

Fund Focus

February 2008

Active Versus Passive Bond Management: A Look at the Numbers

By Stephanie L. King, CFA

Does active bond management work? As an active bond manager, PIMCO believes the answer is yes. Over the long term, actively managed bond portfolios have the potential to provide higher returns than passively managed portfolios with similar risk. An experienced active portfolio manager uses their deep knowledge and resources in an effort to take advantage of inherent inefficiencies and the diverse sources of added value in the bond market to boost returns, while passive strategies, by definition, cannot respond as quickly or effectively to changes in market conditions. In addition, passive strategies are typically far more restricted in terms of the securities in which they can invest.

To illustrate the effectiveness of active management, we examined the performance of PIMCO's Total Return Fund, a diversified portfolio of high quality bonds, over the past 10 years. We then compared the Total Return Fund's performance with that of two passive bond strategies: the Total Return Fund's benchmark index and a U.S. Treasury bond index, which serves as a proxy for a passive investment in U.S. Treasury bonds. Although occasional swings in performance occurred over the short term, PIMCO's Total Return Fund outperformed the passive strategies (after fees) over the 10-year period with comparable or even lower volatility.

Finally, we examined the cumulative impact of outperformance, or higher returns, over time and found that investors who choose passive bond management may end up leaving money "on the table."

Active vs. Passive Management: Returns and Risk

To compare the performance of active and passive management strategies, we first examined the Total Return Fund's performance (institutional share class) versus its stated benchmark index, the Lehman Brothers Aggregate Index (LBAG). As the table below shows, the Total Return Fund has outperformed its benchmark, after expenses, over the long term.

PIMCO Total Return Fund (Institutional Share Class)

As of 12/31/07	Since Inception 05/11/87	10 Yrs.	5 Yrs.	3 Yrs.	1 Yr.	6 Mos.	3 Mos.
After Expenses (%)	8.35	6.73	5.31	5.28	9.07	8.69	3.92
Lehman Brothers Aggregate Bond Index (%)	7.56	5.97	4.42	4.56	6.97	5.93	3.00

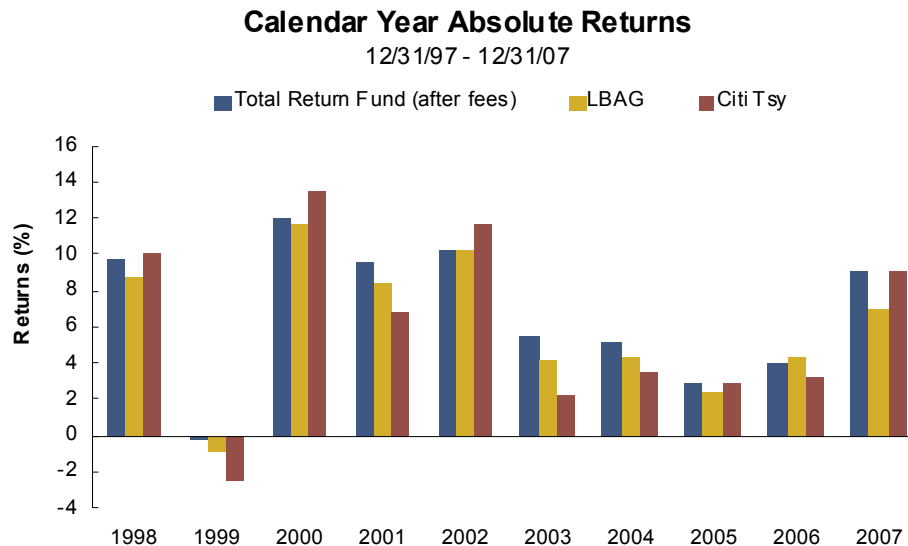
Performance quoted represents past performance. Past performance is not a guarantee or a reliable indicator of future results. Current performance may be lower or higher than performance shown. Investment return and principal value will fluctuate, so that Fund shares may be worth more or less than their original cost when redeemed. Performance data current to the most recent month-end is available at

Fund Focus

February 2008

www.pimco-funds.com or by calling (800) 927-4648. ([Click Here to Access Annual Performance Returns for one, five, and ten year periods](#))

Next, we compared the Total Return Fund's performance in each calendar year to the performance of the LBAG and the Citigroup U.S. Treasury Index, which represents a passive investment in U.S. Treasury bonds, as illustrated in the bar chart below.



