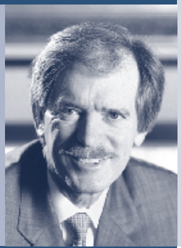

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Investment Outlook

PIMCO

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PHILOSOPHER'S STONE

Home runs, slam-dunks, and go-for-broke downfield passes are the highlight moments in professional sports, but every coach will tell you it's defense that wins championships. Similarly, the Peter Lynch "10-bagger" and PIMCO's recent $35 billion purchase of Treasuries are what gain the raves of journalists and the investment media. But it's a portfolio's structure—in addition to its strategic sizzle—that provides the foundation for consistent alpha generation and long-term performance. It's not that the decisive interest rate calls don't make money, or that the headlines and articles about them don't sell tickets—they do. But you can't count on strategy to add value every year, especially when markets don't move much, although approaching markets from a strategic <u>long-term</u> perspective is one tactic to try to put the odds in your favor. If your "macro" bets germinate from observations of somewhat consistent <u>secular</u> trends such as demographics, globalization, and voter attitudes towards the private or public sectors, then you have a leg up on your competition. That, at least, has been the PIMCO philosophy, and our performance numbers and information ratios for several decades now provide validation. Still, we recognize there is always more than a sporting chance that we can be wrong, that we might wind up in a locker room filled with tears instead of champagne.

When your offense goes flat, when the long bomb falls incomplete or the slam-dunk incredibly bounces off the rim, then a coach looks to his defense to hold the line. I use this metaphor not to report on, or even to anticipate, a secular forecasting "miss." PIMCO has had a high historical percentage rate of completions and I have no reason to anticipate otherwise in future years. It is just that—to restate the metaphor's premise—championships are won with a great defense and in investment terminology that speaks to a portfolio's structure, its fundamental character that incorporates longer than secular, near permanent principles that should be able to deliver alpha during years when the magic shooting touch seems to have disappeared, or there's simply a time-out on the court with secular investment opportunities few and far between.

I have written about investment structure in prior *Investment Outlooks* and, therefore, I will only briefly summarize here. Banks have a formidable investment structure and therefore, a great defense: borrow short near the risk free rate—lend longer and riskier. If a bank doesn't overdo it (and they can and have) profits are almost guaranteed on a long-term basis as long as capitalism as we know it survives. Insurance companies with their "free" reserves and predictable liabilities have another financial structure almost guaranteed to generate a positive return on capital. Closer to home, Warren Buffett's Berkshire Hathaway has a structure dependent on "float"—he writes and talks about it frequently—which when combined with his bottom-up secular stock picks have led to one of the world's great fortunes and investment success stories.

Each of these "structures" shares the common element of longevity and near permanence. They span time periods beyond even the secular segments of 3-5 years, which define our own PIMCO forecasts, or recent secular stretches of inflation/disinflation that have endured over several decades of time. In addition to their profit generating elements then, an investment's structural magic comes from its Methuselahian ability to persist. An investment coach, therefore, would label a structural player as "steady, reliable—a great defender."

PIMCO's defense has evolved through the years, adding a player here, a player there, all of whom exhibited alpha generating capabilities with the goal of year in, year out consistency. While not trying to reinvent the wheel, our ongoing structure acknowledged the formation of an increasing array of <u>new</u> wheels made of rubber and synthetics instead of stone. While some of these financial innovations were judged faulty by us and later disintegrated at high speeds, others promised to provide traction on rain slick highways—a better defense. These were the ones we added to the team, and they include futures, the moderate sale of options and volatility, as well as the use of increasingly liquid credit sectors such as emerging market bonds and swaps.

More recently, my PIMCO associates and I have become enamored with financial market history, deciphering what structural elements of the bond market have provided the best risk/return characteristics over a century of time and asking whether conditions still exist under which these same structures would continue to thrive. They include durational, curve, and real interest rate histories, which in certain combinations have produced consistent alpha relative to the "market" under most environments. Harry Markowitz, while speaking primarily to stocks in the late 1950s, might have labeled this structural quest as an attempt to extend the bond market's "efficient frontier" not via his diversification theories, but through a tilted or <u>less</u> diversified mix of securities that would maximize return relative to desired risk. I would agree with that conceptual framework. A bond portfolio almost certainly has a "structural" efficient frontier and the attempt to find it is allegorically akin to the quest for a financial philosopher's stone, where the money manager instead of turning lead into gold, attempts to turn index returns into "index + alpha" *without increased risk on an intermediate to long-term timeframe (important qualification).*

