

Fund Focus

December 2008

Bob Greer Discusses the Impact of Recent Market Turmoil on PIMCO's All Asset Fund



Bob Greer

Mr. Greer is an executive vice president and real return product manager in the Newport Beach office. Prior to joining PIMCO in 2002, he was with JPMorgan Chase and Daiwa Securities as a developer and product manager of commodity indexes. Mr. Greer has investment experience with real return products, including commodities, real estate, and inflation-linked bonds. He has written about these subjects in several investment journals and publications, and published *The Handbook of Inflation Hedging Investments* in 2005. He has 25 years of investment experience and holds an MBA from the Stanford University Graduate School of Business and an undergraduate degree from Southern Methodist University.

Bob Greer is the product manager for PIMCO's All Asset Fund and All Asset All Authority Fund. In this role he works closely with the funds' sub-advisor, Research Affiliates, which determines how the assets in the All Asset Fund are allocated across stocks, bonds, international investments and alternatives such as commodities. We spoke to him about the funds' investment strategy and his outlook for the All Asset Fund.

Q: You are the product manager for PIMCO's All Asset Fund. Could you please give us an overview of how this fund works?

Greer: The All Asset Fund is actively managed by PIMCO sub-advisor Research Affiliates, using a multi-market strategy that allocates assets tactically among multiple PIMCO funds, including both conventional and alternative market sectors. The All Asset Fund's objective is to seek maximum real return consistent with preservation of real capital and prudent investment management. In making decisions for the strategy, Research Affiliates considers various quantitative and qualitative data relating to the U.S. and non-U.S. economies and securities markets. These data include current yields, projected growth trends, forecasts for interest rates and the relationship between valuations among the various asset classes at our disposal. The outlook and projected growth of various sectors, information relating to the business cycles, and borrowing needs and the cost of capital are also taken into consideration.

Implicit in our process is that when rewards for assuming risk are small, we will be defensive. When we perceive high returns to risk, we look to use our dry powder to buy riskier assets. Implicit also in this approach is that we are not clairvoyant enough to pick tops and bottoms.

Q: We are in the worst bear market for stocks since the Great Depression. What would you say to investors who may be thinking it's time to just take their losses and walk away?

Greer: First, we should note that we have experienced not just a bear market in stocks, but a serious downdraft in virtually all risk assets. Even though it is very tempting to liquidate at the bottom of a bear market, it is not the best thing to do. While bear markets can be very painful, they are also cathartic and cleansing. They help purge the marketplace of speculative excesses, leaving a stronger base for future growth.

For net investors, bear markets offer the opportunity to buy more of the same assets that they purchased a year ago, but at lower prices, which may appreciate when the market eventually recovers.

These markets also may benefit net investors who put more money into the market than they take out. On the other hand, bear markets are bad for retirees who have less disposable income and are in the process of systematically liquidating investments in order to buy goods and services.

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When bear markets reach a point that might be called downside speculative excess, they create a target-rich environment. Human nature conditions us to sell investments that have disappointed us and to shun out-of-favor assets. We believe that the most effective approach is to sell what other investors want most – i.e., the most expensive assets – and buy assets that investors fear, which are therefore cheaper.

Just as there are bubbles in markets where assets are priced higher than any reasonable scenario could justify, there are “anti-bubbles” where assets are priced far below the level that any reasonable scenario could justify. An anti-bubble can present an opportunity to a liquid investor. While putting chips back on the table before a bear market ends may seem counterintuitive, picking peaks and troughs is almost impossible. So it makes sense to take on incremental risk when it is priced at an acceptable premium and ride out the inevitable volatility. In the All Asset Fund, that is exactly what we have begun to do.

For investors who bought shares of the All Asset Fund as a replacement for bond allocations, it is useful to note that the fund actually did better in October 2008 than some bond categories. Additionally, for investors who have been using the All Asset Fund as a substitute for typical hedge fund exposure, returns were within the broad range of hedge fund returns for the month.

Q: What is the benchmark for the All Asset Fund?

