

Bill  
Gross



# Investment Outlook

P I M C O

November 2006

## Alpha/Beta Anemia

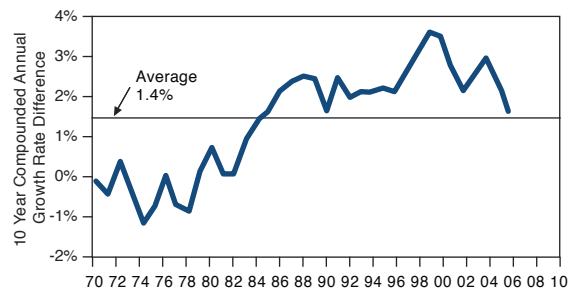
Some of you may recall that I have collected stamps for the past 15 years or so, which is neither here nor there, I suppose. Actually it's probably more "there" than "here" for almost all of you, especially if your enthusiasm for the hobby mimics that of my wife Sue. Although she takes an active interest in everything I do, there is frequently an occasion when I'll bring home a new stamp to add to the collection and carefully display it on the kitchen table for her to admire.

After a smile and a wifely "ataboy" she'll point to the stamp, then point to her wedding ring and say, "Now let's see, which one would I rather have, that little ol' piece of paper or this little ol' shiny white diamond?" That pretty well puts my stamp in its proper place I suppose, stuck in a dusty album far out of sight, while her diamond gets to parade around in the California sunshine.

Still, I'm glad I pursued philately if only because the investment logic I applied to my collecting has its parallels at PIMCO. In the early 90s, I figured that if stamps/collectibles were a valid "asset class," then their annualized rate of appreciation or total return should be somewhat similar to more legitimate holdings such as stocks, bonds, or real estate. Admittedly there was an element of hope in that assumption; Beanie Babies and Cabbage Patch Dolls were hot collectibles long ago, but I don't expect the Ibbotson-Sinquefeld yearbook to be outlining their annualized returns anytime soon. But if there is staying power/longevity to collecting stamps, coins, and art then their returns should mimic other asset categories if only

because they are all correlated to the same thing – the growth rate of nominal GDP. While the use of financial leverage and the vagaries of investor behavior undoubtedly distort a perfect one-for-one correlation, there should be little doubt, even among academics that since nominal GDP growth is a reflection of the growth rate in domestic production/wealth creation/purchasing power – all of which is expressed in annual dollar terms – that the appreciation of assets which for the most part represent the present value of that future growth should closely resemble the path of nominal GDP over long periods of time. The logic of the Capital Asset Pricing Model confirms just that point. Chart 1 points out this relationship although the three primary asset categories displayed have grown slightly faster than GDP (1.4%) if only because of the use of financial/operating leverage, their historical ability to lever/be levered at yields less

**10 Year Annual Growth Rate of Total Assets  
(Stocks, Bonds, Real Estate) in the U.S.  
Deflated by Nominal GDP**



Total assets in the U.S. are calculated from tables L.5 and B.100 of the Federal Reserve's Flow of Funds report. We add the net worth of U.S. households to the total assets of all sectors to arrive at the total assets in the U.S. The 10-year compounded annual growth rate of total assets in the U.S. does not control for changes in valuations, savings rates, and reinvestment rates across asset classes and asset holders.

Source: PIMCO

Chart 1

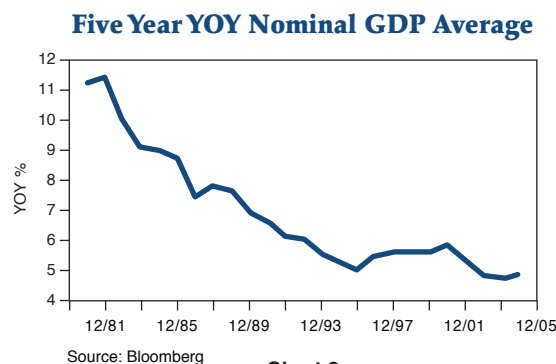
than their rates of growth, and importantly the past 25 years of disinflation, which has boosted the return of assets relative to expectations and assumptions of GDP growth going forward. We may actually be entering a period during the end of disinflation, where asset appreciation actually equals the long-term growth rate of nominal GDP or even less as in the 1970s.

