PIMCO

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Curtis Mewbourne Discusses PIMCO's Diversified Income Strategy

Curtis A. Mewbourne

Mr. Mewbourne is a managing director and generalist portfolio manager in the Newport Beach office. He is co-head of the emerging markets portfolio management team and head of the diversified income and insurance portfolio management teams. Mr. Mewbourne also serves as a member of the Executive Committee and the PIMCO Foundation Investment Committee. Prior to joining PIMCO in 1999, he was a bond trader at Salomon Brothers and at Lehman Brothers. He has 17 years of trading and portfolio management experience. He holds an engineering degree in computer science from the University of Pennsylvania.

With the global economy in the midst of a profound transformation following the recent systemic crises, investors are finding both challenges and opportunities across many markets, including credit. In the following interview, portfolio manager Curtis Mewbourne discusses investing for the New Normal and the PIMCO Diversified Income Strategy, a dynamic, multi-sector approach to investing in credit that looks to take advantage of the most attractive opportunities across global credit markets at any given time within a framework anchored by the firm's investment process, outlook and broad research capabilities.

Q: What are the challenges facing investors as the global economy enters the New Normal?

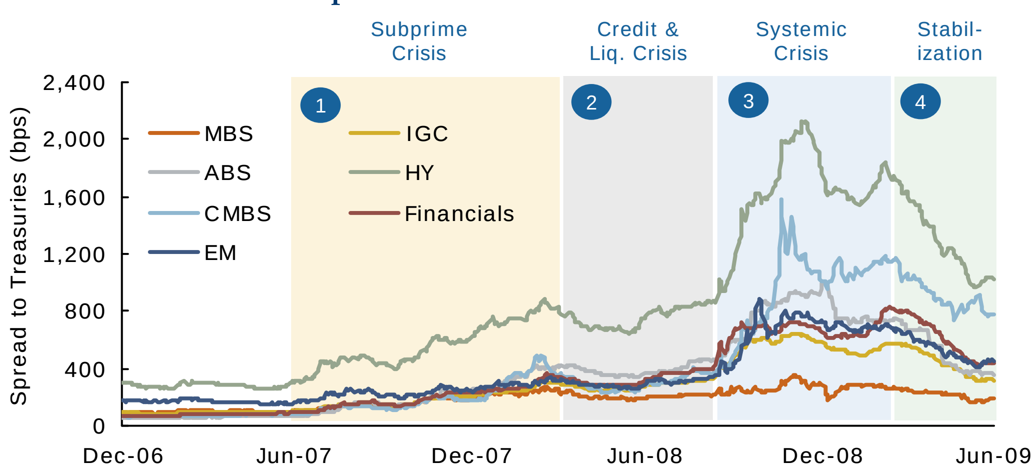
Mewbourne: The world is changing dramatically and very rapidly. Global growth patterns are shifting while the economic and financial crisis continues to play out. Ongoing deleveraging, massive government interventions and new regulations are causing dislocations in existing markets, while at the same time markets for new securities are developing. This presents complex challenges but also offers opportunities for investors.

In the current economic and financial landscape, which PIMCO has dubbed the "bumpy journey to a New Normal," governments have become increasingly involved in capital markets. Opportunities can emerge and disappear quickly among securities that did not exist prior to the crisis, such as FDIC-guaranteed bonds issued through the Temporary Liquidity Guarantee Program (TLGP). When first launched, they presented an opportunity to buy government-backed debt at very attractive yields. Similarly, certain asset-backed and commercial mortgage securities have been positively impacted by the government's Term Asset-Backed Securities Loan Facility (TALF) and Public-Private Investment Program (PPIP). Such fast-moving developments require an investment strategy that can react quickly to shifts in the marketplace.

Q: Where do you think we are along this journey to the New Normal, or more specifically, in the credit cycle?

Mewbourne: Over the past few months, as we moved out of a period of systemic crisis and into a stabilization phase, yield spreads across credit sectors have compressed considerably from their peaks of late 2008 and early 2009 (see Chart 1). Investors' risk appetites have shifted rather dramatically as systemic risks have subsided, and credit markets have been a primary beneficiary of the previously sidelined money that investors have put to work. Valuations that were marked down by indiscriminate selling in the fourth quarter of 2008 were bid up by liquidity-driven buying in the first half of 2009. Amid the strong demand for higher-yielding assets, spreads across most credit sectors now stand roughly where they were in the pre-Lehman days. Contrast this with economic and business conditions, which are significantly worse than in the third quarter of 2008 – there is a clear disconnect between financial markets and underlying fundamentals.

