

## Bond Basics

March 2007

### Municipal Bonds: A Unique Fixed-Income Asset Class

Municipal bonds (munis), which are issued by U.S. state and local governments, are unique among fixed-income asset classes. First, most muni bonds offer Federal tax-exempt income, and second, individuals, rather than institutions, make up the largest investor base. In part because of these characteristics, munis also tend to have certain performance attributes, including credit quality and low volatility relative to other fixed-income sectors and higher after-tax returns than other fixed income securities of comparable maturity.

### Muni Bonds Offer Tax Advantages

Municipal bonds are debt securities issued by or on behalf of U.S. state and local governments, their agencies or authorities. These issuers sell bonds to fund either their general operations or specific projects, such as the construction of bridges or highways. For instance, a local water authority or school district might issue municipal bonds to help fund an expansion.

Aside from the specific set of issuers—state and local governments—the defining characteristic of municipal bonds is their tax status. The interest income earned on most municipal bonds is exempt from federal income taxes. Interest payments are also generally exempt from state taxes if the owner of the bond resides within the state that issued the security, and the same rule applies to local taxes.

The two main types of municipal bonds are *general obligation bonds (G.O.s)* and *revenue bonds*. G.O.s are municipal bonds secured by the full faith and credit of the issuer and usually supported by the issuer's taxing power. Revenue bonds are secured by the charges tied to the use of the facilities financed by the bonds. For example, revenue bonds are issued to fund toll roads, bridges and water treatment facilities, among other projects, and are secured by the tolls or fees collected by these facilities.

About \$2.3 trillion in municipal bonds are outstanding, sold by more than 60,000 issuers, according to the Federal Reserve.

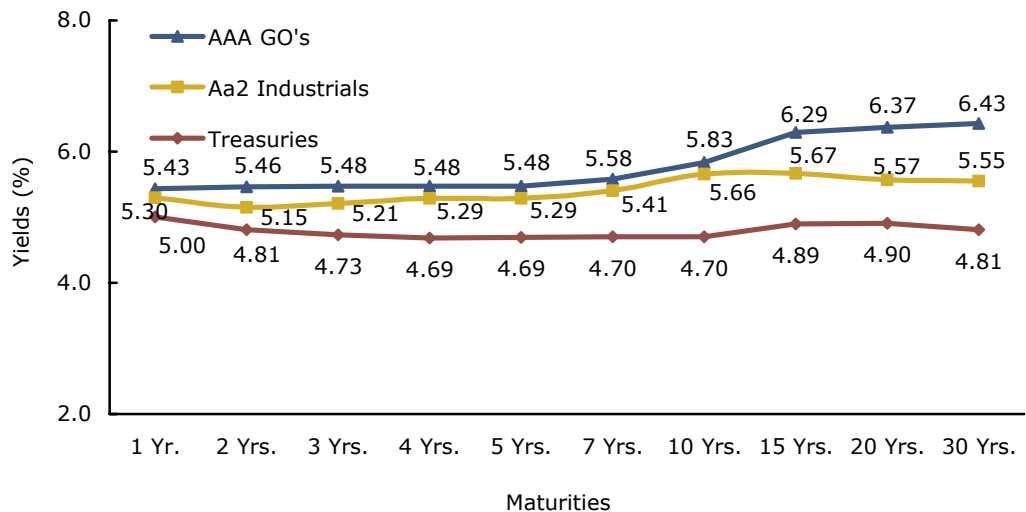
### Munis May Offer Attractive After-Tax Returns, High Credit Quality

In part because of their unique tax status, municipals may generally provide investors with greater after-tax returns than many taxable bonds, including some Treasuries and corporate bonds with similar credit quality and maturities. The following chart compares yields for triple-A rated muni, triple-A rated industrial bonds and U.S. Treasury bonds of similar maturity as of December 31, 2006.

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**Taxable Equivalent Yields: General Obligation Munis, Industrials and Treasuries as of Dec. 31, 2006**



**Sources:** Bloomberg, Municipal Market Data, PIMCO

Note: Fully tax-equivalent yields are derived from the following: 35% federal rate applied to Treasury and corporate bond income; 5% state tax rate applied to muni, Treasury and corporate income; federal benefit given for state taxes paid; and no state taxes paid on Treasury interest.

Municipal debt is also typically of high credit quality. More than 99% of rated municipal bonds carry investment-grade ratings from Moody's Investors Service. Well over half of rated munis are single-A and above. In addition, the 10-year cumulative default rate on municipal bonds was only 0.04% between 1970 and 2000, according to a November 2002 report from Moody's. By comparison, the 10-year default rate for corporate bonds over the same time period was 9.83%, Moody's reported.

