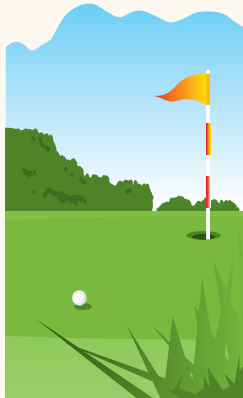


Eagle Putt

August 2007

Mark
Kiesel



In golf, few experiences are more satisfying than making an eagle, or a score of three, on a par five. To make an eagle, a golfer typically must hit a long drive in the middle of the fairway, a solid 3-wood second shot onto the green, and then take one putt to get the ball into the hole. An eagle is very rare. The world's top golfer, Tiger Woods, has made only nine eagles so far this year, having played 720 holes of golf.¹ Assuming the odds for the world's best golfers are roughly one in 100 of making eagle on any one golf hole, the odds for the average golfer of making eagle are extremely low indeed. In the rare case a player hits a second shot on the green on a par five, one or more of the other golfers in the group typically shout: "Eagle putt!" Two words every golfer wants to hear.

In the credit markets, "eagle putt" equivalents are similarly rare, and something to be cherished and carefully navigated. Typically, an investor in this position has made an accurate top-down decision to be over-weight or under-weight credit in comparison to the benchmark, and has made solid bottom-up decisions about which specific credits to hold. Should an investor get both calls accurate – top-down and bottom-up – they will then have the opportunity to putt for an eagle.

It turns out that in combination with the sub-prime meltdown and subsequent credit market contagion, PIMCO's top-down and bottom-up credit investment process has recently produced an eagle putt. We hit a long drive in the fairway, having made an accurate top-down investment decision to under-weight credit risk versus our benchmarks. We also hit an accurate second shot onto the green by making active bottom-up decisions to favor selected emerging market bonds and corporate bonds in the energy sector, and to avoid or under-weight specific credits exposed to housing and sub-prime mortgage risk.

These investment calls, combined with our firm's recent emphasis on high-quality investments in our portfolios, have now given us the

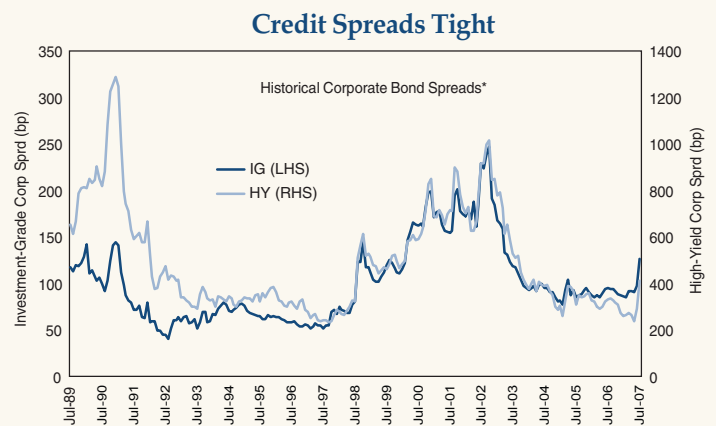
opportunity to line up our eagle putt. How accurately we assess the risks and rewards of today's increasing opportunities in the credit markets will determine whether or not we make our putt. Our initial reading of the putting green suggests that there are selective opportunities in bank loans, financials and credit derivatives that offer increasing value for long-term investors.

The Long Drive in the Fairway

PIMCO's top-down investment process incorporates both secular and cyclical themes with input from portfolio managers, credit and mortgage analysts, and account managers from around the globe. Our near-term cyclical outlook is for below-trend growth in the U.S. due to a significant drag from housing. Our longer-term secular outlook calls for strong global growth, led by continued strength in the emerging markets. Given this framework, our portfolio positioning within the credit markets has aimed to take advantage of healthy overseas growth as well as downside surprise in U.S. housing. Please see our May 2007 U.S. Credit Perspectives piece, *Still Renting*, for more details on our outlook for housing. Our firm's assessment of relative value across the various credit markets, combined with our top-down views, determines where we should take and avoid risk in the credit markets. Do we play it safe or go for the pin?

