



## The Future of Investing Evolution or Revolution?

The title of this *Outlook*, “The Future of Investing,” is a theme that will take the evolving years to resolve, let alone the next few days. Still, PIMCO is an organization that loves a challenge. All of us here today would agree that the answer to both questions will be highly dependent on the evolution of the global economy, and when it comes to those questions PIMCO has excelled because of its long-term secular outlook. It has paid dividends for our clients for over 30 years and it should do so now as well. The fact is, **that the future of investing will depend on the long-term future of the global economy** – its nominal growth rate and the distribution of that growth between public and private interests. And so we should start at the beginning, or perhaps at the top, of our top-down process – **the future of the global economy.**

### I. Future of the Global Economy

**The future of the global economy will likely be dominated by delevering, deglobalization, and reregulating,** yet if so, it is important to state at the outset that we do not envision a mean reversion, cyclically oriented future, but instead a new world where players assume different roles, and models relying on bell-shaped/thin-tailed outcomes based on historical data are less relevant. Historical models look backward while modern-day finance is being fast forwarded and reconstituted almost as we speak.

1) Delevering – The prior half-century of leveraging and the development of the amorphous shadow banking system was growth positive. Major G-10 economies became dominated by asset prices and asset-backed lending most

clearly evidenced in housing markets. Excess consumption was promoted, and investment based on that consumption followed in turn. Savings rates in many countries including Japan, the U.K., and the U.S. fell towards zero as the reliance on rainy day thrift faded. Deleveraging of business and household balance sheets now means those trends must reverse, and as they do, growth itself will slow, bolstered primarily by government spending as opposed to the animal spirits of the private sector.

This topic is one which literally could take hours to discuss, and at PIMCO forums and Investment Committee meetings, it does. There are those of us here as well as highly respected economists outside of PIMCO who would suggest destruction as opposed to slow growth, and they may have a minority, but not insignificant, case. Much depends on the effectiveness of policy responses and the simplistic answer to a simplistic question. Can global financial markets and the global economy heal by pouring lighter fluid on an already raging fire? Can too much debt be cured by the issuance of even more debt? Must the debt supercycle come to an end by crashing and burning or does the world keep breathing with a whimper instead of a bang? We shall see, but there is a near certain probability that the financially based global economy of the past half-century will not return, nor will we experience the steroid driven growth excesses that it facilitated.

2) Deglobalization – Lost in the wondrous descriptions of finance-dominated, Bretton Woods-initiated, global growth has been

the adrenaline push provided by global trade and indeed portfolio diversification into a multitude of markets – developed or developing. Yet historians point out that globalization is not an irreversible phenomenon – witness the aftermath of WWI and nearly three decades of implosion. Now the beginning signs of trade barriers – “Buy American” and “British jobs for British workers” among them – as well as government support of locally domiciled corporations (banks and autos) suggest an inward orientation that is less growth positive. Additionally, “financial mercantilism” is an added threat – a phenomenon that speaks to growing pressure on banks to retreat from international business and concentrate on domestic markets.

- 3) Reregulation – Academics, politicians, investors, central bankers and everyday citizens are questioning the economic philosophy that idolized free markets and their ability to self-regulate. The belief in uncapped and unregulated incentives producing unlimited upside but nearly always cushioned downside losses is fading. While Sarbanes-Oxley was a well publicized but relatively toothless response to the dot-com bust of nearly a decade past, today’s politicians have gained the upper hand, driven by a citizenry that has recognized the unbalanced, disproportionate distribution of incomes. The efficient market thesis, so prevalent in academic theory and market modeling is now in retreat, and perhaps rightly so. In its place, we will experience less efficient but hopefully less volatile economies and markets – monitored and controlled by government regulation. Executive compensation, of course, is just the poster child. Government ownership and control of vital financial and manufacturing institutions will politely be described as “industrial based” policy and “burden sharing,” but we should have no doubt that we will move significantly away from the free market model that has dominated capitalistic countries for the past 25 years.

With the top-down framework for future global economic growth in place, let’s take a look at PIMCO’s outlook for the future of investing – evolution or revolution.

## II. The Future of Investing

*Whether evolution or revolution* it is important to recognize that the aftermath of an economic and investment bubble transitioning from **levering to delevering, globalization to deglobalization and lax regulation to reregulation leads to an across-the-board rise in risk premiums, higher volatility and therefore lower asset prices for a majority of asset classes.** The journey to a new stasis is a destructive one insofar as it affects previously assumed wealth. Rough estimates suggest that as much as 40% of global wealth has been destroyed since the beginning of this delevering process. In essence, asset prices, which are really only the discounted future value of wealth creation, go down – not only because that wealth creation slows down but because it becomes more uncertain. In such an environment, equity interests in the form of stocks, real estate or even high yield bonds become re-rated. Those who believe that capitalism is and will remain a going concern and that risk taking – over the long run – will be rewarded, must recognize that those rewards spring from beginning prices and valuations that correctly anticipate the global economy’s future growth path and volatility. In terms of that old maxim “buy low – sell high,” this means at the minimum that an investor during this period of re-rating must “buy low.”