Wow, that's a plate full and I hope you're still with me - stamps or no stamps. My point in bringing this up is to point out that if the "Beta" or return from various asset classes is correlated to the growth rate of nominal GDP, then what we have to look forward to is a rather anemic "Beta" in future years. In turn, if because of that increasing realization, investors have responded by compressing risk spreads and therefore potential Alpha, then what's looming over the immediate horizon is an Alpha/Beta anemia that can't come close to meeting investor expectations or for that matter come close to immunizing this nation's collective liabilities.

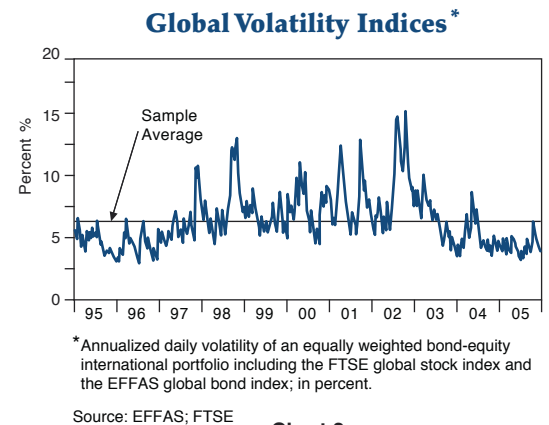
Chart 2 outlines this spectre of future returns to come. As nominal GDP growth rates have declined from 11%+ to a recent 5-year average of less than 5%, future asset returns of a similar magnitude are foretold. While Chart 1 suggests that a 5% GDP growth rate can be levered up to perhaps 6% or 7%, that levering is certainly more difficult with a Fed Funds policy rate higher

than the current growth rate of GDP and with disinflation near its end. In any case, we appear to be looking at maximum 6-7% average annual returns over the immediate future from stocks, bonds, and real estate in total (stamps too!).

Since even that 6-7% is likely not enough to collectively pay for future liabilities, whether they represent college, health-care, or debt obligations, investors have been clamoring for something that returns more. "You take 6 or 7," they'll say, "I need 9-10 like the old days. I'll allocate savings or redistribute assets to hedge funds, spec houses, or other risk-oriented levered products to beat the 'market.' I'll take the high return road, you can have the low road with those stodgy old bonds and index-oriented products." And so the anticipated future Beta anemia leads in turn to a willingness to assume more risk, to drive the prices of risk assets higher – and risk premiums lower – and at some point (like now) to produce an Alpha anemia as well. A recent study by the Bank for International Settlements points out that the annualized volatilities for stock, bond, and currency markets are approaching historic lows, with the implicit assumption that the pricing of risk is following in lock step. Chart 3 shown below is but one of many examples that the BIS uses to make their point. And while the compressed pricing of risk may



**Chart 2**



**Chart 3**

in isolation be more a forewarning of future Beta anemia than that of Alpha, there's no doubt that the chances for successful Alpha "farming" are enhanced with wider risk spreads – whatever the asset class.

To be fair, the BIS also points out that there may be numerous fundamental reasons that justify lower risk spreads. Globalization, the "great moderation" of economic growth in recent decades, increased central bank transparency, and the innovation and promulgation of financial derivatives, which can disperse and spread risk as well as promote increased liquidity are but a few of their major arguments. I concur with much of their logic. But I also agree with Alan Greenspan and economist Hyman Minsky that stability can in time be inherently destabilizing as overconfidence leads to lower and lower risk spreads, more and more financial leverage (Ponzi finance as Minsky called it) and an ultimate vulnerability to the economy and its financial markets on the downside. The BIS points out that financial institutions in recent years may have ultimately increased their overall risk exposure despite the reduction in asset volatility.

**The choice for investors then, and importantly for PIMCO as well, is how to participate in this brave new world of Alpha/Beta anemia:** jump into the pool of one to two foot deep risk spreads or wait for the higher water that we've been used to? If the BIS' fundamentals are correct there shouldn't be any broken legs despite the shallow aqua. However, if stability does lead to Minsky's instability, there could be some sorry investors and sorry investment management firms that decided to lever up at just the wrong time. Playing by the old active management rules in an Alpha/Beta anemic world that doesn't destabilize will likely lead to an erosion of PIMCO's attempt to achieve 100 annual basis points of Alpha in future years. Playing by the new rules

which in part require an assumption of levered risk spreads at historic lows could likely lead to low absolute returns and/or negative Alpha should instability return. Your asset returns – and active portfolio management itself – are now both at risk in this seemingly riskless and increasingly anemic investment return environment.