In corporate bonds, PIMCO has played it safe. We have been under-weight investment-grade corporate bonds and increasingly selective in high yield over the past few years. Our top-down investment process identified several risks which we wrote about in great detail in our March 2007 U.S. Credit Perspectives piece, *A New Era*, our December 2006 U.S. Credit Perspectives piece, *Credit Innovation and Opportunities*, and our September 2006 U.S. Credit Perspectives piece, *Going for the Long Ball*. To summarize, our

firm's view was that rising global liquidity was stimulating an aggressive search for yield which, when combined with rapid innovation in the structured credit markets, was leading to excesses that dislodged the fundamental link between the prices of assets and their underlying values in the corporate bond market. We noticed another discouraging trend as a growing number of private equity deals and aggressive corporate managers were piling more debt on balance sheets through leveraged buyouts (LBOs) and increasing shareholder-friendly initiatives such as share buybacks. Finally, the lack of covenant protection and the tight level of credit spreads (Chart 1) relative to history led us to under-weight investment-grade credit risk, and favor other asset classes where we felt returns would be higher and risks lower.



Source: Lehman Brothers

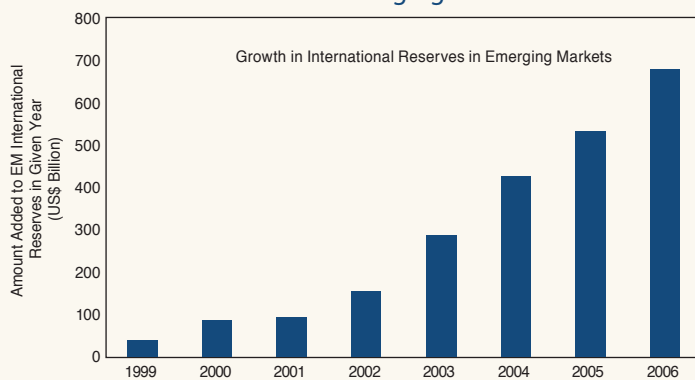
* Before Jan 1994, the spread shown is a simple spread to the 10-yr (not OAS). From Jan 94 to Jul 07 the spread shown is an Option-Adjusted Spread. The pre-1994 period is displayed more as a reference than for a precise comparison.

Chart 1

In emerging markets, several top-down factors over the past few years have caused us to go for the pin. First, more disciplined fiscal policies and stronger economic growth have lowered debt burdens in emerging economies over the past several years. Second, sharp improvements in current account balances have reduced external borrowing requirements and facilitated significant international reserve accumulation, dramatically

boosting liquidity available to service debt (Chart 2). Finally, aggressive liability management through debt buybacks, maturity extension, and local market development has reduced these countries' vulnerability to financial turbulence in developed financial markets. Our emerging markets team has analyzed these topics in great depth.²

Significant Credit Improvement in Emerging Markets

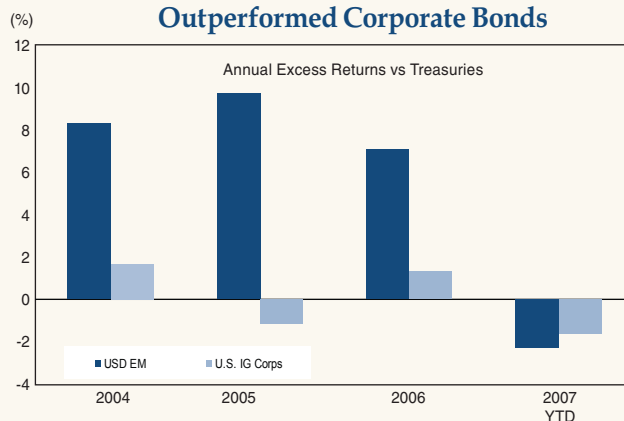


Source: IMF World Economic Outlook April 2007.

