would be an example of a global sector, while a clothing manufacturing is usually more regional. But in terms of an individual telecom company, we would be looking for growth characteristics regardless whether the company is in U.S. or in Europe.

Idea generation mostly comes from regional sources. Then we put together our best ideas and in the final conclusion, we're looking for quality growth and valuation. In terms of the final analysis, we're biased towards growth and quality, because just to get to the valuation screen on a regional basis, the company should have demonstrated vast earnings.

**Q: Can you describe the research process that turns an idea into a holding?**

**A:** Probably about 75% of the process is bottom up and about 25% is top down. The top-down approach has three components. The overall economic outlook would be the lowest in terms of priority. The second component is that we review not only every holding, but also the various markets and sub-markets around the world. We use various tools available for risk analysis. That's a grand universe, so we need to know our primary attributions, country exposure, sector exposure, etc. For instance, now we're underweight in Japan and we're just aware of that. If that begin to hurt us, the tools will automatically prompt us to do more in terms of our bottom-up process. The third component, which is the most important one, is the bias towards regions with higher growth opportunities. Such regions include some of the emerging markets, which may go through a repetition of what happened when Portugal lead itself into the Western European economy, for example. So we do have a top-down bias for consumer companies in Eastern Europe.

In terms of the bottom-up process, we're trying to pick good companies that can grow over time. We don't have allegiance to any country, region, or sector. We utilize resources from around the world but the actual decision to buy or sell is made here. Structurally, we're a global company and we work with our colleagues around the world but we don't compete with them.

In the bottom-up process, we use many tools to screen a large universe for quality growth and valuation. And we do this in a very methodical fashion. We are also independently visiting and researching companies as we have analysts located around the world at many of the major financial centers. We have a unified information system for the company as a whole so that we can draw upon that resource. In addition, we have various pools of portfolio managers and assets around the world.

**Q: Could you give us an example of stocks that you found through your research process and purchased for the portfolio in the past?**

**A:** I was just talking with a colleague in the Frankfurt office with interest in companies that are leveraged towards Eastern Europe. An example would be a German company with outbursts of manufacturing based in Ukraine as they have a competitive advantage in providing automobile cables. It has become one of the leading companies in Europe.

Another company, which did not show up on our screening process because no one covered it then on the sell side, is the Vienna Insurance Company, which happens to be the number two insurer in Eastern Europe. A colleague, back in the 1990s when he was at UBS, visited the company. I have never head of it and we started discussing it during our weekly virtual get-together. He leveraged the local insurance analyst to slice and dice it and we did some of our own independent analysis. The combined results were very positive.

They don't have to fight against somebody when selling automobile or household insurance, because people are literally buying it for the first time. In terms of quality consistently from an insurance point of view, the company passes just about any test. In terms of growth, insurance isn't a mega-growth industry but we identified peak areas. Valuation-wise, they weren't at all expensive, so we made the purchase. This is the way

the global network performs. They mentioned it, I was even more enthusiastic about it, and the stock came into the portfolio.

**Q: What are your criteria for selling?**

**A:** One of them would be automatic because we have a small-cap stock mandate. When a stock becomes twice bigger than our benchmark, we'll let it go because it's really not a small-cap stock anymore. We do let our winners run, but I don't think it's quite right with the characteristics of the portfolio to let it run indefinitely.

The other reason to sell is related to our regular screenings. We have many tools available for monitoring valuation and we utilize price targets. Many of our companies are not covered by analysts, but if they are, we know them. If the price is 15% within its target, I'll know because every Monday morning I run the screen which gives us something to consider. In terms of valuation, we monitor the absolute and the projected valuation to consider whether we might want to take a profit.

Otherwise, there's an automatic sell decision if the rationale for buying the stock is violated. Another factor would be if we find a company which has much greater upside potential. Most of the time we're pretty close to being fully invested, so we may have to sell to buy something else.

**Q: Since you have a global mandate, how do you handle fraud or other risks related to East European markets, especially Russia?**

**A:** We have to find companies that make sense in terms of quality, growth, and valuation. The problems in Russia bother me very much but from the start we sought to avoid Russian companies where the government is involved directly or indirectly. So we don't have anything that has to do with the energy sector in Russia. That was a strategic decision, part of the top-down approach, because I just didn't feel comfortable


with them. But I don't think that the consumer theme is affected by these developments.