What to do? As noted above, I and we at PIMCO accept many of the realities/fundamentals of this new world low nominal GDP growth. Financial innovation, central bank transparency, and even globalization's great moderation of economic volatility are powerful arguments suggesting the old days of copious Alpha and Beta are over because 5% GDP growth and compressed risk spreads are not likely to permanently return to historic levels. Yet we have a collective sense that risk spreads will not remain so low over the next 12-24 months, and that instability – whether it be sparked by U.S. housing, global overinvestment, or geopolitical events – will one day temporarily resurface. If both major assumptions have merit, then the strategic and structural case for now should be guided by the New Age acceptance of change and the Old Age wisdom that bad things can happen to apparently good assets in the short term.

Such New Age acceptance, it would seem to me would be embodied in the willingness to utilize more concentrated strategic bets that lead to increased daily and annual volatility compared to historic indices. Closet indexers will not prosper in this new world. If chosen properly in historic PIMCO fashion, the increased volatility should translate into higher Alpha and higher returns than would otherwise be the case. If that were true, PIMCO clients would get more return and come a little bit closer to those higher single digit numbers that supposedly only hedge funds and private equity can produce. And they would get it, by the way, with fees at a fraction of the

alternative. Does this mean that PIMCO wants to turn itself into a hedge fund on the cheap? Hardly. But it does mean we should be willing to scale up our most confident strategies in a way that could lead to additional Alpha for you the client at the temporary expense of increased volatility.

Old Age wisdom would caution that some New Age risk spreads are hardly justified by common sense and that if an investor/PIMCO is to increase the scale of its strategies, they should be focused in the few categories which offer the most attractive reward relative to subjectively and quantifiably identified risk. All of you, I'm sure are familiar with the advantages of Markowitz-style portfolio diversification. In a world of Alpha anemia, however, a diversified portfolio of overvalued assets may expose an investor to not only anemic Alpha, but also significantly lowered BETA if "stability" ever leads to "instability" in a systemic way. A New Age PIMCO therefore that is cognizant of compressed risk spreads should be willing to do less index hugging because index risk spreads are overvalued. The scaled up strategies we do endorse, however, must fit in the area common to both New and Old Age intersecting circles as shown in Chart 4.

These strategies will make sense if we remain in the New Age of compressed spreads or if we temporarily return to expanded spreads during instability. In brief, the favored concentrations reflect positions in high quality front-end yield curves as well as duration extension, especially during periods of market weakness such as we have experienced in October. If New Age spreads persist, front-end high quality positions and duration extension

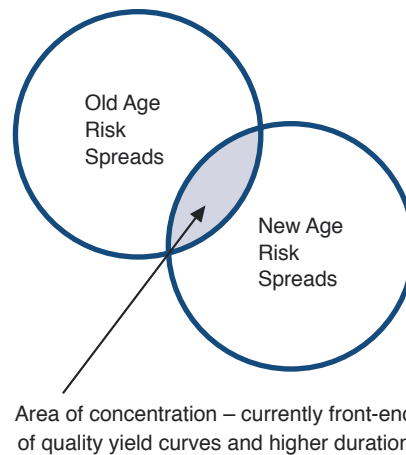


Chart 4

will benefit due to their relatively high structural risk premiums. If Old Age instability takes hold, these same positions benefit even more as the Fed lowers the overnight rate to much lower levels.

If the appreciation of stamps, diamond rings, stocks, bonds, and real estate is at risk of falling below expectations in an Alpha/Beta anemic world, then investors will seek ways to maximize returns in order to compensate. An intelligent investor, it seems to me, will recognize this reality while at the same time understanding the risk that accompanies such a transition. PIMCO hopes to intelligently navigate its way through these seemingly becalmed rapids in future months and years, and remain THE Authority on Bonds.

William H. Gross  
Managing Director

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*Each sector of the bond market entails risk. Alpha represents a fund's risk-adjusted performance (the difference between a portfolio's actual returns and the expected performance, given the portfolio's level of risk as measured by beta). It is possible that during any timeframe, the alpha of a portfolio can be positive while the actual total return performance of the portfolio is negative. Beta is a measure of price sensitivity to market movements. The beta of the market is 1.00 by definition.*

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840 Newport Center Drive  
Newport Beach, CA 92660  
949.720.6000