

Takin' Care of Business (The Last Vigilante Part II)

"It never rains in California, but girl don't they warn ya, it pours, man it pours."

Albert Hammond

One of the interesting, as opposed to frustrating aspects of our ongoing sojourn through the landmines of regulatory scrutiny and occasional public opprobrium is the individual reactions from people who know you, but just not well enough to KNOW you – if you get my drift. Some drop their eyes towards the ground – perhaps to avoid seeing that presumed scarlet letter – but others muster up more courage than I myself might have in a similar situation. Just yesterday an elderly gentleman at my yoga workout across the street came into the gym and out of the ongoing winter storm of several days duration and said, "Boy it's raining on your parade both literally and figuratively isn't it." "Yeah, I guess it is," I laughed and the phrase from the early '70s pop hit cited above came straight to mind. It's never rained in PIMCO's California, but when it does, man it at least feels like it's pouring. Having said that, let me assure you that we have a requisite number of umbrellas and are looking forward to the forecast of sunnier days ahead although with weathermen you never know. Rest assured as well that through all of this travail our spirits are still undaunted, our chins are visibly high though not quite as elevated as Jay Leno's and perhaps most importantly – at least from the standpoint of this *Outlook* – we are still managing portfolios. "Busi-

ness as usual" might be a stretch since the hours are longer these days but "Investing is Job 1" would not be. Throughout all of this, we intend to give you a great year of relative performance. Your unspoken but presumed challenge is unanimously accepted by all of us.

Having said that, I thought it would be instructive to lay out a follow-up strategy piece to last month's *Investment Outlook* which generated lots of attention and a record 70,000 hits on our PIMCO website. Goodness gracious, who would have thunk it? That *Outlook*, to summarize, laid out the case for a financed-based economy laden with debt and the inability of policymakers to retreat in any meaningful way from reflationary policies whether they be budget deficits, currency depreciation, or negative real short-term interest rates. It suggested ultimately higher inflation (not much in 2004), but the last paragraph hinted at the possibility (not probability) of a renewed downward economic spiral should foreign or even domestic bond market investors pull the plug on their willingness to underwrite America's profligacy. "The Last Vigilante" was really an entreaty for common sense and a return to investment market vigilance. The timing and in fact the very reincarnation of that discipline was held out for question.

Missing from that piece, however, primarily because of its length, was a list of bond market strategies that might benefit from the unfolding of events despite economic uncertainty. Investment managers in order to succeed against their bogies and peers must take what I consider to be “measured risk” – that is their portfolios must make a statement and express a personality, although that

persona must not be a case history from a textbook on abnormal psychology. The day following my posting of January’s *Outlook* to our website, I printed an E-mail to our Investment Committee members and all PIMCO portfolio managers around the globe as to how we should invest in a vigilant investment world. The following, reprinted in full is that recommendation:

-----Original Message-----

From: Gross, Bill
Sent: Tuesday, February 03, 2004 10:26 AM
To: Investment Committee; Port Managers
Subject: The next Vigilante

As a follow-up to my IO of last night I ask myself how would a portfolio manager behave if he wanted to be a Vigilante?

- 1) Reduce durations in reflating countries (US, Japan) and increase durations in relatively vigilant ones (Euroland)
 - 2) Make some bets against reflating and structurally deficient country currencies (US)
 - 3) Own inflation protection in reflating countries (US TIPS)
 - 4) Own securities expected to benefit from an eventual unwind of unsustainable structures (US budget/current account deficit - which ultimately must be addressed via higher tax rates)---US Municipals
 - 5) Own the front-end of reflating country curves---both for inflation protection and to participate in the rolldown/carry offered by the reflating instrument of choice---low real short rates
- Having written this, there are decent probabilities that reflationary policies fail and that a deflationary bust eventually takes hold. To protect against such an eventuality----
- 6) Void risk holdings (corporates, emerging?) at spreads where Treasury futures compensate for giveup in carry----the free put
 - 7) Maintain overall durations relatively close to benchmark and monitor success/failure of policies very closely

Other thoughts?