Chart 2

PIMCO's over-weight in emerging markets and under-weight in investment-grade corporate credit has enhanced performance for many of our clients (Chart 3).³ Nice drive! 300 yards and in the middle of the fairway.

Emerging Markets Have Outperformed Corporate Bonds



Source: Lehman Brothers; YTD returns through 7/31/2007.

Chart 3

The 3-wood Second Shot on the Green

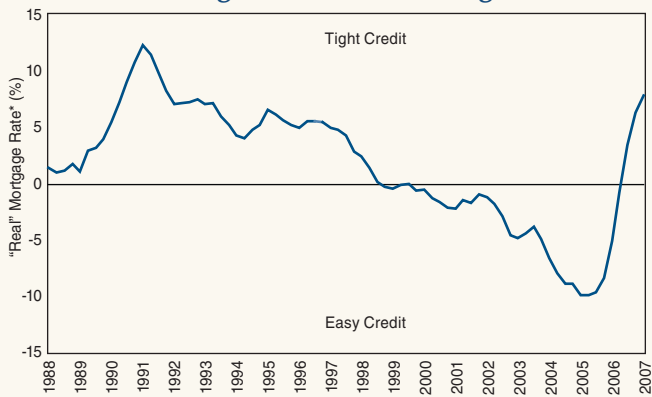
PIMCO's team of 28 credit analysts around the globe helps drive our bottom-up credit selection process. Our top-down macro themes influence our sector decisions while our bottom-up micro credit work determines which specific companies and countries we should or shouldn't invest in. The process involves significant teamwork, sharing of ideas, collaboration, coordination and execution skills.

Over the past two years, PIMCO has maintained an especially strong conviction with two bottom-up investment themes and we have made pro-active investment decisions to over-weight and under-weight specific risks in our portfolios. First, through our bottom-up analysis of the energy sector, PIMCO identified opportunities in selective emerging market and energy credits and over-weighted investments in those areas favored by our credit team. Our view was that rising global demand, changing consumer and investor preferences, growing oil dependency, under-investment and shrinking share capacity would lead to rising energy prices and outperformance for both companies and countries heavily exposed to energy. Please see our October 2005 U.S. Credit Perspectives piece, *Got Energy?*, for more details on our long-term outlook for energy. PIMCO over-weight holdings in emerging market countries such as Brazil, Russia and Mexico, and several independent energy exploration and production companies and refiners, have proven to be a solid bottom-up investment call.

The second bottom-up opportunity where PIMCO has benefited thanks to significant credit analysis from both our corporate and mortgage team has been our belief that the U.S. housing market would surprise on the downside. We have written extensively on our housing views and our positioning across PIMCO portfolios remains

under-weight housing, sub-prime and cyclical credit risks. Rising inventories, tightening lending standards, and significant sub-prime and prime adjustable-rate mortgage (ARM) resets were an early warning sign that prompted us to reduce housing and sub-prime mortgage exposure. Not surprisingly, the relationship between home prices and mortgage rates has changed amid falling prices and tightening credit conditions. The real mortgage rate (Chart 4), or the difference between the current 30-year mortgage rate and the year-over-year change in housing prices, has been rising sharply. Investors who moved into these asset classes without thoroughly analyzing risks are now clearly wishing they had done more bottom-up credit work. Fortunately, PIMCO's bottom-up investment process prompted us to pro-actively steer our clients away from these risks.