In turn, investor preferences towards risk taking, even when correctly calculated and modeled must be considered. Peter Bernstein has for several years counseled that policy portfolios structured for the long run and based on historical return statistics should be reconsidered. The standard pension or foundation approaches to policy portfolios are being challenged, he asserts, and PIMCO agrees. Stocks for the long run? Home prices that cannot go down? The inevitable levering

of asset structures to double or quadruple returns relative to risk-free assets? These historical axioms must now be questioned. In fact, as of March 2009, the superiority of risk-asset returns are not what many assume them to be. For the past 10, 25, and 40 years, for example, total returns from bonds have exceeded those for common stocks.<sup>1</sup> Home prices have declined a staggering 30% since their peak in late 2006, and have barely kept up with inflation for the last century according to Case-Shiller statistics. Commercial real estate when ultimately mark-to-market over the next several years will likely show similar results. In short, our stereotyped conceptions of what makes money are being challenged. As Bernstein says, there is no predestined rate of return. And a PIMCO corollary would counsel that future rates of return will be dependent on the beginning price and future growth rates and risk preferences that cannot necessarily be derived from historical models. Government policies will also play an important role, especially insofar as they impact long-standing property rights and capital structures. What I have previously described as a CQ – a common sense quotient – may take precedence over IQ and quantitative analysis in future years. How much of a benefit, for instance, did the renowned risk modeling of some of our major competitors produce over the past several years in terms of their bond funds and derivative-related products as compared to PIMCO's? We invite comparison, not only of our own risk models, but our collective common sense quotient.

What then does common sense tell us about future asset returns? Let's revisit our previous conclusions on the developing environment for some clues. They include: delevering, deglobalization, reregulation leading to slow global growth, a heightened risk aversion, a distrust of conventional investment model portfolios, and a greater emphasis on surviving as opposed to thriving. If valid, then an investor or an investment committee would likely stress the bird in

the hand – as opposed to the one in the bush; stable and secure income – as opposed to uncertain capital gains; a government-regulated utility model – as opposed to innovative yet risky venture capital investments. At current price levels, to cite one example, the current income from corporate bonds is higher and certainly more secure than the dividend income from stocks.<sup>2</sup> A return to an era reminiscent of the first half of the 20<sup>th</sup> century is not unimaginable where stocks were viewed as subordinated income producers with yields exceeding their senior bond companions on the liability ladder.

But let me not go too far in suggesting that asset classes near the perimeter of risk have no future. They do if only because they eventually will be priced right. In fact, PIMCO intends to participate in the management of many of them, and as argued previously should be well and healthily positioned to do so. Our recent launch of a global multi-asset fund featuring tail-risk protection is just one example. The potential participation in TALF and other government-sponsored levered structures is another. Still, the tide seems to be going out and as Buffet suggests, all swimmers are being exposed, swimming suits or bare-bottomed naked.

There are a host of investment implications that one can subjectively conclude from this outgoing tide, although they have not been officially endorsed by our upcoming secular forum. It seems to me, though, that one has only to ask what investments were positively affected by the previous long-term cycle of leveraging, deregulation, and globalization in order to imagine which ones will do poorly as the trends reverse. A short list might read as follows:

- (1) The Dollar – As the center of structured finance and the shadow banking system, the dollar was bolstered as it sold paper to the rest of the world. To date, its recent strength seems counterintuitive. Weakness may more accurately describe its future.

- (2) Credit – Lax regulation and increasing leverage squeezed risk premiums and spreads to historically overvalued levels. We are now moving in full reverse.
- (3) Equity – In addition to the previous conclusions, it is evident in retrospect that narrow risk premiums in credit markets facilitated narrow equity premiums in stocks if only because they seemed cheap by comparison and allowed corporations to borrow cheaply and buy back their own stock.
- (4) Emerging Market Globalization and lax lending standards re-rated emerging and developing country financial markets to unrealistic levels. Eastern Europe is likely the first to fall.

Many of these trends, of course, have now reversed course, direction, and magnitude, and there will come a point where those low and lower prices, as well as the potential for successful policy healing, will favor what is now in disfavor. For now, however, let it be simplistically said that the trend is your friend and that the ad hoc, disjointed and anemic policy responses of government appear to be too little, too late. Investors should therefore favor stable income as opposed to speculative growth or the subordinate liability structures of most private market balance sheets. Shake hands with the government is and has been our motto although the contractual certainty of a government handshake may now be questioned in an increasingly number of marginal areas.

Another way to summarize our caution would be to quote a recent comment by Barton Biggs.

“I am a child of the bull market,” he said which upon further elaboration meant that he bought on cyclical dips with the expectation of riding mean reversion to an upward sloping trend line of prosperity and ultimately higher peaks. In a sense, we are all children of the bull market, although some of us are more mature than others – a bull market of free-enterprise productivity and innovation, yes, but one fostered by a bull market in leverage, deregulation and globalization that proved unsustainable in its excesses. We now must view ourselves as chastened adults, forced into acknowledging a new reality that is dependent upon bear-market delevering and debt liquidation to deliver us to our new and ultimate restructured destination – wherever it lies. Thus, while historians might describe these years as an evolution, for those of us living it day-by-day it most assuredly has the feel of a revolution. Much like Irving Fisher’s “permanently higher plateau” of prosperity that was quickly turned on its head in 1929, those who would forecast a “permanently lower valley” of despair might similarly be off the mark. Yet there should be no doubt that the bull markets as we’ve known them are over and that the revolution is on. Investing is no longer child’s play.

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<sup>1</sup> Source: Research Affiliates.

<sup>2</sup> Source: Bloomberg. As of 3/30/09, the current yield on the Barclay’s investment-grade credit index is 7.11% and the current yield on the S&P 500 is 3.66%.

**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. U.S. Government securities are backed by the full faith of the government; portfolios that invest in them are not guaranteed and will fluctuate in value. Corporate debt securities are subject to the risk of the issuer’s inability to meet principal and interest payments on the obligation and may also be subject to price volatility due to factors such as interest rate sensitivity, market perception of the creditworthiness of the issuer and general market liquidity. High-yield, lower-rated, securities involve greater risk than higher-rated securities. 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.

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