



Tom Hanks – Portfolio Manager

“History doesn’t repeat, but it rhymes.”

Mark Twain

There are a number of ways to skin a cat or analyze the fortunes of the bond market. Fed watching, economy and inflation forecasting, supply and demand analyzing – take your pick, mix and match ‘em, above all be prepared to be humbled. If it were easy, I might not be writing *Investment Outlooks* for a living. (Surely a joke.) The older I get however, the more dependent I become on history. “Older, but wiser” goes the conciliatory saying with its presumption that age can lead to an understanding of sorts unavailable to the more youthful and less experienced. Those of us pressing 60 and beyond certainly hope so – it’s one of the few pegs we have left to hang our hats on. “I was here first” doesn’t cut it when you’re trying to outperform the bond market with a \$350 billion portfolio. Perhaps age with its inherent appreciation for

history does, however. If you can’t out analyze ‘em or out Fed watch ‘em then throw the history book at ‘em. Hopefully, as Mark Twain suggested, there will be a rhyme or two that leads to something that the rest of the pack has failed to pick up on.

This nouveau fascination with history actually began way back in my youth. Thomas Bailey’s The American Pageant was sort of my high school Bible – it still sits prominently on my library bookshelf. Later, Paul Johnson’s Modern Times and A History of the American People consumed hours and hours of personal reading and reflection. “They were us – we are them...we leave almost identical footprints in the sand,” was the rhyme I heard more than anything else when reading them. And so it was only natural, I suppose, with such a heritage and

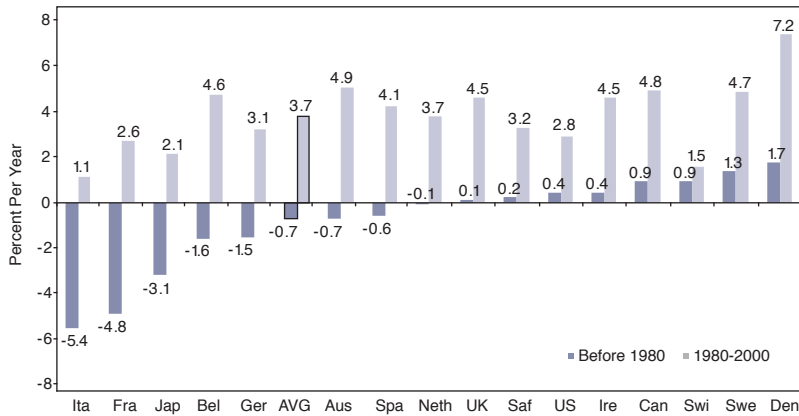
completing my sixth decade and all, that I should turn to financial history in an attempt to outskin my feline bond market competitors. Now, there are two coffee-table sized books that sit prominently on the right side of my library desk – Triumph of the Optimists and the 2003 Yearbook of Ibbotson Associates' Stocks, Bonds, Bills, and Inflation – where before there were none. Now, I turn to their historical statistics for bond market wisdom where before I would consume a myriad of Wall Street talking pieces. I'm placing more of my bets these days on the rhyme instead of the cacophonous noise. Let's hope it works.

These two books are voluminous. I tell clients that one could be stranded on a desert island like Tom Hanks in "Castaway" and never finish appreciating all the information that lies inside. You want to know the long-term winner of the growth stock versus value horse race? Page 157 of the Ibbotson Yearbook will tell you. Do you want to know returns on South African bonds for the 20th century,

decade by decade? Turn to page 281 of Triumph of the Optimists. Still, most of you wouldn't go that far, even if you were stranded on a desert island. You'd start up a conversation with a volleyball named Wilson instead. So let me summarize a few of the highlights, a selective history of bonds that might make the most difference as we wind our way through the next 12 months or even the next 12 years.

First of all, as readers of my *Outlooks* discussing TIPS and real interest rates will remember, I find it fascinating that investors and economists believe that the real interest rate experience of the last two decades of the 20th century should be the norm for the first twenty years of the 21st. The "Outlook 2004" edition of the highly respected *Bank Credit Analyst*, for instance, states that the "equilibrium level for the fed funds rate is between 4 and 5%, so there is a long way to go before policy becomes restrictive." Not so, I would claim, especially given the history of real rates from Triumph of the Optimists shown on the following page.

Real Interest Rates Internationally Pre- and Post-1980

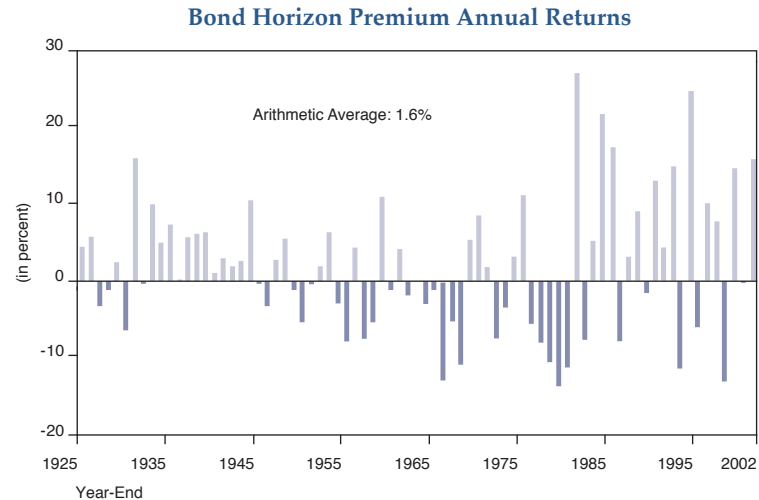


Source: Triumph of the Optimists: 101 Years of Global Investment Returns, Princeton University Press