Greer: As a fund that targets “real return” – that is, inflation-adjusted returns – the fund’s primary benchmark is the Barclays Capital U.S. TIPS 1–10 Year Index. However, the fund’s secondary benchmark is the annual percentage change of the Consumer Price Index plus 5%, against which we measure ourselves over a complete business cycle. The idea is that we believe that this secondary benchmark reflects the Fund’s long-term investment strategy.

Recently, the fund has underperformed these benchmarks, with a net of fees return of –12.86% in October, and –7.67% for the third quarter as of 9/30/08. The All Asset fund has an annualized return from inception through September 2008 of 8.24%, net of fees. These return figures are for the institutional share class.

PIMCO All Asset Fund Performance (Institutional Share Class)

As of 9/30/08	Since Inception (7/31/02)	5 Yrs.	1 Yr.
After Expenses (%)	8.24	5.80	-6.46
Barclays Capital U.S. TIPS 1-10 Year Index (%)	6.04	4.99	7.89

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. A redemption fee of 2% may apply to shares that are redeemed or exchanged within 7 days of acquisition. Performance shown does not reflect any applicable redemption fees, the performance figures would be lower if the fee was applied. Performance data current to the most recent month-end is available at www.pimco-funds.com or by calling (800) 927-4648.

Q: What were the reasons for the underperformance?

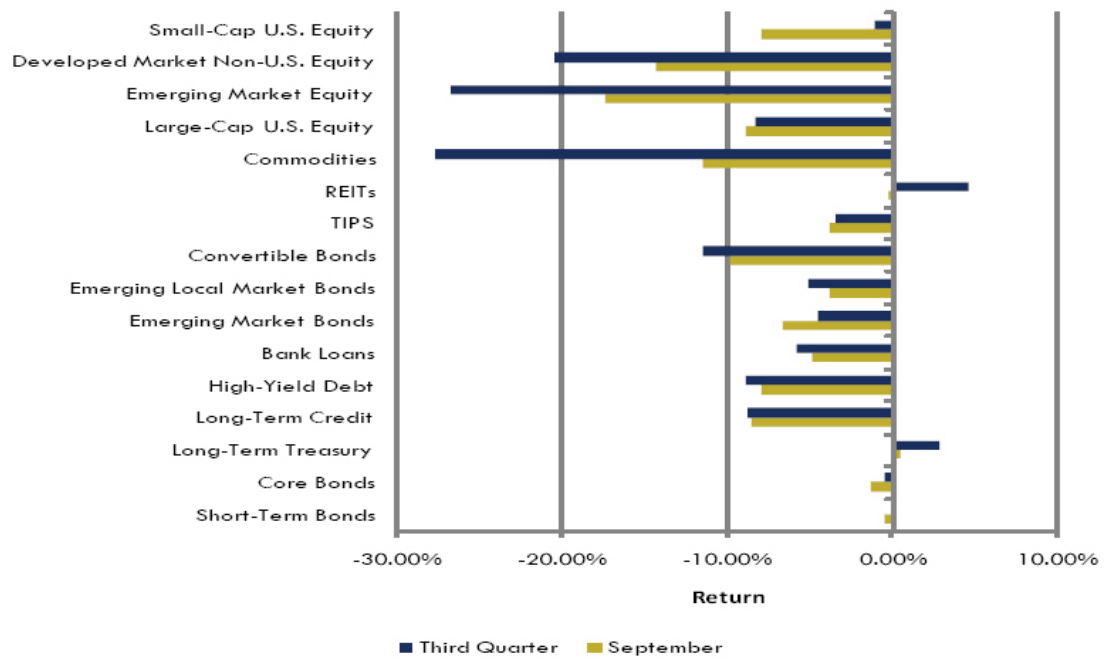
Greer: The extent of the financial turmoil, both in September and in October, was worse than we ever could have expected and there was just nowhere to hide. Research Affiliates has tracked 16 different, broad asset classes monthly for the past 20 years, and September was the first time

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that 15 of the 16 classes were down (Chart 1), and by an average of 9%. There is no precedent over that 20-year period for that range of financial markets being down for a month, and only one period of time that the average monthly drop was worse than 9%. That was during the Long-Term Capital Management meltdown, but at least then there were a few asset classes that rose in value.

