

Product Focus

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Mohamed El-Erian, Vineer Bhansali and Curtis Mewbourne Discuss PIMCO's Global Multi-Asset Strategy



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Shifts in power and influence are changing the world fundamentally, creating fresh challenges and opportunities for investors. In the following interview, Mohamed El-Erian, Vineer Bhansali, and Curtis Mewbourne discuss PIMCO's Global Multi-Asset Strategy, a complete investment solution aimed at navigating the new global economy. For this product, El-Erian is overseeing asset allocation, Mewbourne is overseeing alpha strategies, and Bhansali is overseeing risk management.

Q: What is PIMCO's Global Multi-Asset Strategy?

El-Erian: The Global Multi-Asset Strategy brings the full breadth and depth of PIMCO's time-tested and proven investment process to work for investors in multiple asset classes across the world. It seeks to enhance our clients' ability to tap investment opportunities and manage risk.

What does this mean practically? The strategy involves three distinct, though interrelated, steps. First, a forward-looking asset allocation aimed at maximizing the value offered by markets across different risk factors; second, additional relative value positioning to enhance return potential; and third, proactive risk management, including an inherent focus on "tail risks." We believe that these three factors are crucial to navigating the structural transformation in the global economy, present and future.

The Global Multi-Asset Strategy offers the complete expression of PIMCO's secular and cyclical views. It differentiates risk-factor diversification from asset class diversification, and the focus on "tail risks" reflects the fact that policy mistakes and market accidents are virtually inevitable in the rapidly transforming global economic and financial situations where traditional market linkages are in flux and the market/policy infrastructure is increasingly stressed.

Q: PIMCO has historically been a fixed-income manager. What makes PIMCO capable of doing global tactical asset allocation?

El-Erian: Although PIMCO's investment focus has historically been in the global fixed-income markets, our investment process has never been limited to the fixed-income space. Specifically, the process addresses the entirety of the economic, financial and institutional capital structure, and it does so by drawing on detailed bottom-up and top-down analyses.

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Throughout PIMCO's history, one of our strengths has been the ability to evaluate the full spectrum of global developments – economic, financial, institutional, legal, demographic, regulatory and geopolitical – all in a risk-factor framework. This speaks to the entire capital structure and allows us to clarify which risk exposures we want to take, and separately to identify investments that best compensate us for that embedded risk. Over the last few years, we have been expanding the expression of those views beyond traditional core fixed-income markets.

For example, people don't think of PIMCO as a real estate manager, yet over the past few years we have successfully developed a strong analysis of the U.S. residential real estate market. Specifically, we identified that real estate risk was something to avoid, given our view of a significantly overleveraged and overvalued housing market. The same may be said for commodities, convertibles, emerging markets, and many others. We also spent time and resources expanding our analysis of the linkages between the lower (equities) and upper (senior debt) components of the capital structure.

Q: So should investors consider this a bond product, a stock product, an alternative investment, or something else?

EI-Erian: The Global Multi-Asset Strategy is intended to be an important part of a complete portfolio solution for clients, anchored by PIMCO's investment process. Investors should view this strategy as part of their total investable assets rather than applicable to a narrow bucket within an asset allocation.

As a simple reference point, think of the so-called balanced investment strategies that typically offer a mix of equity and fixed-income exposure in a set proportion. The Global Multi-Asset Strategy seeks to offer investors a more flexible and diversified approach.

Ultimately, of course, the way the Global Multi-Asset Strategy fits specifically into an investor's broader portfolio is a reflection of each investor's particular circumstances. And while we anticipate that most investors might apply the strategy to a portion of their approach to all asset classes, some might simply use it as a tactical component of a more static policy-driven allocation.

Q: Mohamed mentioned "tail risk." Can you expand on this?

Bhansali: The term "tail risk" stems from our tendency to consider ranges of potential investment outcomes on a bell curve. The areas near the center of the bell curve, where it is tallest, are the more likely outcomes, while the areas where it thins out toward the edges – the "tails" – are the extreme but unlikely outcomes. In our tail risk-management efforts, we focus on the left tail – that is, market scenarios that, while not highly likely to occur, can cause outsized losses for an investor. Put another way, tail risk is the risk of a dangerous market crisis or systemic event that can severely hurt portfolio returns.