The fact is that 4-5% equilibrium short rates which in today's inflationary environment equate to 2-3% real rates shown in the chart, were a product of disinflationary policies begun in 1979 and were meant by and large to be restrictive, to bring inflation down presumably at the expense of growth. But the first 80 years of the century experienced average real short rates of .4% in the U.S., .1% in the U.K., and negative in many Euroland countries. This history tells me to expect a long stretch of close to 0% real interest rates in the U.S. and most G-10 countries, especially since reflation is now the stated goal of two of three of the world's most important central banks – the U.S. and Japan. One of the most

important conclusions to be drawn from this history lesson, as outlined in last month's Outlook, is that bonds (and stocks too) will be low return asset classes for the foreseeable future. That is so because the market's interest rate North Star, the short-term yield which guides and steers buyers and sellers through carry and arbitrage activities, will be close to 0% real – if history rhymes.

Investors desiring something more than 0% after inflation from their bond investments will be comforted by what Ibbotson labels the "horizon premium" and what others might call the "yield curve risk premium." The chart on the following page displays a



Source: Stocks, Bonds, Bills, and Inflation 2003 Yearbook. Ibbotson Associates

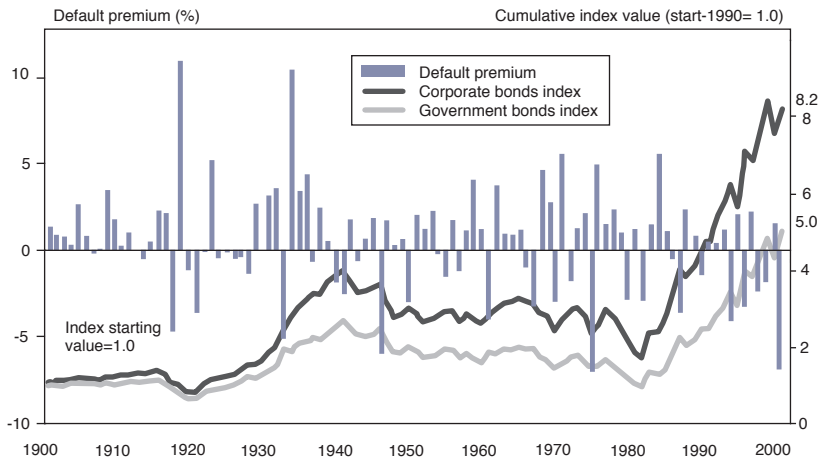
77-year history of the annual returns of long-term Treasury bonds versus 30-day Treasury Bills.

Although the yearly numbers are obviously volatile due to the direction and price change of the long bond, the historical annual outperformance of 1.6% for the long bond has to be instructive. First of all it alerts a bond investor to the risks and rewards of “horizon” or maturity extension. It says in any given year you should expect 1.6% more from owning 30-year bonds than 30-day bills, but to expect a Wild Toad’s ride for the advantage. Secondly, it almost screams that today’s 30-year TIPS, which provides

a real yield of 2.4%, is still a bargain by historical standards. Since 30-day bills have averaged approximately .5% real and long Treasuries carry a premium of 1.6% to that, then a long maturity TIPS should yield 2.1%, all else equal. Since it still yields more, and because today’s reflationary environment should afford an insurance yield discount to the TIPS as opposed to the nominal 30-year bond, history says tilt your Treasury duration in the direction of inflation protected securities. We have been.

Financial history’s next lesson concerns corporate bonds and the risk versus return of owning them over

Cumulative Real Returns and Default Premia From U.S. Corporate Bonds, 1900-2000



Source: *Triumph of the Optimists: 101 Years of Global Investment Returns*, Princeton University Press

time. Triumph of the Optimists offers a chart displayed above that details the “default premium” and the cumulative total return of U.S. Aaa/Aa corporate versus Treasury bonds. The annual default premium includes not only losses from defaults, downgrades, and early calls, but spread widening and spread narrowing.

This is history’s total package of risk versus reward when it comes to corporate bonds, with a standard deviation by the way of 3.0% over the past 100 years. The message it sends is that yes, Aaa/Aa corporates do outperform Treasuries over time – by an average

of 53 basis points a year. Since the annual default premium is 48 basis a year however, it says that in order to get that 53 you need to start off with a spread of (53+48) or 101 basis points. Today’s spreads of 30-35 are far shy of that and indicate that the odds of successfully outperforming Treasuries are substantially reduced. Holders of lower investment grade and junk bonds should heed this warning light as well.