Major Asset Classes, September 2008 and Third Quarter 2008 Returns



Source: Research Affiliates

Chart 1*

We believe that the Research Affiliates models generally worked over this period, concentrating positions primarily in high-quality sectors of the market. The problem is that even high-quality sectors were ravaged in September and October.

With prices hammered across the whole risk spectrum, many asset classes are currently discounted and may potentially see higher returns going forward. Yields alone for some fixed income categories are attractive, while there is the potential for capital appreciation if yields decline.

Q: The economic backdrop to this bear market seems pretty bleak. What are the Research Affiliates models indicating?

Greer: The global economic backdrop is both interesting and challenging right now. Research Affiliates suggest that the worst of the credit squeeze, the dislocation in the credit markets and the plunge in financial service sector stocks is behind us. That doesn't mean there will not be additional shocks; it just suggests that additional shocks in the next 12 months might be smaller than the shocks we've seen over the last 12 months.

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Research Affiliates work also suggests we are already in a consumer-led recession, which is the other shoe that has not dropped in the market, and stock prices are not yet fully discounting the impact of this on companies outside the financial services sector. So there are segments of the market where the worst is behind us and segments where the worst is still ahead, and a whole array of markets, including the broad U.S. stock market, where some risks are not necessarily priced in yet.

For investors in these types of markets, the main pitfalls are the temptation to chase returns and the failure to rebalance and diversify portfolios. It's very tempting for investors to continue to buy into a market that has risen considerably, or to bail out after it has gone down and the damage is already done. It can also be painful for investors to rebalance their portfolio after major market moves, because it generally means selling your winners and buying more of your losers. It's also easy for investors to lose sight of risk diversification. For many investors, even though their portfolio may hold both stocks and bonds, 95% to 98% of their risk budget is related to stocks.

The All Asset Fund is addressing each of these issues. First, it is broadly diversified at the market level. Second, it embraces rebalancing and it doesn't chase returns; on the contrary, it tends to buy assets that have fallen in price.

Q: How is the All Asset Fund positioned to take advantage of the current market environment?

Greer: The fund has maintained its allocation to TIPS (Treasury Inflation-Protected Securities), which have recently risen to real yields that are much higher than is typical for U.S. Treasuries – and TIPS are designed to avoid the major risk to Treasuries, which is inflation. TIPS have suffered price declines as investors, in a flight not just to safety but to liquidity, have flocked to nominal Treasuries in recent months. However, TIPS may revert back toward historical norms once markets calm a bit and if investors realize that TIPS and nominal Treasuries should have the same forward-looking inflation rate priced in. This leaves the potential for capital gains on rising TIPS prices, as well as potential attractive yields.

Another area that the Research Affiliates currently favors is emerging market debt denominated in local currencies, for two main reasons. First, they are priced to reflect an additional yield premium because of the view that these economies have more credit risk. But many of these countries have fiscal surpluses as well as current account surpluses, and unlike in previous global financial storms, they are well-positioned to deal with both internal and external shocks. Second, there is an additional yield premium for investing in the local currency, which is pricing in risk that the currency may fall. However, Research Affiliates believe that despite the recent strengthening of the dollar, emerging market currencies on average will likely rise against the dollar as liquidity returns to financial markets. Investors could potentially receive two yield premiums, one for investing internationally in emerging economies, and one for investing in their currency.

To the extent that the All Asset Fund is invested in more conventional fixed income securities, it is emphasizing quality. Credit spreads have widened significantly, creating some attractively-priced opportunities in high-quality credit. It is still too early in the cycle – near the beginning of a recession – to pursue lower-quality credit opportunities such as high-yield bonds. There are also some niche opportunities, such as convertible bonds where redemptions have forced liquidations from convertible arbitrage portfolios, flooding supply into the market and driving down prices.