Credit Conditions Have Changed as Credit Tightens While Housing Prices Fall



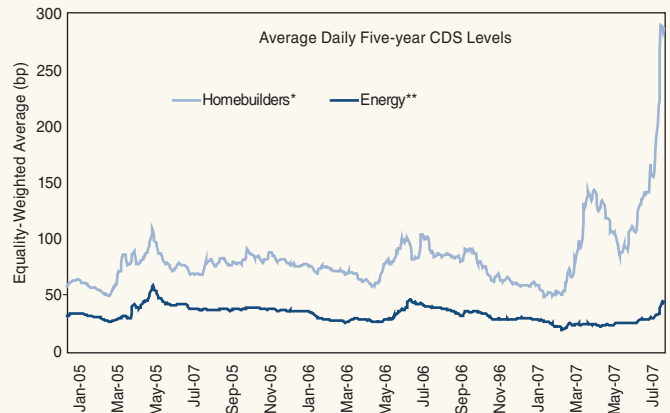
Source: National Association of Realtors and Federal Housing Finance Board.
*Average 30-year mortgage contract rate minus year-over-year change in median sales price.

Chart 4

Knowing when to avoid risk and play it conservatively, as in golf, is just as important as knowing when to take risk. At PIMCO, we saw opportunity in the energy sector and risk in the housing and homebuilder sector that markets were not priced to reflect. Fortunately for our clients

with credit exposure, these bottom-up decisions have paid off as energy sharply outperformed homebuilders (Chart 5). In golf terms, our corporate bond, mortgage and credit teams have just hit a 3-wood 250 yards right on the green.

Homebuilders vs. Energy



* Avg of 5-yr CDS levels for the senior unsecured debt of Centex, Lennar, Toll Brothers, Pulte, and D. R. Horton.

** Avg of 5-yr CDS levels for the senior unsecured debt of Anadarko, Apache, Devon, XTO Energy, and Canadian Nat Res

Source: Markit Partners Data

Chart 5

Reading the Green

At PIMCO, we realize putting for eagle is a rare opportunity. As a result, portfolio managers and credit analysts are diligently analyzing all current opportunities in the credit markets. Our thorough examination of the putting green is giving us a solid opportunity at making an eagle. Our current strategy will be to move a portion of our high-quality investments into more credit risk as opportunities present themselves. One opportunity may be in the bank loan market, which has re-priced significantly, and specifically in the credit default swap market which references bank loans. The loan credit default swap index (LCDX), which references a diversified basket of bank loan credit default swaps (LCDS), has gone from initial spreads of LIBOR+120 to over LIBOR+350 in roughly two months. This has caused the relationship of the spread on the high

yield credit default swap index (HY CDX), which references a diversified portfolio of high yield CDS, and LCDX to change dramatically (Chart 6). Banks hedging bridge loan commitments have likely influenced the move wider in LCDX and its recent underperformance versus HY CDX. Given the significant forward calendar of new issuance lined up to come to market, it is not surprising recent covenant-lite bonds and loans have come under pressure. Despite these near-term negative technical factors, our initial analysis of the putting green suggests bank loans, and specifically LCDX, have cheapened considerably.

LCDX “cheap” vs. HY CDX?

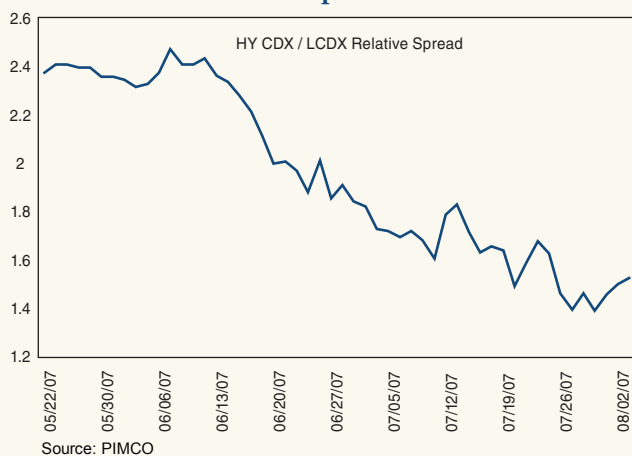


Chart 6

Tightening credit conditions have also raised significant uncertainty about whether or not announced LBOs will get funded. Higher financing costs, due to tighter credit conditions and widening credit spreads, should reduce the momentum of future deals. The institutional forward loan calendar has grown significantly (Chart 7) and, as a result, the stock market could face increasing headwinds, with less aggressive private equity support and higher financing costs on future deals. In the bond market, tighter credit conditions, more robust covenant protection, and wider credit spreads are leading to opportunities

for our clients. A recent bank loan deal with a spread of LIBOR+400 priced recently at a significant discount. This type of pricing is now giving us the opportunity to potentially earn significant returns on senior secured bank loans over the next several years.