With the Lehman Brothers Aggregate as one of our clients' referenced bogeys, however, we start every January 1st "alphaless." And while alpha typically refers to pure "active" return which is the value added by the manager, I would argue that structural, semi-permanent alterations in portfolio composition relative to their index can qualify as alpha as well, even though "structural" changes may seem glacial as opposed to frequent. To add alpha via structure though, we must alter an already existing structure without increasing measurable risk in a significant way, or better yet, we must find those structural elements within the index itself that exhibit the best reward relative to risk over time and accentuate those while reducing and de-emphasizing the structures that do just the opposite. I did this in another form while playing a professionals' game of blackjack in Las Vegas during 1966. I made small bets when the odds favored the dealer and doubled, tripled and quintupled them when the remaining cards in the deck favored me. This is not Markowitz's efficient frontier based on diversification, but an attempt to maximize return relative to risk by concentrating "structural" positions. In structural bond market parlance, such a strategy would lead to accentuating longer-term profitable structures and de-emphasizing less profitable, "alpha lite" alternatives—assuming they even existed. While the short-term, day-to-day volatility of this new bulked-up structure would logically be greater than its index, it should be (and has proved to be) minimal relative to increased returns. In fact, PIMCO's historical tracking error for a representative number of our bond portfolios relative to their respective indices approaches 1.0 with resultant information ratios approaching 1.0 as well.*

Such a structural, alpha+ assumption might initially appear as futile as looking for that alchemist's stone that could turn lead into gold. But what if, unlike the physical world of atoms and relatively stable elements and compounds, longstanding human/investor preferences exerted a risk/reward bias on the bond market? What if accounting standards, mortgage structures, regulatory biases, or simply individual risk/liquidity preferences moved an index or the market itself away from the efficient frontier, sacrificing too much return for too little reduction in risk? Then you would have a crack in the door and a chance to open it and find the bond market's structural philosopher's stone—a near enduring structure that added alpha even <u>without</u> active management. In fact, a goodly portion of the advertised "active" management would consist of research and ongoing thinking to not only find new high reward/low risk structures, but to ensure that those in place remained profitable and consistently alpha generating.

This, ladies and gents, is my Merlin's eye vision of the modern day and future PIMCO. As coach for nearly three decades and, hopefully, a few more (years), I have come to appreciate the importance of providing consistent alpha. In addition, whereas in the early years, that alpha was generated almost exclusively by offensive thrusts, utilizing secular strategies oriented around interest rate and sector spread forecasting, today we have used our draft choices and free agency to build a solid structural defense as well that comes in especially handy when secular investment strategies are limited by reduced volatility. When you visit today's avant-garde PIMCO, it is hopefully very obvious that there are lots of Barry Bonds, Peyton Manning, and Shaquille O'Neal look-alikes on our various floors, although none with size 24 shoes! But it should also become increasingly apparent that we have bulked up our linebackers and developed a host of Gold Glove defenders.

"Not so obvious to me," you say. "You've written here about philosopher's stones and defensive structural strategies without ever really telling me much about what they are so that I could judge for myself whether you're making sense or merely dressing up in a sorcerer's costume with a pointed hat shouting 'Abracadabra'." Well, not so. In the last few years of *Investment Outlooks*, I have written about nearly all of them in some detail. In addition, during your individual and joint PIMCO seminar visits, I have elaborated as well. To reiterate the general philosophy: *bond market structural alpha exists because of segmentation, regulatory, and risk biases that almost invariably lead to higher returns relative to inherent risks for some investments. By identifying those structures (curve, the mild sale of volatility, and utilization of futures instead of cash Treasuries*—to name the primary ones) and emphasizing the alpha generating ones relative to sub-par index holdings, a portfolio manager can generate structural alpha that is independent of day-to-day or year-to-year investment strategies with hopefully (and historically) similar volatility.

Can't I still be more specific? Well, I'm running out of space and like I said, all you have to do is read the old *Outlooks* and ask about what might be new when you visit. Besides, you wouldn't expect a so-called magician to be telling you all his tricks would you? That would take all the mystery and maybe even some of the alpha out of it.

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Past performance is no guarantee of future results.

**This information is based on a representative total return account that makes up the majority of the total return strategy portfolios with at least 10 years of performance data.*

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