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Q: Are PIMCO and Research Affiliates now making more subjective overrides to the asset weightings that the models suggest?

Greer: Yes. The mechanism that leads us to override the models is actually a simple question we ask: “What’s going on in the world that our models would miss?” In the current environment there are more things than usual going on that the models are not designed to capture. Key investment professionals from PIMCO and Research Affiliates go through this questioning process at least monthly (and lately, even more frequently).

For instance, if there is an asset class where there’s an artificially inflated supply because exogenous events are forcing liquidations, the models would not identify that opportunity. These overrides can serve as a check on the asset allocation models. With many exceptional events going on in the global economies and markets that cannot be quantitatively modeled, it makes sense to consider more overrides, which tend to be relatively small modifications, with usually around a 5% or less overweight or underweight for a sector compared to what the models suggest.

Q: Our discussion has focused on PIMCO’s All Asset Fund. You also offer the All Asset All Authority Fund. Could you conclude by discussing that strategy as well?

Greer: I’m glad you asked about the All Asset All Authority Fund. It is quite similar to the All Asset Fund in that it is a mutual fund that owns other PIMCO mutual funds, and is sub-advised by Research Affiliates, who use the same economic and quantitative models as for the All Asset Fund. The key differences are that the All Asset All Authority Fund can get inverse exposure to the U.S. stock market by buying the PIMCO StocksPLUS Total Return Short Strategy Fund. Also, it has a borrowing facility so that it can utilize explicit leverage in buying shares of underlying funds. Because of these structural differences, the primary benchmark of the All Asset All Authority Fund is the S&P 500 and the secondary benchmark is the annual percentage change of CPI plus 6.5%. We would also expect, over a business cycle, for the All Asset All Authority Fund to be somewhat more volatile than the All Asset Fund. The All Asset All Authority Fund, which entered the market more than a year after the All Asset Fund, has an annualized return from inception through September 2008 of 6.51%, net of fees, for the institutional share class. The third quarter performance, net of fees, was -6.72%, while October’s one-month net of fee return was -9.64%. This fund is typically considered by investors who take a more aggressive approach to tactical asset allocation, yet remain concerned about real, inflation-adjusted returns.

PIMCO All Asset All Authority Fund Performance (Institutional Share Class)

As of 9/30/08	Since Inception (10/31/03)	3 Yrs.	1 Yr.
After Expenses (%)	6.51	3.18	-1.41
S&P 500 (%)	4.09	0.22	-21.98

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. A redemption fee of 2% may apply to shares that are redeemed or exchanged within 7 days of acquisition. Performance shown does not reflect any applicable redemption fees, the performance figures would be lower if the fee was applied. Performance data current to the most recent month-end is available at www.pimco-funds.com or by calling (800) 927-4648.

Q: Thank you, Bob.

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* The above asset classes are represented by the following indices in order of appearance: Russell 2000 USD index; MSCI EAFE index; MSCI Emerging Markets index; S&P 500 index; DJ AIG Commodity index; FTSE NAREIT All REITS index; Barclays Capital Global Inflation Linked US TIPS index; Merrill Lynch Convertible Bonds index; JPM ELMI+ index; JPM EMBI+ index; Credit Suisse Leveraged Loan index; Barclays Capital Corporate High Yield Index; Barclays Capital U.S. Long Credit Index; Barclays Capital U.S. Long Treasury Index; Barclays Capital U.S. Aggregate Index; and Merrill Lynch U.S. Corporate Government 1-3 Year Index.

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. All periods longer than one year are annualized. Redemption fees are paid to and retained by the Fund and are not sales charges. Details regarding any Fund's redemption fees can be found in the Fund's prospectus.