**Q: Could you explain your portfolio construction process?**

**A:** Everything we buy has a growth bias, which really hasn't been the place to be in the past couple of years. In terms of portfolio construction, once the companies have gone through the filter of entering our working universe of stocks, then we only have some broad constraints in terms of regional allocations.

These are risk control guidelines where we delineate according to the North American block, the Euro block, and the Japanese block. Relative to the benchmark, the broad parameters will be 50% towards the lower part and double weighting towards the upper part on a relative basis. The other cross selection is according to the potential risk of underperformance. The number of holdings tends to be between 115 and 150 at maximum, while the turnover is about 85%.

**Q: What kind of risks do you monitor and how do you mitigate them? Since you are a global investor, do you also hedge currencies?**

**A:** I don't do hedging as this is a concept that I'm not comfortable with. We look at individual company risks using the broad valuation tools that we have. We're relatively widely diversified and regarding the risk in individual holdings, we do analysis using Northfield Risk Analysis in terms of the overall tracking errors and factor analysis to see where the risks are emulating from. We also do portfolio attribution analysis, which identifies if something is going against us and if we should back to doing the bottom-up stock analysis. I believe that one of the greatest risks for growth managers is the risk of stock implosion if we are wrong, so our bias toward the quality side serves us well. Naturally, if growth really comes back into favor, that should help too. 

## Allianz RCM Global Small-Cap

|           |  |
|-----------|--|
| Symbol    | <b>RGSAX</b> (Class A); <b>DGSCX</b> (Class I)                         |
| Website   | <a href="http://www.allianzinvestors.com">www.allianzinvestors.com</a> |
| Address   | Allianz Global Investors<br>2187 Atlantic Street<br>Stamford, CT 06902 |
| Tel. No.  | 800-426-0107   |
| Inception | 12/31/1996 (Class I)   |

### PORTFOLIO

|                              |         |
|------------------------------|---------|
| Total Net Assets*            | \$223   |
| Median Market Cap *          | \$1,300 |
| Average Price/Earnings Ratio | 7.6     |
| Average Price/Book Ratio     | 3.5     |
| Turnover Ratio               | 73%     |

### INVESTMENT INFORMATION

|                            |         |
|----------------------------|---------|
| New Investment             | Open    |
| Min Initial Investment     | \$5,000 |
| Min Subsequent Investment  | \$100   |
| Min Initial IRA Investment | \$2,500 |

### RISK (AGAINST MSCI WORLD SMALL-CAP INDEX)

|                   |       |
|-------------------|-------|
| Alpha             | N/A   |
| Beta              | 1.34  |
| R-Squared         | 0.61  |
| Ann Std Deviation | 12.52 |
| Sharpe Ratio      | N/A   |

### RETURNS VS. MSCI WORLD SMALL-CAP INDEX\*\*

|               | DGSCX  | Index  |
|---------------|--------|--------|
| 1 Year (Cum.) | 23.73% | 19.97% |
| 3 Year (Ann.) | 21.44% | 19.97% |
| 5 Year (Ann.) | 18.33% | 17.64% |

### RETURNS VS. LIPPER GL SMALL/MID-CAP GRO FD IX \*\*

|               | DGSCX  | Index  |
|---------------|--------|--------|
| 1 Year (Cum.) | 23.73% | 22.90% |
| 3 Year (Ann.) | 21.44% | 19.16% |
| 5 Year (Ann.) | 18.33% | 14.08% |

### FEES AND EXPENSES

|                             |       |
|-----------------------------|-------|
| Max Sales Charge - Front*** | 5.50% |
| Max Sales Charge - Deferred | 0.00% |
| Max Redemption Fee ****     | 2.00% |
| Total Expense Ratio         | 1.77% |

### PORTFOLIO MANAGER

|             |           |
|-------------|-----------|
| Thomas Ross | 9/30/2002 |
|-------------|-----------|

\*millions \*\*Performance data as of 11/30/2006

\*\*\*for amount less than \$50,000

\*\*\*\* for shares held less than 30 days

Data through: 10/31/06

Source: Company Documents; Lipper

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