Sector Spreads: from Crises to Stabilization[1]



Source: Barclays Capital
bps = basis points; MBS = mortgage-backed securities; ABS = asset-backed securities; CMBS = commercial mortgage-backed securities; EM = emerging markets; IGC = investment grade credit; HY = high yield

Chart 1

Barring another event as disruptive as the collapse of Lehman Brothers, we think the worst of the credit market crisis is likely behind us; however, there is still potential downside in credit markets, particularly among the riskier sectors. We don't think we are in the rebound leg of the business cycle just yet.

Q: Where does PIMCO currently see the most compelling relative value opportunities across all the credit markets?
Mewbourne: Despite the recent rally in credit markets, we are still finding selective opportunities across the spectrum of credit sectors. Attractive investments still exist within the markets for global investment grade corporate bonds, high yield bonds and emerging market debt – as well as within other "non-core" areas of the credit market, including taxable municipal bonds and bank loans. However, from an asset allocation perspective, we maintain a strong bias for higher-quality, income-producing bonds that reside at the top of a company's or country's capital structure. This speaks to favoring

investment grade–rated credits relative to sub–investment grade rated credits and favoring income over capital appreciation as a key source of total return.

I would also stress the selective aspect of our approach to investing in credit markets. Given the New Normal low growth environment that PIMCO thinks we are entering, business models pursued by certain companies and growth models pursued by certain emerging countries will likely be challenged. Haircuts on debts of some corporations and developing nations in the form of restructuring or outright default will likely persist as a result. In addition to the potential rise in default rates, we also expect that recovery rates, which historically have run in the 40% range but more recently have dropped below 20% as reported by Moody's, will remain depressed. With this as a backdrop, careful attention to credit selection and avoidance of so-called "black holes of credit" will likely be a critical component to a successful investment strategy in credit space going forward. Our focus within the credit research and selection process is on credits that we think will be the strongest survivors in this uncertain environment.

Within the investment grade corporate bond market, we are finding compelling value in a number of sectors, particularly in large banking and financial institutions, utilities and certain parts of the energy complex. Yield spreads for high-quality investment grade corporate bonds are still wide relative to historical levels, and we think attractive risk-adjusted value still exists in certain areas of this market.

We're somewhat more cautious about high yield corporate bonds. We don't think a large allocation to high yield makes sense right now given our expectations that default rates will continue to rise and recovery rates will remain lower for unsecured bondholders. However, there are select opportunities within the below–investment grade universe given dislocations in both the bank loan and high yield bond markets. For instance, certain metals and mining issuers, particularly those that stand to benefit from developing countries' continued demand for commodities, look cheap given their improving credit fundamentals.

With respect to emerging market bonds, we believe that the secular growth story underpinning a strategic emphasis on the sector remains intact. However, we also believe emerging economies will likely divide into two groups as we continue along the path toward the New Normal. Countries with fiscal and economic imbalances will likely return to the old paradigm that alternates between austerity and instability. Those in stronger financial condition and with growing internal markets, such as China and Brazil, will likely maintain their development breakout phase, though not at the torrid pace of recent years. Within this select group of countries, we are also finding very attractive opportunities in quasi-sovereign and systemically important EM corporate credits as a substitution for lower-quality sovereign issues. We also continue to make tactical use of local currency opportunities when our analysis suggests favorable risk-reward dynamics, such as in Brazil and Mexico.

Outside of the three core credit sectors, other areas that we are favoring include residential and commercial mortgage markets. Overall, we remain cautious on these sectors, but there are pockets of dislocation where we believe investors may earn favorable yields on very senior tranches of commercial mortgage-backed securities as well as pools of residential mortgages.