Sources: PIMCO, Lehman Brothers, Citigroup

Performance quoted represents past performance. Past performance is not a guarantee or a reliable indicator of future results. Current performance may be lower or higher than performance shown. Investment return and principal value will fluctuate, so that Fund shares may be worth more or less than their original cost when redeemed. Performance data current to the most recent month-end is available at www.pimco-funds.com or by calling (800) 927-4648.

As the chart illustrates, PIMCO's actively managed bond fund outperformed (after fees) its benchmark, the LBAG, in eight out of the past 10 years. It outperformed (after fees) the passive U.S. Treasury bond investment in seven out of the past 10 years.

How did the Total Return Fund outperform the passive indexes? As an example, we looked at the Total Return Fund's active management strategies in 2004, when the Total Return Fund returned 5.15% after fees, compared with 4.34% for the LBAG and 3.53% for the Citigroup Treasury index. The Total Return Fund's outperformance is notable because 2004 was a difficult year for the U.S. bond market: the Federal Reserve raised interest rates five times; the 10-year Treasury bond rose in value despite the rate increases, while the value of Treasury bonds with shorter maturities fell; the U.S. dollar began to weaken; and other sectors, such as mortgage-backed securities and corporate bonds, strengthened to the point of appearing overvalued.

Fund Focus

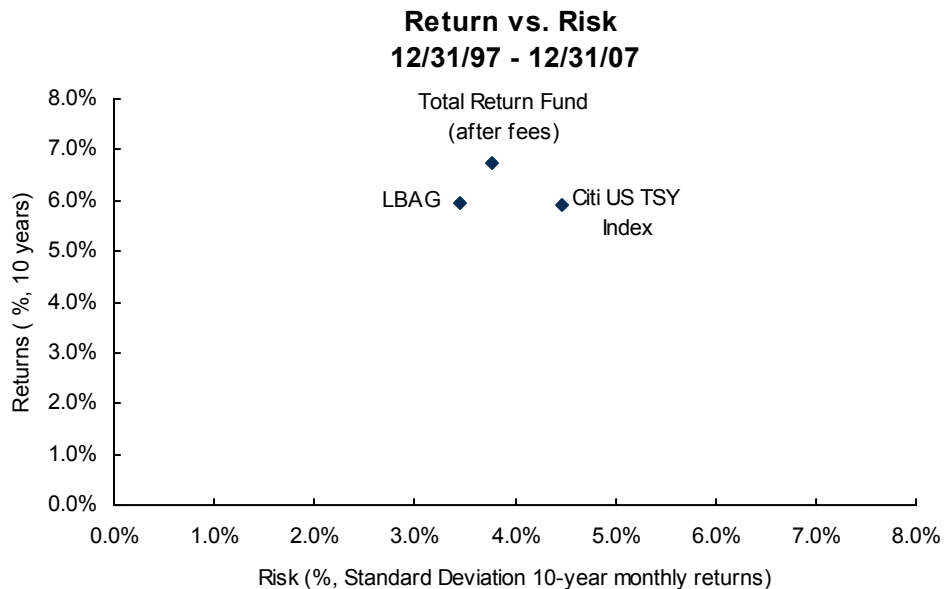
February 2008

Given this environment, PIMCO's active management strategy focused on underweighting sectors of the index that appeared overvalued while taking small positions in non-index sectors that appeared to offer more value, such as emerging market bonds, European government bonds, and foreign currencies, including the yen and the euro.

