

## Product Focus

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### **PIMCO's CommodityRealReturn Strategy**

Because the performance of stocks and bonds can be affected by similar market factors, diversifying a portfolio into non-correlated assets, or assets that have returns that are impacted by differing market factors such as commodities, may offset losses suffered should any one asset in a portfolio underperform, hence reducing overall portfolio risk. This concept is commonly known as Modern Portfolio Theory ("MPT") and was proven by Nobel Prize-winning economists Drs. Harry Markowitz and William Sharpe who studied the effects of diversification on a portfolio's overall risk level.

PIMCO's approach to the commodity index markets relies on our core strengths as a derivatives manager and active fixed income manager. Rather than purchase individual commodities, PIMCO matches a broad index of commodity prices while seeking to enhance overall returns through the use of inflation-linked fixed income securities.

This "double real"<sup>™</sup> strategy typically employs swap agreements to gain exposure to changes in a broad index of commodity futures prices, using portfolio assets as collateral. Such commodity indices typically include a rate of return on the underlying collateral that is roughly equivalent with money market rates.

PIMCO seeks to invest the portfolio assets that serve as collateral in predominately inflation-linked bonds (TIPS), which offer returns measured in real, not nominal, terms. If these fixed income investments provide a higher return than the rate embedded in a commodity index, the total return of the overall portfolio should be enhanced by the difference between these two rates. Economically, this "double real"<sup>™</sup> portfolio provides real returns in the form of income from the commodity index exposure and consistent real return income from the inflation-indexed securities.

The enhanced index approach capitalizes on two of PIMCO's core strengths: efficient management of derivatives positions and effective management of fixed-income securities. As one of the largest participants in the fixed income market, PIMCO has developed the resources, analytics and substantial experience to effectively manage positions in real return securities. PIMCO was an early leader in recognizing the value of inflation-indexed securities, and remains among the largest in the TIPS market. In addition, PIMCO has a history and a specialized staff with extensive experience and expertise in commodity index-linked derivatives.

### **The Return Benefits of a Broad Commodity Index**

For separate account assignments, PIMCO can track any investable commodity index. PIMCO's CommodityRealReturn Strategy seeks to match the Dow Jones AIG Commodity Index. The DJ-AIG Commodity Index reflects changes in a broad range of commodity futures prices, from crude oil and coffee to gold and cattle.

The DJ-AIG Index offers the added benefit of re-balancing on a price percentage basis. This means that as the price of a particular commodity rises, it is effectively "sold" to

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bring the exposure to that commodity back to the target price percentage level, which is adjusted once a year (see table below for weightings as of March 2006). This is important because commodity prices tend to revert to an equilibrium level, rising or falling to meet changes in demand and then reversing course when supply responds to the change in price, as it ultimately does.

Components of Dow Jones-AIG Commodity Index			
As of March 31, 2006			
Energy	30%	Natural Gas	9%
		Crude Oil	13%
		Unleaded Gas	4%
		Heating Oil	4%
Livestock	9%	Live Cattle	5%
		Lean Hogs	4%
Grains	19%	Wheat	5%
		Corn	6%
		Soybeans	7%
Industrial Metals	21%	Aluminum	7%
		Copper	7%
		Zinc	4%
		Nickel	3%
Precious Metals	9%	Gold	7%
		Silver	3%
Food/Fiber	9%	Sugar	4%
		Cotton	3%
		Coffee	3%
Vegetable Oil	3%	Soybean Oil	3%

Source: AIG

For example, a sustained rise in the price of oil makes it worthwhile to produce more oil. By re-balancing, the index would "sell" oil as the cost exceeded its given price percentage and "buy" oil once prices decline in response to the increase in production. As long as the price of all or most of the commodities in the index do not rise and fall in unison, price re-weighting should produce positive returns even if the price of commodities as an asset class drifts sideways.

### The Benefits of Commodity Exposure

Since long-term inflation rates are highly unpredictable, it is difficult to protect the real value of portfolios through traditional investments in equities and non-inflation indexed bonds. Equities—even those of commodity producers—can be affected by external

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factors such as the financial structure of the company, management talent, or trends and valuation in the overall stock market. All of these factors may decrease the link between portfolio returns and the rate of inflation.

Commodities, however, tend to respond directly to changes in the economy that tend to produce inflation. For example, an increase in demand for finished goods and services that puts upward pressure on consumer prices will likely be accompanied by rising demand for the raw material commodities that go into producing goods and services, such as energy or metals.

In addition, commodity returns have historically demonstrated little correlation with returns from either stocks or nominal bonds, meaning commodities tend not to move in tandem with these more-traditional asset classes. This is largely attributable to the fact that rising inflation tends to result in higher interest rates, because inflation erodes the value of investments that pay a fixed rate of return. And an environment of rising inflation and rising interest rates is typically not favorable for equities. The lack of correlation between commodities and more traditional asset classes can help improve portfolio diversity.

Commodities can also act as a hedge against unforeseen developments. War, weather and other events can suddenly and unexpectedly affect commodity futures prices differently than they affect stock or bond prices.

### Conclusion

Commodities and commodity index investments can offer investors a number of benefits. Since commodities are well correlated with inflation, but non-correlated with traditional asset classes such as stocks and bonds, exposure to a broad commodity index should improve a portfolio's long term real-return potential and increasing diversification, which tends to reduce risk.

PIMCO's enhanced-index approach to commodity investing relies on our core abilities as a bond manager: effective fixed income management and efficient management of derivatives positions. Both are critical to success in this area. In addition, broad commodity indices offer return potential even in the absence of a general uptrend in commodity prices, because of the benefits of index rebalancing.

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Each sector of the bond market entails risk. Municipals may realize gains & may incur a tax liability from time to time. The guarantee on Treasuries & Government Bonds is to the timely repayment of principal and interest, shares of a portfolio are not guaranteed. Mortgage-backed securities & Corporate Bonds may be

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sensitive to interest rates. When interest rates rise, the value of fixed income securities generally declines and there is no assurance that private guarantors or insurers will meet their obligations. An investment in high-yield securities generally involves greater risk to principal than an investment in higher-rated bonds. Investing in non-U.S. securities may entail risk due to non-U.S. economic and political developments which may be enhanced when investing in emerging markets. Diversification does not ensure against loss.

Inflation-indexed bonds issued by the U.S. Government, also known as TIPS, are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation. Repayment upon maturity of the original principal as adjusted for inflation is guaranteed by the U.S. Government. Neither the current market value of inflation-indexed bonds nor the value of shares of a fund that invests in inflation-indexed bonds is guaranteed, and either or both may fluctuate. The credit quality of the investment in the portfolio does not apply to the stability or safety of the investment. Duration is a measure of the portfolio's price sensitivity expressed in years. Diversification does not ensure against loss.

Portfolios may use derivative instruments for hedging purposes or as part of the investment strategy. Use of these instruments may involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk and the risk that a fund could not close out a position when it would be most advantageous to do so. Portfolios investing in derivatives could lose more than the principal amount invested. A portfolio's investments in commodity-linked derivative instruments may subject the Fund to greater volatility than investments in traditional securities. The value of commodity-linked derivative instruments may be affected by changes in overall market movements, changes in interest rates, and other factors such as weather, disease, embargoes, and international economic and political developments.

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