

Product Focus

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Brent R. Harris on PIMCO's Strategic Markets Products, The Case for Hedging Equity Exposure and the Continued Importance of Real Returns



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Mr. Harris is a Managing Director, and member of PIMCO's Executive Committee. Mr. Harris developed and oversees Strategic Market initiatives at the firm and directs portfolio management in this area. Mr. Harris also serves as Chairman of PIMCO Funds and PIMCO Commercial Mortgage Securities Trust, Inc. Mr. Harris joined PIMCO in 1985, having previously been associated with the Claremont Economics Institute. He has twenty-two years of investment experience and holds a bachelor's degree in Economics from Claremont McKenna College and an MBA from the Harvard Business School.

PIMCO Managing Director Brent Harris developed the firm's Strategic Markets products, which include the CommodityRealReturn Strategy, the RealEstateRealReturn Strategy and the All Asset Strategy, as well as the StocksPLUS Total Return and StocksPLUS Short Strategies ([Click here for an overview of PIMCO's Strategic Markets products](#)). In the interview below, Mr. Harris discusses the broad aims of the Strategic Markets products offering and current strategies being employed in Strategic Markets products.

Q: Let's start with the big picture. Why did PIMCO develop the Strategic Markets products and what do they have in common?

Harris: PIMCO began developing the Strategic Markets products nearly five years ago as yields on conventional assets—earnings yields for stocks and current yields for bonds—approached historically low levels. We believed the investment return implication of low yields and high valuations was really quite significant because it meant that a typical asset allocation of 60% stocks, 30% bonds and 10% 'all other' was simply not likely to produce the rate of return that would enable investors to meet their long-term liabilities, including important retirement and savings programs. So, given the valuations at the time, there was a disconnect between what the markets were likely to return going forward and where investors' return expectations were.

Because of this disconnect, we saw an emerging need for investment strategies that could provide higher real return potential over the long term while also improving the diversification of a traditional portfolio of stocks and bonds. So PIMCO began to expand its product line-up to include new asset classes and strategies that had the potential to provide higher real returns. At the same time, the continued development of the futures and swaps markets created the potential for us to take alpha-generation from bond management and "port" it on top of these other asset classes in an effort to create an enhanced return to that asset. This is one of our key value-creation points driving our Strategic Markets products returns.

Q: The Strategic Markets products specifically target real returns, and many of these products use alpha-generation strategies that rely on Treasury Inflation-Protected Securities (TIPS). PIMCO expects benign inflation over the longer term, so why might an investor find strategies that target real returns attractive right now?

Harris: Economic growth in the U.S. has pushed real interest rates up to levels that are attractive compared to last year, particularly on long-term TIPS. So we believe current

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levels offer investors in the Strategic Markets products an opportunity to lock in attractive real rates.

We also believe the U.S. economy is likely to experience a significant slowdown or even recession sometime within the next year, which is one reason inflation should remain benign. In the event of an economic slowdown, strategies targeting higher real returns offer two potential benefits. First, real rates would likely decline along with economic growth, which should lead to capital gains in bonds and enhance the Strategic Markets products' potential for adding alpha through bond-based alpha strategies. Second, inflation tends to lag changes in the economy and would probably remain elevated for a bit even if the economy were to slow. What that means is that if the nominal returns from equities or other asset classes decline along with the economy, inflation would erode those returns even further, in which case investors may benefit from exposure to real return strategies.

Q: Are there other strategies in addition to real return bonds that PIMCO employs in an effort to enhance real returns in the Strategic Markets products?

Harris: The underlying goal of any investment is to increase purchasing power of the investor's assets over the long term. Inflation puts this goal at risk, which is why several of the Strategic Markets products attempt to enhance real returns with inflation-indexed bonds. But inflation is not the only factor that can put long-term purchasing power at risk. For U.S. investors, who buy lots of imported goods, a decline in the dollar can also decrease the purchasing power of dollar-based assets. The dollar has benefited from heavy foreign investment in U.S. assets, but at some point foreign investors are likely to reach a saturation point and look to diversify into non-dollar assets. We think this is already occurring to some extent and that the dollar will be under pressure over the long term, so we are currently employing modest exposure to several different foreign currencies in U.S. Strategic Markets products.