On the whole, these active management strategies enabled the Total Return Fund to outperform the LBAG and the Citigroup Treasury indexes for the year. It is important to note that the Total Return Fund did not outperform the indexes in all of the past 10 years, and even in 2004, the Fund underperformed its benchmark, the LBAG, for three months. Such short-term swings can be expected, but active portfolio managers have the flexibility to adjust a portfolio that is underperforming in an effort to get performance back on track relatively quickly. Passive strategies cannot change allocations easily because first, they typically track indexes, which invest in a defined group of securities, and second, they lack the oversight of an active manager who can make such decisions quickly.

Return and Risk

A discussion of returns would not be complete without a discussion of risk; investors should know whether an investment strategy achieves higher returns by taking on more risk. The following chart shows both returns and risk, as measured by monthly standard deviation of returns, over the past 10 years for the Total Return Fund as well as for the LBAG and the Citigroup U.S. Treasury Index.



Sources: PIMCO, Lehman Brothers, Citigroup

Performance quoted represents past performance. Past performance is not a guarantee or a reliable indicator of future results. Current performance may be lower or higher than performance shown. Investment return and principal value will fluctuate, so that Fund shares may be worth more or less than their original cost when redeemed.

Fund Focus

February 2008

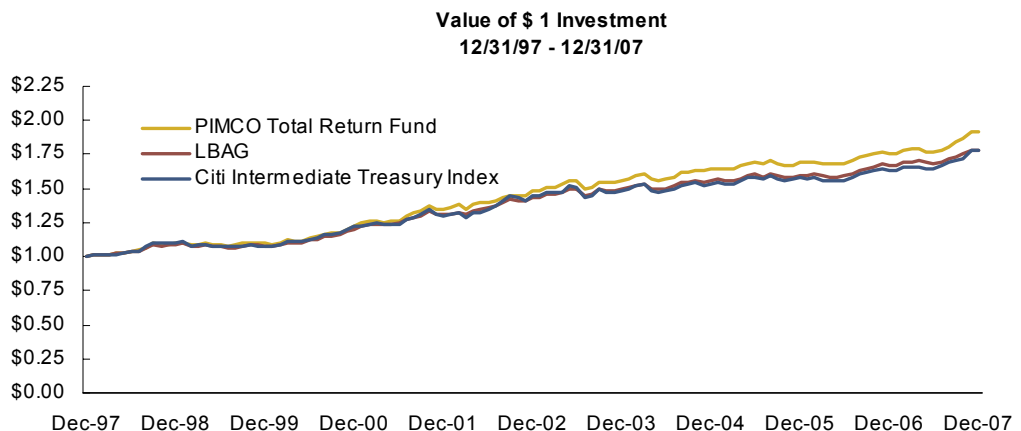
Performance data current to the most recent month-end is available at www.pimco-funds.com or by calling (800) 927-4648.

During the 10 year period examined in the chart above, PIMCO's Fund provided the highest return at 6.73% (annualized, after fees), outperforming the Citigroup U.S. Treasury Index by an annualized 0.82% and the LBAG by an annualized 0.76%, with substantially less volatility than the Citigroup Treasury Index (3.77% vs. 4.47%) and with only slightly more volatility than the LBAG (3.45%). Different time periods may have produced different results. Even though, in comparison to these two indexes, PIMCO's Total Return Fund may invest in slightly more risky securities when we feel the return justifies the added risk, diversification is the key to reducing volatility. PIMCO's Total Return Fund is far more diversified than the Citigroup Treasury Index, which invests only in U.S. Treasury bonds. As a result, the Fund is significantly less volatile than the Treasury index.

The Bottom Line: Cumulative Performance

As noted above, over the past 10 years, PIMCO's Total Return Fund outperformed (annualized, after fees) the LBAG by 76 basis points and the Citigroup Treasury index by 82 basis points. While such gains may seem small on an annual basis, they add up over the long term.

To show the cumulative impact of higher returns from active management over time, PIMCO examined the value of a \$1 investment made 10 years ago in PIMCO's Total Return Fund, compared with the value of a \$1 investment made in the LBAG and the Citigroup Treasury indexes.



Sources: PIMCO, Lehman Brothers, Citigroup

Performance quoted represents past performance. Past performance is not a guarantee or a reliable indicator of future results. Current performance may be lower or higher than performance shown. Investment return and principal value will fluctuate, so that Fund shares may be worth more or less than their original cost when redeemed.