Institutional Loan Forward Calendar

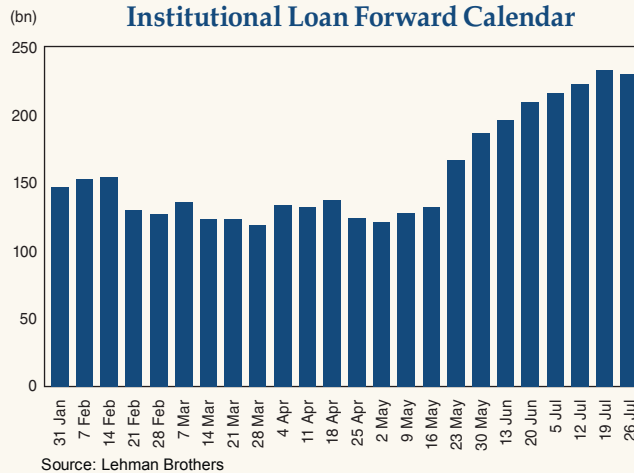
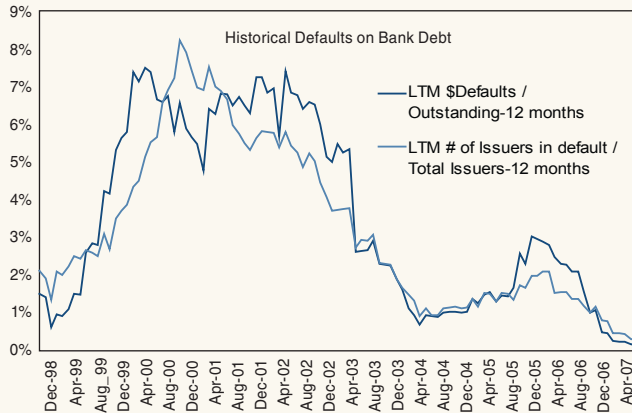


Chart 7

PIMCO will seek to capitalize on selective opportunities in the new issue and secondary bank loan market now that terms are becoming more favorable for bondholders. Bank loans historically recover around 75% in the event of default due to senior positioning in the capital structure. Credit fundamentals remain healthy for a lot of companies, and bank loans are currently experiencing less than 1% default rates (Chart 8). What’s the big picture? At current spreads of roughly LIBOR+400, a diversified portfolio of bank loans would have to default at near 16%, assuming a 75% recovery rate, for an investor to break-even versus LIBOR. While bank loan defaults rose to 8% in 2000, a rise from the current level below 1% to anything remotely approaching 16% is highly unlikely. Clearly, technicals, not fundamentals, are driving spreads in the bank loan market.

Solid Credit Fundamentals Have Contributed to Low Defaults on Bank Loans

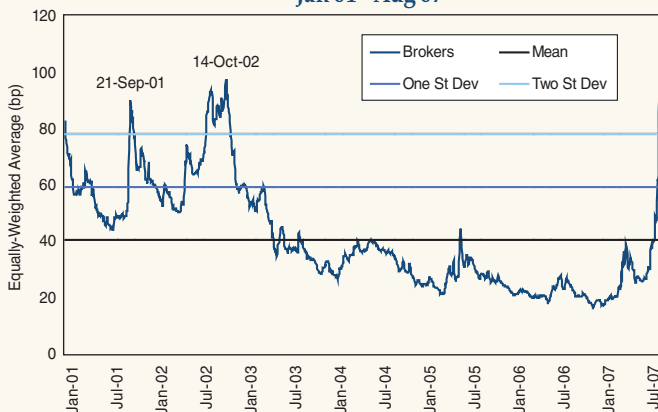


Source: S&P

Chart 8

Within the credit markets, another area of potential opportunity is in financials, which have sharply underperformed recently, with both banks and broker spreads (Chart 9) moving to levels not seen in over five years. Uncertainty surrounding sub-prime, housing and bridge loan exposure has changed the outlook for the financial sector.