Finally, if only to keep this *Outlook* reasonably brief, let me acquaint you with two charts from Ibbotson that absolutely fascinate me – and

hopefully will do the same for you. The first is a table of long-term versus intermediate-term U.S. government bond returns over the past 75 years. Based on the horizon premium example mentioned on previous pages, an investor might reasonably expect to earn a total return advantage from long bonds, especially during a 75-year environment which offered a mild bull market as the table below indicates via the “capital appreciation” row. The returns however are almost identical (a 100-year “Optimists” study of the U.K. shows 5-year intermediate Gilts outperforming long Gilts by .2% annually). The secret to this conundrum comes from the simplistic phenomena of yield curve roll down, which allows for a 5-year Treas-

ury to morph into a 4-year Treasury at a lower yield and a higher price over a 12-month period of time.

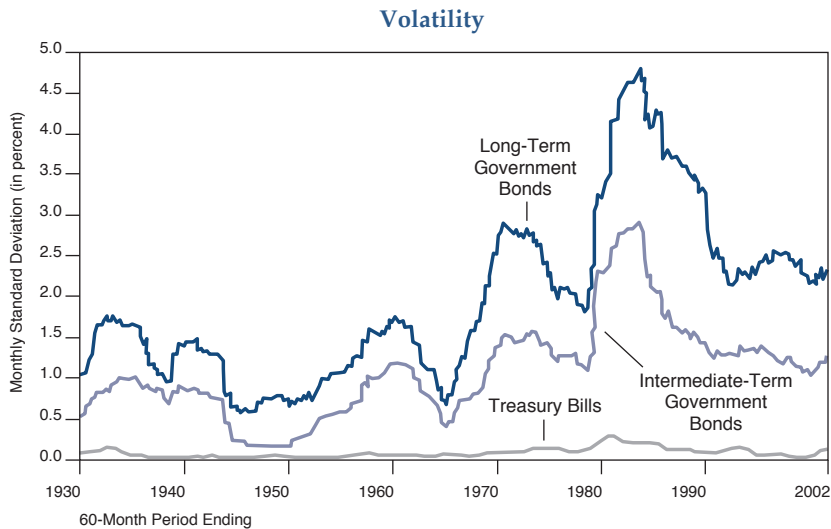
The 5-year Treasury’s nearly identical performance, however, comes with the benefit of sharply reduced volatility as seen in the chart on the next page.

Such combinations are a bond investor’s dream. Identical returns – half the volatility. This history leads to a myriad of possible portfolio structures, all emphasizing the short to intermediate portion of the curve. Last month’s *Outlook* detailed some of them. For those investors who value higher returns as opposed to volatility but want to match liability durations of 10+ years, a double or triple barreled

Long Bond vs. 5-Year Treasury Returns

Series	Geometric Mean	Arithmetic Mean	Standard Deviation	Serial Correlation
Long-Term Government Bonds				
Total Returns	5.5	5.8	9.4	-0.07
Income	5.2	5.2	2.8	0.96
Capital Appreciation	0.1	0.4	8.2	-0.22
Intermediate-Term Government Bonds				
Total Returns	5.4	5.6	5.8	0.15
Income	4.8	4.8	3.0	0.96
Capital Appreciation	0.5	0.6	4.5	-0.20

Source: Stocks, Bonds, Bills, and Inflation 2003 Yearbook. Ibbotson Associates



Source: Stocks, Bonds, Bills, and Inflation 2003 Yearbook. Ibbotson Associates

portfolio of intermediate bonds should be a viable solution. For those investors who treasure a stable net asset value and a good night's sleep, yet want returns close to the yields offered by long-term bonds, a simple intermediate-term portfolio might be the answer. Long bonds are the loser in this historical and presumed future bond market environment.

And for those of you already conversing with Wilson the volleyball, I offer my humble apologies. Desert islands inhabited au solitaire can lead to strange behavior from even seemingly normal types. What I experi-

enced on my "island" was a lesson in financial history that could pay huge "dividends" in future years. That history points towards an environment of lower than expected real rates of interest, low total returns for bonds (a 4% total return future world), an apparently overvalued corporate sector, and intermediate maturity bonds that should perform equally with long bonds at half the volatility. The one bond investment that fits into each of these boxes? Intermediate maturity TIPS. You'll likely only earn 2-3% annually after adjusting for inflation, but hey – 25 years on that island, you get rescued, come back, cash in that 401k

and you've got twice as much as you had before in inflation-adjusted terms. For those of you who prefer to avoid islands altogether while managing a bond portfolio of countless millions or billions of dollars, I suggest you bone up on your financial history anyway. It may not repeat, but it surely rhymes and what a sweet sound that out-performance can make. Mark Twain, Wilson – and Tom Hanks – would be envious.

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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 fund that invests in inflation-indexed bonds is guaranteed, and either or both may fluctuate. Duration is a measure of price sensitivity expressed in years.

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