

Product Focus

March 2008

Sabrina Callin Discusses PIMCO's Fundamental Advantage Strategies



Sabrina C. Callin, CFA, CPA
Executive Vice President

Ms. Callin is an Executive Vice President and the head of the StocksPLUS product management team responsible for PIMCO's global portable alpha-based equity business. Prior to joining PIMCO in 1998, she was a manager in the assurance and business advisory services group at KPMG Peat Marwick, LLP. She has sixteen years of investment experience and holds two bachelor's degrees with majors in finance, accounting and economics from Texas Christian University, and an MBA from the Stanford University Graduate School of Business. She is also the lead author of *Portable Alpha, Theory and Practice: What Investors Really Need to Know*, which will be published by Wiley in April 2008.

For more than two decades, PIMCO has been a pioneer and innovator in the realm of alpha-beta separation and portable alpha strategies. The most recent addition to PIMCO's lineup in this area is Fundamental Advantage. This highly innovative product entails similar investment techniques as PIMCO's other portable alpha products, but the end result is a unique and highly diversified alternative investment strategy. In the interview below, Sabrina Callin, PIMCO Executive Vice President and Head of Equity Portable Alpha products, discusses Fundamental Advantage.

Q: What is PIMCO's Fundamental Advantage Strategy and how does it work?

Callin: Fundamental Advantage is a unique strategy that provides two distinct sources of highly diversified return for every dollar invested, in a single portfolio. The first is long-short equity exposure that is risk-neutral with respect to the broad equity market. The second is an actively-managed fixed income portfolio that seeks to capture structurally-based yield premium relative to the risk-free rate and also benefit from the capital preservation characteristics of the high quality segment of the fixed income markets.

For the long-short equity exposure, the strategy simultaneously maintains long exposure to the Enhanced Research Affiliates Fundamental Index (Enhanced RAFI) and short exposure to the S&P 500 to isolate Enhanced RAFI potential excess returns, or "alpha." The Enhanced RAFI approach is designed by subadvisor Research Affiliates to outperform the S&P 500 by eliminating the performance drag resulting from systematic overweighting of overpriced stocks and underweighting of underpriced stocks in traditional stock indices, such as the S&P 500, that are weighted by market capitalization. (For more information on the underlying concept of Fundamental Indexing, read [PIMCO's interview with Rob Arnott.](#))

Because the long and short equity exposures are obtained through the derivatives market, the vast majority of the portfolio capital is available for investment in an actively-managed PIMCO fixed income strategy whose purpose is to provide a second complementary source of return. This is the distinction between the two current offerings of this strategy: **Fundamental Advantage TR** couples the long and short equity exposures with an unconstrained version of PIMCO's Total Return strategy, while the underlying fixed income

Product Focus

March 2008

portfolio in **Fundamental Advantage Tax Efficient** is PIMCO's High Yield Municipal Bond strategy.

Both versions of the Fundamental Advantage strategy provide a significant degree of diversification because the fixed income and the Enhanced RAFI alpha return engines generally exhibit a low to negative correlation with the equity market, which tends to be the dominant source of risk in most investors' portfolios. In addition, the two sources of return are expected to exhibit little to no correlation with one another, so the returns are additive while the risk is not. The result: a strategy that offers diversification for investors, with the potential for equity-like returns but with downside risk closer to what is generally associated with bonds.

Q: Is Fundamental Advantage a stock market product, a bond market product, or something else?

Callin: Fundamental Advantage is not a stock market product in the sense that it does not provide stock market exposure. Rather, the short S&P 500 exposure cancels out any equity market risk exposure, or equity "beta" in the Enhanced RAFI. In fact, the Fundamental Advantage stock market beta is expected to average around 0.0 over full market cycles. Likewise, the strategy is not expected to exhibit any material positive correlation with the equity market.

Despite the low equity market correlation, investors may categorize Fundamental Advantage as an equity "substitute" given the similar level of expected return. Conversely, from a risk standpoint – particularly downside risk – Fundamental Advantage is more closely related to a high-quality bond portfolio for the total return strategy, and a high yield muni bond portfolio for the tax efficient strategy, for long-term investors. As a result, some may characterize Fundamental Advantage as a true alternative to traditional equity and bond investments. However, it is ultimately up to investors themselves to determine how it will best fit within their broader investment portfolio.

Q: What does Fundamental Advantage offer investors relative to other types of alternative investment strategies?

Callin: Fundamental Advantage is a very exciting strategy because the potential benefits are closely aligned with what investors are typically seeking from alternative investments: attractive positive return opportunity across most market environments, noteworthy diversification benefits, and a relatively moderate risk of materially negative returns.

But we must remember that as a category, alternative investments encompass a huge array of strategies with entirely distinct return profiles and risk exposures. For example, while a desire to achieve greater diversification of investment risk is one of the factors driving demand for alternatives, many alternative strategies – in direct contrast to Fundamental Advantage – have proven to have strong positive correlations with equities, particularly in times of market stress.

Product Focus

March 2008

Speaking of market stress, one of the unique attributes of Fundamental Advantage relative to many types of alternative investments is that the strategy is designed to avoid the type of financing and liquidity risk that can lead to painful losses amid margin calls and the associated forced selling that may ensue.

Fundamental Advantage is also a highly liquid strategy, unlike certain types of alternative strategies that look to capture illiquidity risk premiums as a key driver of return. In addition, it is highly transparent in terms of investment strategies and associated risks, which can be very valuable to investors constructing and maintaining optimally diversified investment portfolios.