Q: The Strategic Markets products also include strategies that provide long or short exposure to equities. With the U.S. economy growing well, why might an investor want to consider PIMCO's StocksPLUS Short strategy?

Harris: Risk assets, including U.S. equities, have benefited significantly from the liquidity that central banks have provided in the global financial system by keeping interest rates quite low during this global economic recovery. But the Federal Reserve, the European Central Bank and the Bank of Japan are all now in the process of normalizing interest rates and withdrawing liquidity from the global financial system. This normalization of interest rates is most advanced in the U.S., where the Fed has increased rates by 400 basis points since 2004. At the same time, leverage in U.S. equities due to margin investing is near maximum levels, and corporate profits as a percentage of U.S. GDP are near their highs. In addition, total equity fund manager cash, adjusted for the level of short rates, is at extremely low historical levels and this is worrisome. All of these factors suggest U.S. equities may be vulnerable at current levels, and that savvy investors might do well to consider possible tactical short exposure to the stock market.

Q: Are you suggesting the U.S. equity market may be near a peak?

Harris: Fewer stocks are making new highs, and many are making new lows, which is emblematic of a market with weakening momentum, and has traditionally been seen prior to the emergence of full bear trends. With the Fed's discount rate at 6% for the

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first time since the large equity market top in the winter of 2000, which subsequently led to the fierce decline in equities through July 2002, caution and equity hedging may be in order.

PIMCO's StocksPLUS Short strategy, which is part of our Strategic Markets product area, can be an efficient way to implement a structural short position in the S&P 500 as a hedge against a downturn in equities. The StocksPLUS Short strategy is similar to our StocksPLUS Total Return strategy, but instead of gaining long stock market exposure through equity futures, the StocksPLUS Short strategy sells futures to gain short exposure to the S&P 500 index. We back that exposure to equity futures with a portfolio of bonds that employs PIMCO's well-known total return investment style. The bond portfolio serves as collateral on the futures position as well as a structural source of potential alpha.

Q: Can you elaborate on the bond-based alpha strategy PIMCO employs in the Strategic Markets products? How is this a structural source of alpha and how does it work?

Harris: The alpha strategy used in the Strategic Markets products capitalizes on the normal upward sloping structure of the bond market yield curve. Over the business cycle, short-term rates, because of the constant demand for liquidity for transactions, usually yield below intermediate and long-term rates. From time to time, the shape of the yield curve changes, such as when the Fed tightens, as it has done since Summer 2004. But, historically, that tends to be relatively short-lived; yields on intermediate and long-term bonds are usually higher than on short-term bonds.

Futures and swaps contracts tend to incorporate a financing rate based on the short-term rate, partly due to industry convention and partly due to the dominance of short-term program trading. By paying the short-term rate to finance market exposure in futures and then investing the rest of the portfolio in longer-term bonds, we have the potential to generate longer-term structural alpha based on the differential between short and long-term interest rates.

Institutional investors have a naturally longer-term time horizon compared to most futures market participants and can potentially utilize this important advantage to produce attractive, enhanced long-term returns from equities and other asset classes—real estate through equity REITs, as in PIMCO's RealEstateRealReturn Strategy, and commodities through commodity indexes, as in our CommodityRealReturn Strategy. The basic approach works in much the same way in each of these asset classes, enabling us to provide the potential to outperform in asset classes that heretofore have been viewed as either alternative, highly illiquid, expensive to operate in, or all three. The new strategies share common heritages and lever PIMCO's expertise into areas that most people wouldn't normally associate with PIMCO. Utilizing the discipline described, we believe we can compete effectively against traditional asset managers—far afield from the bond management business—and hopefully deliver attractive returns to longer-term and performance attuned investors in a range of important asset classes.

Q: Thank you for this update on PIMCO's Strategic Markets products, Brent.

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Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. In an environment where interest rates may trend upward, rising rates will negatively impact fixed income securities. Bonds with a longer duration (a measure of the expected life of a security) tend to be more sensitive to changes in interest rates, usually making them more volatile than securities with shorter durations. The Standard & Poor's 500 Composite Index (S&P 500) is an unmanaged index of U.S. companies with market capitalizations in excess of \$4 billion. It is generally representative of the U.S. stock market.

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