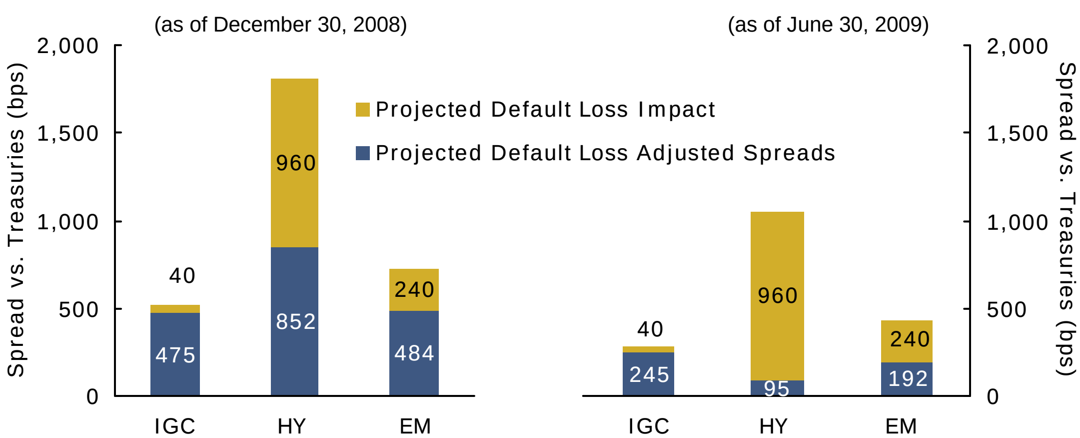
We have also taken advantage of opportunities in select taxable municipal bonds, notably those issued through the government's Build America Bonds (BABs) program. The BABs program, which the Treasury Department initiated in April 2009 to help states finance capital infrastructure projects, points once again to the importance of having a flexible investment strategy in the current environment.

Q: In this environment, what are the advantages of PIMCO's Diversified Income Strategy, and how has it evolved as times have changed?

Mewbourne: PIMCO's Diversified Income Strategy is a dynamic, multi-sector approach to investing in credit, which means it is designed to take advantage of what we feel are the most attractive opportunities across global credit markets at any given time. In the volatile journey to the New Normal, this approach to investing is particularly appropriate given the tactical flexibility to adapt and change the portfolio's weightings depending on where we see the best risk-adjusted value.

While yields across different credit sectors can vary widely, simple adjustments to allow for the impact of expected default rates can reveal greater parity in these relationships (see Chart 2). In addition, the relationship between risk-adjusted yields can vary fairly dramatically over time. These analyses may offer the opportunity to enhance returns through both bottom-up security selection, focused on avoiding defaults, as well as top-down sector rotation, focused on emphasizing those sectors that present the most compelling yield opportunities after adjusting for downside risks.

Credit Sectors Analysis[2]



Source: Barclays Capital, Merrill Lynch, JPMorgan, Moodys

Chart 2

Another important aspect of the Diversified Income Strategy is the broad range of sectors where it looks to invest. This gives us the flexibility to take advantage of both new credit markets and investment products as well as to opportunistically seek to benefit from credit dislocations that emerge in the New Normal.

Q: What is the benchmark for the Diversified Income Strategy?

Mewbourne: PIMCO offers commingled vehicles benchmarked against the Barclays Capital Global Credit Index, but in practice the strategy is not necessarily tethered to a specific benchmark in terms of the broad investment universe that it looks to utilize. We are simply trying to capture the best risk-adjusted return opportunities across global credit markets, and we make strategic and tactical asset allocation decisions as economic and market conditions change.

Q: Does the strategy invest in equities?

Mewbourne: We don't typically invest in equities within this strategy. Currently, we believe that certain sectors of the fixed income market have the potential to generate equity-like returns with far less volatility; for example, the credit markets may offer very attractive yields without equity-like risk, and can serve as a good substitute for equities. We therefore see little need to dip down into lower portions of the capital structure in our efforts to achieve equity-like returns.

Q: How do you apply PIMCO's firm-wide investment process in constructing a Diversified Income portfolio?

Mewbourne: The Diversified Income Strategy can be thought of as a complete expression of PIMCO's secular and cyclical views as they apply to fixed income credit sectors, both from the top-down and bottom-up perspective.

From an asset allocation standpoint, the composition and relative weights of the various credit sectors are driven by the firm's top-down macroeconomic outlook. We recently conducted a study of how different asset classes performed through economic cycles from 1988 to 2008, and found that returns across credit sectors can vary considerably in different stages of the business cycle (see Chart 3). Specifically, the empirical data showed that investment grade corporate bonds typically outperformed both lower-quality credits and equities during the early stages of a recession, while high yield bonds typically led equities and outperformed investment grade corporates coming out of the late stages of a recession and into the early stages of a recovery. This study concluded that a top-down approach to credit sector rotation has the potential to add value through the business cycle. PIMCO's ability to determine where we are in the business cycle helps determine the sector rotation component of our Diversified Income Strategy.