**Historical Attractiveness of the Brokers
Average Daily Five-year CDS Level
Jan 01 - Aug 07**



(1) Eq-Wgtd Avg of 5-yr CDS levels for senior unsecured debt of Goldman, Lehman, Merrill, Bear Stearns, and Morgan Stanley

Source: Markit Partners Data

Chart 9

PIMCO has a global banking and financial team of seven portfolio managers and credit analysts around the world that coordinate global banking and financial credit exposure for the firm. While widening spreads in bank debt, bank capital securities and brokerage paper could represent opportunities, we are being highly selective in our bottom-up credit process to ensure we avoid unnecessary risks. PIMCO’s philosophy of avoiding double bogeys is as important as making birdies and yes, the occasional eagle.

Finally, credit derivatives continue to be the “tail that wags the dog” given recent volatility. PIMCO has devoted increasing global resources over the past several years in both trading and analyzing valuations for both individual CDS and CDX contracts. Our financial engineers model outright valuations and relative value across various securities while our credit analysts collaborate with portfolio managers to provide bottom-up analysis of the various companies indexed in each CDX contract. Our reading of the putting green in the CDS and CDX market suggests that several opportunities have emerged.

Fortunately for PIMCO, recent changes in the credit markets are leading to significant opportunities for investors with strong liquidity, and the analytical resources necessary to read today’s markets. In certain sectors, we may even see further deterioration over the medium term. Given our firm’s positioning, global resources, and the current opportunities in the credit markets, our chance of making an eagle have increased. Nevertheless, to assist in our efforts to fully capitalize on this eagle opportunity, we will be patient and selective by adding credit risk in the appropriate amounts and sectors and taking the necessary time to be thorough in our analysis.

Eagle Putt

In golf and investing, relying solely on the eagle putt is not enough to generate a winning score. Minimizing mistakes (bogeys and double bogeys) is also of utmost importance, and perhaps most crucial of all. PIMCO's depth of experience, rigorous research, cyclical and secular forum process and risk management systems, allow us to fully exercise our judgment of when to take and avoid risk. Our clients expect this of us through good times and bad. We are committed to our goal of minimizing volatility against benchmarks and to outperforming when we are being aptly compensated for taking risk.

Knowing when to play it safe in the face of tempting riskier opportunities is paramount. We do not increase risk when we feel it is unsafe to do so. Now, with spreads in the credit markets significantly wider than a few weeks or months ago, we can be discriminating in choosing when to take advantage of the right opportunities for our clients. Within the credit markets, PIMCO is currently in the unique position to focus on our eagle opportunity, but not without keeping a vigilant eye on the risks we take.

Mark Kiesel
August 8, 2007

¹ www.pgatour.com

² See PIMCO's Michael Gomez, "Is it Safe?" *Emerging Markets Watch*, September 2006; Curtis Mewbourne, "A Look Back, A Look Ahead," *Emerging Markets Watch*, January 2007; Michael Gomez, "Can You (Point Your Fingers and Do the Twist)," *Emerging Markets Watch*, April 2007; and Ramin Toloui, "When Capital Flows Uphill: Emerging Markets as Creditors," *Capital Perspectives*, June 2007.

³ Please note that while specific investment decisions may have benefited certain holdings within a portfolio, the performance of the holdings within the portfolio does not necessarily represent the portfolio's overall performance and each client's holdings and performance may vary.

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