The All Asset and All Asset All Authority funds invest in other PIMCO funds and performances are subject to underlying investment weightings which will vary. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Commodities contain heightened risk including market, political, regulatory, and natural conditions, and may not be suitable for all investors. Inflation-linked bonds (ILBs) issued by a government are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. Inflation-linked bonds (ILBs) issued by a government are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. Treasury Inflation-Protected Securities (TIPS) are ILBs issued by the U.S. Government. 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. The cost of investing in the All Asset and All Asset All Authority funds will generally be higher than the cost of investing in a fund that invests directly in individual stocks and bonds. The use of leverage may cause a portfolio to liquidate positions when it may not be advantageous to do so to satisfy its obligations or to meet segregation requirements. Leverage, including borrowing, may cause a portfolio to be more volatile than if the portfolio had not been leveraged. Diversification does not ensure against loss.

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.

The Barclays Capital High Yield Index is an unmanaged market-weighted index including only SEC registered and 144(a) securities with fixed (non-variable) coupons. All bonds must have an outstanding principal of \$100 million or greater, a remaining maturity of at least one year, a rating of below investment grade and a U.S. Dollar denomination. Prior to November 1, 2008, this index was published by Lehman Brothers.

The Barclays Global Inflation-Linked Bond Index measures the performance of the major government inflation-linked bond markets. The index is designed to include only those markets in which a global government linker fund is likely to invest and includes Government domestic debt only, i.e., debt issued by a government in the domestic currency of that country. Bonds in the index must have a minimum remaining life of one year on the rebalancing date.

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The Barclays Capital Long-Term Treasury consists of U.S. Treasury issues with maturities of 10 or more years. Prior to November 1, 2008, this index was published by Lehman Brothers.

The Barclays Capital U.S. Long Credit Index is the U.S. Credit component of the U.S. Government/Credit Index. It consists of publicly issued U.S. corporate and specific foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. Prior to November 1, 2008, this index was published by Lehman Brothers.

The Barclays Capital U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. Prior to November 1, 2008, this index was published by Lehman Brothers.

The Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the \$U.S.-denominated leveraged loan market. The index inception is January 1992. The index frequency is monthly. New loans are added to the index on their issuance date if they qualify according to the following criteria: Loans must be rated "5B" or lower; only funded term loans are included; the tenor must be at least one year; and the Issuers must be domiciled in developed countries (Issuers from developing countries are excluded). Fallen angels are added to the index subject to the new loan criteria.

The Dow Jones AIG Commodity Total Return Index is an unmanaged index composed of futures contracts on 19 physical commodities. The index is designed to be a highly liquid and diversified benchmark for commodities as an asset class.

The FTSE NAREIT Real Estate Index Series is an unmanaged index designed to present investors with a comprehensive family of REIT performance indexes that span the commercial real estate space across the U.S. economy, offering exposure to all investment and property sectors.

JPMorgan Emerging Local Markets Index Plus tracks total returns for local currency-denominated money market instruments in 22 emerging markets countries with at least U.S. \$10 billion of external trade.

The JPMorgan Emerging Markets Bond Index Plus is a total return index that tracks the traded market for U.S. dollar-denominated Brady and other similar sovereign restructured bonds traded in the emerging markets.

The Merrill Lynch All Convertibles Index is an unmanaged market index comprised of convertible bonds and preferred securities.

The Merrill Lynch Government Corporate 1-3 year index is an unmanaged index that trades short-term U.S. government securities and short-term domestic investment-grade corporate bonds with maturities between 1 and 2.99 years.

The MSCI EAFE (Morgan Stanley Capital International Europe, Australasia, Far East Index) is an unmanaged index of over 900 companies, and is a generally accepted benchmark for major

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overseas markets. Index weightings represent the relative capitalizations of the major overseas markets included in the index on a U.S. dollar adjusted basis.

The Morgan Stanley Capital International Emerging Markets Index is an unmanaged index that measures equity market performance in the global emerging markets. As of May 2005, the Emerging Markets Index (float-adjusted market capitalization index) consisted of indices in 26 emerging countries: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey, and Venezuela.

The Russell 2000 Index is an unmanaged index generally representative of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index.

The Standard & Poor's 500 Stock Price Index is an unmanaged market index generally considered representative of the stock market as a whole. The index focuses on the Large-Cap segment of the U.S. equities market.

It is not possible to invest directly in an unmanaged index.

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