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Average Sector Returns Across Business Cycles, 1988–2008[3]

Early Expansion	Mid Expansion	Late Expansion	Early Recession	Late Recession
Emerging Market Debt 15.01%	Emerging Market Debt 16.95%	Equities 13.15%	Treasuries 10.62%	High Yield Bonds 20.36%
High Yield Bonds 13.39%	Convertible Bonds 12.35%	Emerging Market Debt 9.69%	Investment Grade Corporates -1.45%	Convertible Bonds 14.38%
Convertible Bonds 12.01%	High Yield Bonds 11.2%	Convertible Bonds 9.36%	Emerging Market Debt -6.72%	Investment Grade Corporates 11.52%
Investment Grade Corporates 8.94%	Equities 10.63%	Treasuries 7.73%	High Yield Bonds -21.91%	Equities 10.22%
Treasuries 7.26%	Investment Grade Corporates 7.78%	Investment Grade Corporates 6.83%	Convertible Bonds -25.69%	Treasuries 9.58%
Equities 4.29%	Treasuries 6.49%	High Yield Bonds 4.21%	Equities -27.39%	Emerging Market Debt 7.65%

Sources: Standard & Poor's, J.P. Morgan, Merrill Lynch, National Bureau of Economic Research.
Data through December 31, 2008.

Chart 3

From a bottom-up perspective, the security selections that we make for the portfolio are driven by the research and analysis of our credit analyst group and sector specialist desks. Our seasoned credit analysts internally rate every credit held in our portfolios. Their research is focused on finding issuers that exhibit stable or improving credit profiles. The analysts keep an eye on both the global economic environment and industry-specific dynamics, which gives us the ability to identify what we feel are attractive opportunities that are consistent with our long-term economic forecasts.

That last point is critical to careful asset allocation. The top-down themes expressed in an asset allocation framework must also be expressed in the bottom-up security selection process; otherwise the securities used to construct the portfolio may unwind the asset allocation decisions. For instance, if you have a bearish outlook for consumer spending, your asset allocation will likely express that view in some form. But if within your allocation to investment grade corporate bonds you concurrently have an overweight to consumer cyclical issuers, that position will likely offset your asset allocation decision.

Thank you, Curtis.

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[1] Spreads for MBS, ABS, IGC, Financials, EM, HY are nominal spreads over Treasuries. MBS is represented by the Barclays Capital Agency Fixed Rate MBS Index; IGC is represented by Barclays Capital U.S. Corporate Investment Grade Index; ABS is represented by Barclays Capital ABS Index; Financials is represented by the Barclays Capital Investment Grade: Financial Institutions Index; EM is represented by the strip spreads for the JPMorgan EMBI Global Index; High Yield spreads are represented by Barclays Capital Corporate High Yield Index; TSY is represented by Barclays Capital U.S. Treasury Index; EM($) is represented by the JPMorgan EMBI Global; Non-U.S. is represented by the JPMorgan Non-US Gov't Bond Unhedged Index; EM (LC Bonds) is represented by the JPMorgan GBI-EM Global Div Unhedged USD; EM (LC) is represented by the JPMorgan ELMI + Unhedged. HY, ABS, and MBS outperformed Treasuries.

[2] Spreads for IGC, EM, HY are nominal spreads over Treasuries. IGC is represented by Barclays Capital U.S. Investment Grade Credit Index; EM is represented by the JPMorgan EMBI Global Index; HY is represented by the Merrill Lynch High Yield Master II Index. Assumed Default/Recovery Rates = Investment Grade Credit: 1%/20%, High Yield Credit: 10%/20%, Emerging Market Debt: 2%/30%, Bank Loans: 10%/50%.

[3] Investment Grade Corporates is represented by Merrill Lynch All Corporates Index; Emerging Market Debt is represented by the JPMorgan EMBI Global Index; High Yield Bonds is represented by the Merrill Lynch High Yield Master II Index; Treasuries is represented by the Merrill Lynch Treasury Master Index; Convertible Bonds is represented by the Merrill Lynch All Convertibles Index; Equities is represented by the S&P 500 Index.

Past performance is not a guarantee or reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. High-yield, lower-rated, securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and while generally backed by a government, government-agency or private guarantor there is no assurance that the guarantor will meet its obligations. Certain U.S. Government securities are backed by the full faith of the government, obligations of U.S. Government agencies and authorities are supported by varying degrees but are generally not backed by the full faith of the U.S. Government; portfolios that invest in such securities are not guaranteed and will fluctuate in value. Convertible securities may be called before intended, which may have an adverse effect on investment objectives. Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. There is no guarantee that these investment strategies will work under all market conditions and each investor should evaluate their ability to invest for a long-term especially during periods of downturn in the market.