

Q&A

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Paul Reisz Discusses Cash Investing and the Impact of Recent Market Events

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Investors in cash strategies, including both money market and enhanced cash strategies, have faced unexpected volatility since the credit crisis began a year ago. Liquidity issues associated with the asset-backed commercial paper market initially led to the crisis, and other market dislocations this year exacerbated the problem for enhanced cash strategies. In the following Q&A, PIMCO discusses these events, their impact on cash investing and PIMCO's investment strategies in the current market.

Q: Starting at the beginning, what exactly has happened in the money market and enhanced cash arena?

A: Over the past year, there have been ongoing issues for many money market and enhanced cash strategies, stemming from significant volatility in short-term securities.

Prior to the summer of 2007, investors paid little attention to the holdings of their money market and cash strategies; they were confident that high ratings on the securities held by their portfolios and their recent track records meant that their strategies were sound. Money markets were providing the liquidity and safety needed by investors and yields were reasonably attractive. Enhanced cash strategies had moderate price volatility but were still considered to be relatively stable.

But the credit crisis of the past year has had painful results for many investors. Many funds experienced significant volatility and some of their investments, which were believed to be safe, actually declined in value. As the credit crisis progressed, many investors in enhanced cash strategies experienced capital losses, and several managers and sponsors had to provide capital infusions or purchase illiquid assets from their portfolios because there was potential for the net asset values of their money market portfolios to fall below \$1.

It's important to note here that enhanced cash, or short-term strategies, are not the same as money market strategies. Because enhanced cash strategies may hold slightly longer-term and modestly higher risk securities, investors should generally expect a degree of volatility in net asset value (NAV) over time. Money market strategies, meanwhile, are expected to hold only the safest and shortest-term investments, and investors generally expect that the NAV will not fall below \$1.

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Q: Haven't cash strategies traditionally been known to hold relatively low risk investments?

A: Yes, these strategies generally hold highly rated short duration securities. But for several years prior to last summer, spreads on securities that money market and enhanced cash strategies traditionally invest in had become very tight, and in general, risk premiums in the bond markets were at historical lows. This led many cash portfolio managers to search for alternative sources of yield from highly rated short-term instruments. Asset-backed commercial paper (CP) offered just that: higher yields with the highest credit ratings. Because investors were comfortable with the ratings on asset-backed commercial paper, they didn't scrutinize the collateral, or assets, that backed the paper.

When the credit crunch began, the demand for asset-backed commercial paper declined precipitously as investors began to question the value of the collateral. In particular, investors feared that the CP was backed by subprime mortgages. Due to a lack of liquidity, many money market and enhanced cash strategies were forced to hold on to assets that they could not dispose of and to write down their value. Today, most of the problematic asset-backed CP has already matured, rolled off or been refinanced, but the losses that many money managers incurred are still fresh in the minds of investors.

In the current market, basically the larger asset-backed CP programs with the liquidity support of large bank sponsors are the only programs to have retained their access to the markets and continue to have investor support. Many other programs that issued asset-backed CP were basically mortgage finance vehicles and ran into liquidity issues due to a lack of investor support.

Q: Has PIMCO been affected by these problems?

A: Although PIMCO's guidelines do not prohibit purchases of asset-backed CP, we avoided exposure because of the uncertainty over the underlying collateral. After the credit crisis sharply increased risk premiums, or yields, we saw an opportunity last December and decided to purchase some asset-backed CP that met certain criteria and our high investment standards. Other than that however, our money market and short-term strategies have not owned asset-backed CP associated with collateralized debt obligations (CDOs), because the conduits, or vehicles, that they are issued through are not completely transparent. PIMCO was able to weather the storm. Our focus on rigorous risk management helped us avoid many of the sectors and securities that were negatively impacted by the liquidity crunch.

Q: Are we seeing changes across the industry aimed at assuring investors about money market and enhanced cash strategies?

A: The events of the past year have reminded investors and managers that the focus in money market and short-term strategies should be on liquidity and capital preservation. Of course, everybody wants to outperform the benchmark, but not at the expense of incurring downside risk. Many investors have realized that managing cash is not as easy as they thought, and they are spending significantly more time evaluating managers.

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There have also been changes with respect to the way managers report to shareholders. We have seen a trend toward more detailed disclosures of portfolio risk characteristics and believe this will benefit investors as they perform due diligence on their cash managers.

Finally, cash investors are doing much more detailed analysis of securities, and they are monitoring these investments much more closely. Investors learned that not all triple-A securities are created equal, so they are checking under the hood to make sure that they have a full understanding of their investments.

Q: Has PIMCO made any changes in response to events in the cash market over the past year?

A: We believe that we have been very transparent in communicating our outlook and portfolio strategies, so we have not made dramatic changes in our client communication and reporting. Our philosophy has always been that money market and short duration strategies are the equivalent of cash, which means that preservation of principal is paramount. So, we have always communicated that we do not think it makes sense to take on significant risks in cash portfolios.

We will also continue to emphasize risk management in our portfolios. We have experienced many market cycles and understand the risks associated with cash equivalent instruments. We believe that investors should be compensated fairly for risk embedded in securities, and as many investors have learned, securities that pay a higher yield of one or two basis points may not be worth buying when the downside risk is a price markdown of 20% – or even potentially more. We focus on helping our investors understand and trust our risk management practices, our secular investment process, and our ability to communicate our strategies.

Q: Finally, what strategies are being implemented by PIMCO in this market?

A: We continue to manage money market and enhanced cash portfolios conservatively. We are focusing on providing capital preservation and liquidity for investors in these portfolios and we are doing that by diversifying our exposure into securities such as high quality traditional commercial paper, Treasuries, agencies, and floaters where appropriate, in an effort to provide a competitive return for our clients. These are cash portfolios, and investors are not expecting surprises.

There are a number of interesting investment opportunities that can be utilized in our short-term strategy despite the higher level of market volatility lately. As I mentioned earlier, we view the short-term strategy as a cash strategy where we do not want to take on excess risk. Nevertheless, market volatility has led to some interesting opportunities that may deliver attractive returns to investors. In addition, debt reduction and balance sheet realignment, and the resulting dearth of liquidity, have contributed to a dramatic increase in risk premiums across a variety of fixed income assets. We do not often see favorable environments like this with historically wide spreads, competitive yields, and a steep yield curve that may offer the potential for gains as bonds “roll down,” or mature, along the steep yield curve over time.

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PIMCO will be discriminating as it pursues these opportunities. We believe that the best risk-adjusted returns will be found in the senior part of the economy's capital structure. These securities include top quality corporates, municipals, mortgages and other asset-backed bonds where valuations have cheapened less because of credit weakness than because of system-wide liquidity constraints.

We were able to weather the storm over the past year through our risk-focused process and philosophy. Now, we see an exciting environment with many great opportunities, and we hope to capitalize on them for our clients.

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. Money Market portfolios are not insured or guaranteed by FDIC or any other government agency and although the portfolios seek to preserve the value of an investment at \$1.00 per share, it is possible to lose money by investing in money markets strategies. Government securities are backed by the full faith of the issuing government; portfolios that invest in them are not guaranteed and will fluctuate in value. Asset-Backed Commercial Paper (ABCP) is a securitized product used to fund purchases of receivables, loans, leases, and other assets by special purpose finance companies, also called conduits. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and while generally supported by a government, government-agency or private guarantor there is no assurance that the guarantor will meet its obligations. Income from municipal bonds may be subject to state and local taxes and at times the alternative minimum tax. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

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