Fund Focus

February 2008

Performance data current to the most recent month-end is available at www.pimco-funds.com or by calling (800) 927-4648.

The cumulative performance of the PIMCO Total Return Fund (after fees) exceeds the indexes, as shown in the chart. While \$1 invested in the Total Return Fund 10 years ago would have risen to \$1.92, the same \$1 invested in the LBAG would now amount to \$1.79 and in the Citigroup Treasury Index, \$1.78. The chart also makes clear that investing in passive strategies—such as the LBAG or a portfolio of U.S. Treasury bonds—would have produced smaller gains, resulting in an “opportunity cost” to investors. The gap between the value of an investment in the Total Return Fund and investments in the indexes widens over the 10-year period, illustrating that this opportunity cost increases over time. As a result, a \$100 million investment in the Institutional Share Class of the Total Return Fund made at the end of 1997 would have grown to \$192 million by the end of 2007, earning \$14 million more than a passive investment in the Citigroup Treasury Index and \$13 million more than a passive investment in the LBAG.

Conclusion

Choosing between active and passive investment strategies is a crucial decision because it can affect returns. When an active bond manager has demonstrated an ability to deliver consistent outperformance versus passive strategies with a similar degree of risk, investors have the potential to earn higher returns through active bond management over the long term.

About the Author

Stephanie L. King, CFA is a Senior Vice President and account manager with a focus on institutional client servicing. She joined PIMCO in 2001, previously having been associated with Morgan Stanley and Blue Capital Management, LLC. Prior to that, she was employed as a strategic management consultant with Bain & Company. Ms. King has six years of investment experience and holds a bachelor's degree in economics from the University of Pennsylvania's Wharton School and an MBA from Stanford University Graduate School of Business.

Investors should consider the investment objectives, risks, charges and expenses of the funds carefully before investing. This and other information are contained in the fund's prospectus, which may be obtained by contacting your PIMCO representative. Please read the prospectus carefully before you invest or send money.

Past performance is not a guarantee or a reliable indicator of future results. The performance figures presented reflect the total return performance for Institutional Class shares (after fees) and reflect changes in share price and reinvestment of dividend and capital gain distributions. Performance shown does not reflect any applicable redemption fees, the performance figures would be lower if the fee was applied. All periods longer than one year are annualized.

Funds typically offer different share classes, which are subject to different fees and expenses (which may affect performance), have different minimum investment requirements and are entitled to different services. Performance for certain charts and

Fund Focus

February 2008

graphs may be limited by date ranges specified in those charts and graphs; different time periods may produce different results.

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. Investing in non-U.S. securities involves heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and while generally backed by a government, government-agency or private guarantor there is no assurance that the guarantor will meet its obligations. Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. High-yield, lower-rated, securities involve greater risk than higher-rated securities. Diversification does not insure against loss.

Standard deviation is a statistical measure of dispersion about an average which, for a mutual fund, depicts how widely the returns varied over a certain period of time. The greater the dispersion, the greater the risk.

Growth of \$1 results are calculated at NAV and assume that all dividend and capital gain distributions were reinvested. They do not take into account sales charges or the effect of taxes. Results are not indicative of future performance.

Citigroup U.S. Treasury Index is an unmanaged market index comprising of a universe of US Government Treasury securities. Lehman Brothers Aggregate Index (LBAG) is an unmanaged index, considered generally representative of investment-grade fixed income securities issued within the U.S. It is not possible to invest in an unmanaged index.

The value of most bond funds and fixed income securities are impacted by changes in interest rates; bonds and bond funds with longer durations tend to be more sensitive and more volatile than securities with shorter durations.

This article contains the current opinions of the author but not necessarily those of Pacific Investment Management Company LLC. Such opinions are subject to change without notice. This article has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Pacific Investment Management Company LLC. ©2008, PIMCO.

Distributed by **Allianz Global Investors Distributors LLC**, 840 Newport Center Drive, Newport Beach, CA 92660.