Fundamental Advantage Tax Efficient looks to provide the additional benefit of a high degree of tax efficiency for taxable U.S. investors, primarily because the interest income in the high yield municipal bond portfolio is free from federal tax and, in some cases, state tax. This is a unique benefit in comparison to many types of alternative investments that employ strategies that are fairly tax inefficient. In fact, Fundamental Advantage Tax Efficient is even more tax efficient than buy-and-hold equity strategies that currently benefit from the 15% long-term capital gain and dividend tax treatment, due to the fact that the high-yield municipal bond component is fully tax exempt.

Q: What is it about Fundamental Advantage that offers diversification in a portfolio?

Callin: Investors can increase the efficiency of a portfolio by either increasing return at a given level of risk, or decreasing risk at a given level of return. There are two ways to do this: one is to achieve greater risk-adjusted returns (alpha) and the other is to improve risk diversification at the portfolio level. In many cases, of course, the two are interrelated, and this definitely holds true with the Fundamental Advantage strategy.

Fundamental Advantage seeks to capture two independent sources of alpha - the Enhanced RAFI approach through our sub-advisor Research Affiliates, and the fixed income alpha generated through PIMCO's active management. These two independent sources of alpha have little or no correlation to the equity market.

On the fixed income side, both high quality taxable bonds and high yield municipal bonds generally exhibit low correlations with equities, particularly during periods of equity market stress, and PIMCO's active management attempts to further enhance this potential benefit. On the long-short equity side, the short S&P 500 position isolates the Enhanced RAFI alpha, which is not only expected to have no correlation with the equity market over the long term, but also may deliver very strong results during equity market corrections.

This lack of equity market correlation is the key to the portfolio level diversification benefit of Fundamental Advantage, as equity market risk accounts for the overwhelming majority of volatility and negative returns in a typical investment portfolio. To this point, a portfolio that has a 60% core equity allocation and 40% core bond market allocation tends to be 98% to 99% correlated with the equity market, and exhibits very little, if any, correlation with the bond market. You see the same results if you actually decompose the volatility of a 60/40

Product Focus

March 2008

portfolio: the equity market contribution to portfolio volatility is north of 90% while the bond market contribution is well under 5%, with the difference accounted for by the slightly positive to slightly negative correlation between the two.

Q: How is Fundamental Advantage expected to perform in different market environments?

Callin: Both components of this strategy – the actively-managed bond portfolio and the long Enhanced RAFI/short S&P 500 equity exposure – are designed to provide a return premium relative to the risk-free rate over a majority of 3-5 year periods.

Because the Enhanced RAFI is weighted by fundamental factors as opposed to market capitalization, it might show less outperformance or potential underperformance versus cap-weighted indexes during strong equity bull markets, when price momentum drives equity market returns. Conversely, the periods of strongest outperformance of the Enhanced RAFI approach may coincide with very weak equity markets, when previously overvalued stocks may experience significant price corrections.

On the bond side, yield has proven to be the best predictor of returns over most long time periods, because most high quality bond portfolios bear very little price risk from the standpoint of long-term investors. However, price volatility can also come into play, especially over shorter time periods. When interest rates rise, bond prices generally fall. Conversely there can be capital appreciation in bonds when interest rates are falling. As an active manager, PIMCO has the ability to substantially reduce or increase the interest rate exposure depending on our market outlook. Generally speaking, however, the return potential may be higher when interest rates are falling and lower when interest rates are rising. Another consideration with the fixed income component is the “flight to quality” benefit that typically accrues to high quality assets during periods of equity market stress.

Added together, these components can result in attractive potential returns, particularly during periods of weak equity markets, broad financial market stress, and falling interest rates – all times when attractive returns may prove highly valuable to investors.

Q: How is Fundamental Advantage similar to other PIMCO portable alpha products -- StocksPLUS in particular – and how is it different?

Callin: The primary similarity between Fundamental Advantage and the various versions of StocksPLUS is that both strategies seek to benefit from PIMCO’s long-standing portable alpha expertise that spans more than two decades.

In the case of our extensive suite of StocksPLUS strategies, we are replicating different equity market exposures using derivatives and simultaneously investing in different actively managed fixed income portfolios. The choice of each equity and bond component depends on a client’s specific objectives and other related considerations. The Fundamental Advantage strategy is implemented in a very similar manner, with the key difference being the addition of a short S&P 500 derivatives position to remove the equity market risk. As a

Product Focus

March 2008

result, Fundamental Advantage is effectively equity market-neutral, while StocksPLUS provides 100% long exposure to the equity market.

So even though the mechanics are similar, the resulting risk profile is very different by design. Different versions of StocksPLUS may make sense for investors who are seeking equity market exposure plus diversified sources of incremental alpha, while Fundamental Advantage may be a viable alternative for investors who are seeking equity-like returns from a strategy that is expected to be uncorrelated with the equity market and offer lower downside risk potential.

So clearly, the Fundamental Advantage strategies capitalize on our long-standing experience with alpha-beta separation and portable alpha. But Fundamental Advantage takes this expertise in a new direction that is in line with investor interest in diversified alternative investment strategies.

Q: Thanks, Sabrina.

Past performance is not a guarantee or a reliable indicator of future 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. High-yield, lower-rated, securities involve greater risk than higher-rated securities. Income from municipal bonds may be subject to state and local taxes and at times the alternative minimum tax. 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.

This material contains the current opinions of the manager and such opinions are subject to change without notice. This material 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 material may be reproduced in any form, or referred to in any other publication, without express written permission of Pacific Investment Management Company LLC, 840 Newport Center Drive, Newport Beach, CA 92660. ©2008, PIMCO.