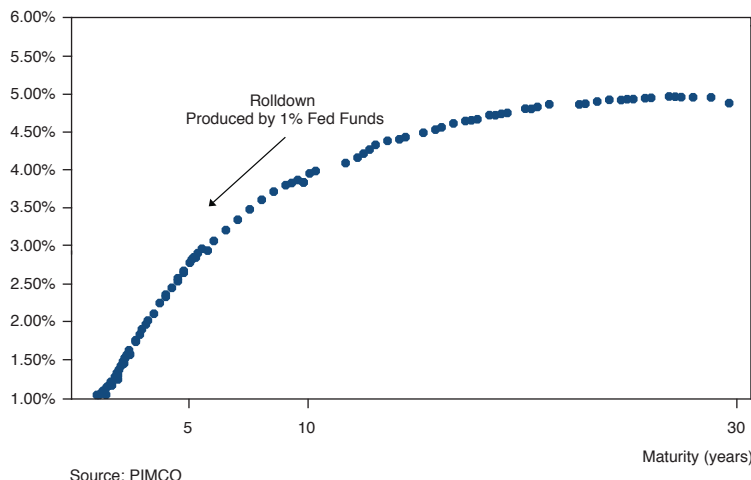
WHG

While the above road map seems commonsensical, an overall qualifying observation leaps immediately front and center: almost all of the recommendations appear to involve some sacrifice in yield or what is referred to these days as “carry.” Minimizing corporates, purchasing Euroland bonds with a near 100% currency hedge, accumulating municipals at 90% of Treasury yields, and even owning TIPS at breakeven inflation rates of 2.2% seem to protect against reflationary policies but at a cost – a lower yield. And while “total return” is the name of the game one must always be cognizant of what constitutes the majority of that return over long periods of time – interest payments. After all, a portfolio manager intent on purchasing insurance against reflationary policies would move to “cash” in various proportions depending on her confidence in that outlook. Cash, however, comes with a 1% “hook,” an onerously-expensive, negatively-yielding real interest rate which is meant to discourage reflationary fears and encourage long-term investing if only because of the consequences. So yield or carry must be a consideration here.

The rather startling comeback to this observation is that most PIMCO portfolios as currently constituted do out-yield the bond market, while still purchasing

reflatory insurance at what amounts to be a negligible cost. Our calculations show most PIMCO total return domestic and global portfolios at a carry of 30-40 basis points over respective bogies. How so? Part of the explanation comes from a front-end yield curve strategy mentioned in #5 on the preceding page that appears to sacrifice yield, but which in reality adds it. November’s *Investment Outlook* introduced the idea of “duration space” and how a bond with a long maturity and a higher yield can actually yield less when combined with 1% cash to match market duration averages. Although the higher “yielding” front-end intermediates may have historically higher volatilities and therefore less option-adjusted yield per unit of duration space than they appear to possess, the “bet” of course is that short-term interest rate volatility will be less than historic proportions. A central bank attempting to reflate does so via extended periods of stable, low, real interest rates – witness Japan for the past decade as well as the U.S. for the past 14 months. “Carry” in this environment comes not from the conventional extension of maturity, but from voiding 30-year bonds and benefiting from the “rolldown” of intermediates on the 2-8 year portion of the yield curve. The following chart displays that strategy.

Rollin', Rollin', Rollin'



There is lots of technical bondspeak in that last paragraph that may take a while for the reader to digest. Perhaps easier to swallow might be my explanation in #6 on the preceding page that suggests that Treasury futures can actually out-yield investment grade corporate bonds at existing spread levels. It appears they have and can. Our calculations suggest an average cheapness to 10-year Treasury futures of 4 ticks or 4/32s a quarter, which translates into a 50 basis point annual advantage of Treasury futures over their cash market look-alikes. The explanation for this apparent miracle rests primarily on the proposition that mortgage/investment banking hedging requires the sale of futures (or swaps) that lowers prices just enough to induce investment managers such as PIMCO to take the other side. 50 basis points is that price. If that is the outcome, then most A and Aa corporates can be eliminated from our portfolios at existing spreads with little if any give-up in yield. The result is what #6 refers to as a free "put" on corporate spreads. If currently narrow spreads widen over the next 12 months, PIMCO portfolios benefit from their absence. If not, their "yield" provides at least a tie or a "push" as the term is commonly used.

I could go on – but my natural inclination to keep it brief and readable shouts, "Wrap it up." Hopefully by extensively reviewing the E-mail exhibit on the preceding page, clients and interested readers can understand the bulk of our strategies designed to benefit from current reflationary attempts. Perhaps next month I will elaborate further on points #1-4. Of equal importance though is the caveat/hedge mentioned in #7 that speaks to the monitoring of the success/failure of current government policies. You see, reflationary policies produce asset bubbles, which can continue to (1) inflate or – (2) POP! Higher inflation speaks to the success of the government's current efforts. The popping speaks to financial destruction and a potential deflationary economy. Because of these two alternative outcomes, durations must be relatively market neutral until a conclusion becomes more visible. Our May Secular Forum will assist us with an up-to-date analysis. In the meantime, we're all business, all the time as the phrase goes. We intend to give you a great relative year.

William H. Gross
Managing Director

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

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