Many municipal bonds are backed by insurance, in addition to the credit of the municipality or the revenues from the project being funded. If an insured municipal bond defaults, an insurance company should step in and make all principal and interest payments on the bond.

**Volatility Tends to be Lower on Munis**

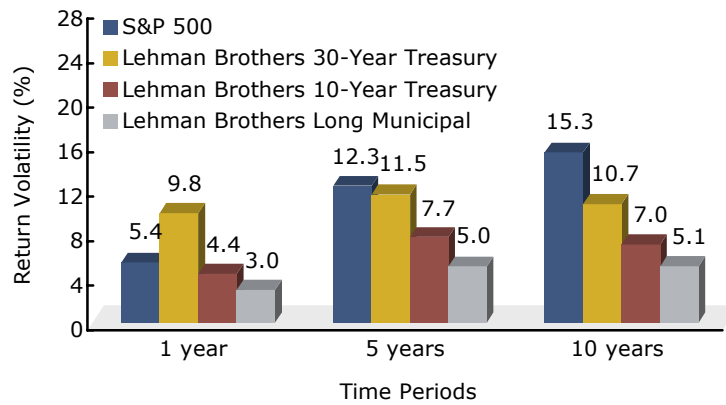
Historically, returns on municipal bonds tend to be less volatile than those on other asset classes, from equities to long-term Treasuries, as shown in the chart below.

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### Annualized Return Volatility

Periods Ending Dec. 31, 2006



**Sources:** PIMCO, Lehman Brothers, Standard and Poor's

Note: 30-year Treasury bonds are represented by the Lehman Brothers 30-year Treasury Index, 10-year Treasury bonds are represented by the Lehman Brothers Long Term Treasury Index (10+ years), and the Long Muni is represented by the Lehman Brothers General Municipal Bond Index.

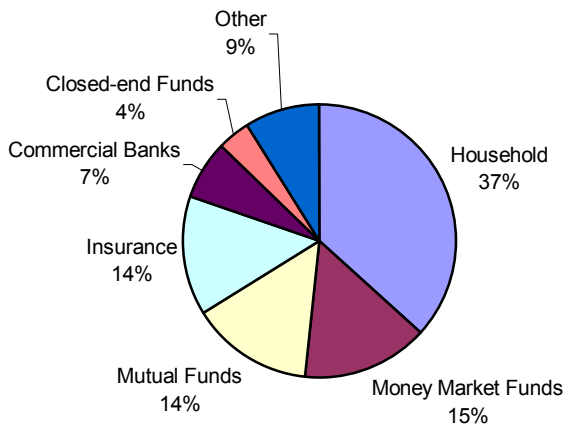
One reason for the lower volatility: individuals are the main investors in the municipal bond market and in general do not actively trade the bonds. Retail investors tend to buy and hold muni bonds to maturity. This contrasts with many other fixed-income sectors where institutional investors dominate.

Individuals comprise more than 70% of the municipal bond investor base. In the chart below, individuals account for households, mutual funds, bank trust departments, closed end funds, and money market funds. Property and casualty insurance companies are the next largest set of investors at around 14%. The remaining investors are banks and corporations. Some institutions are crossover, or arbitrage, investors who buy munis when they are particularly attractive versus other fixed-income asset classes.

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### Municipal Bond Investor Base As of Sept. 30, 2006



Source: Federal Reserve

### Conclusion

Municipal bonds are issued by or on behalf of state and local governments to finance general operations or specific projects. Interest payments on most muni bonds are exempt from federal taxes, and when the investor resides in the issuer's state and locality, interest payments may also be exempt from state and local taxes.

In addition to their tax-exempt status, muni bonds may offer several advantages, including: higher after-tax returns than many other taxable bonds, high credit quality, and relatively low volatility. While institutional investors dominate the investor base in most fixed income sectors, retail investors form the biggest investor base in the municipal bond market.

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**Past performance is no guarantee of future results.**

Each sector of the bond market entails risk. The guarantee on Treasuries, TIPS and Government Bonds is to the timely repayment of principal and interest, shares of a portfolio that invest in them are not guaranteed. With corporate bonds there is no assurance that issuers will meet their obligations.

Municipals may realize gains and shareholders will incur a tax liability from time to time. Income from the portfolios that invest in them are subject to state and local taxes & may at times be subject to the alternative minimum tax. It is important to note that portfolios concentrating in a single state are subject to greater risk of adverse economic conditions and regulatory changes than portfolios with broader geographical diversification. The views and strategies described may not be suitable for all investors. This material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for, accounting, legal or tax advice. You should consult your tax or legal advisor regarding such matters. Please contact your account manager for further information.

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