Just because tail risk is not necessarily the highest probability outcome doesn't mean that it should be ignored. In fact, given the severe damages that tail events can cause for investors' portfolios, it's prudent to pay close attention to these risks. Traditional risk management and pricing tools often underestimate the frequency and severity of these events and, by extension, their detrimental effect on returns. Investors who fail to account for tail risk – or who use a "just in time" portfolio insurance approach – will likely suffer as long-term returns fail to meet their investment objectives.

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Q: How does PIMCO identify tail risks?

Bhansali: To help protect against the potentially severe effects of market dislocations or market-impacting policy mistakes, PIMCO evaluates a wide range of extreme scenarios and available instruments that can hedge against these risks.

To understand why our approach is unique, it's important to remember that traditional asset allocation methods treat risk simply as volatility of returns, or variance. However, variance from the mean is only one measure of risk, and does not directly account for "kurtosis," which is the distance of the tails from the mean. Put differently, kurtosis is the magnitude of unlikely outcomes, or how "fat" the tails are.

In practice, this means we evaluate portfolios with respect to a variety of actual and potential stress scenarios, both with and without various tail hedging instruments. We then arrange these instruments in what we have determined to be the optimal hedge portfolio that balances cost and potential payoff.

Q: If tail risk events are unlikely future events, how do you identify which tail-hedging strategies will be effective?

Bhansali: Historically, we find that tail risk is almost always a systemic risk that reduces availability of financing and liquidity. In episodes of systemic risk, everyone desires liquidity, but no one is willing to provide it. Therefore, tail risks, including episodes of deleveraging, are generally macro risks and are highly correlated with monetary policy. They can therefore be hedged through macro markets, such as broad bond, stock, foreign exchange, credit or commodity exposures. While there may be episodes of relative illiquidity or richness in some of these markets over the business cycle, they are generally deep enough to allow attractive entry points. So the strategy is simple: acquire variously cheap hedges over the cycle to hedge against systemic risks. Since correlations rise in absolute value when systemic crises happen, these seemingly disconnected hedges can be a good tail hedge in times of stress.

There are four basic ways we can implement our tail risk hedges:

- Purchase Treasuries or Eurodollar futures, which should rally during a flight to quality or monetary policy easing.
- Acquire options or option-like securities such as puts or calls on macro markets, swaptions, or out-of-the-money tranches on CDX or iTraxx indexes.
- Take positions with negative correlation to tail risk, such as momentum strategies that move with volatility indicators including the VIX (CBOE Volatility Index).
- Simply move off the mean-variance efficient frontier by reducing exposure to risk assets, such as credit or stocks.

Q: So is the value of the Global Multi-Asset Strategy purely in how PIMCO balances various global asset classes, or are there other potential benefits for investors?

Mewbourne: As Mohamed said, there are three key elements to the Global Multi-Asset Strategy: asset allocation, which he described, tail risk management, which Vineer covered, and relative value opportunities.

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Relative value opportunities can arise from short term dislocations, where securities are priced significantly above or below fair value, as well as from longer term structural inefficiencies. We are constantly monitoring and investing across global markets, and our investment process is designed to identify and take advantage of the opportunities we find. PIMCO's track record speaks for itself, but importantly we think is a critical component of any successful investment solution.

Q: Is it a quantitative or qualitative process to identify these relative value trades?

Mewbourne: Looking across the industry, there are a lot of asset allocation offerings that manage tactical exposures and other alpha strategies through highly quantitative model-driven processes. At PIMCO we are naturally skeptical of these "black box" programs. While models do provide a degree of discipline, they can be inflexible. In an evolving world where the drivers of asset class returns and macroeconomic variables are changing, a rigid quantitative approach can pose real risks. This is especially true when a crisis occurs, which basically throws historical relationships out the window.

What makes PIMCO unique is that our process is very broad based, utilizing a comprehensive, "top down", macro framework with "bottom up" input from specialists across a broad range of asset classes. This qualitative process allows us to be flexible in a transforming global economy, where market correlations, risk factors and cause-and-effect are constantly changing. In addition, the process is designed to have more staying power over the long term than rigid quantitative processes.

Q: Could you explain more about the asset allocation process? How do you determine the optimal balance of so many asset classes?

EI-Erian: The investment process for the asset allocation strategy builds off PIMCO's global investment process. The starting point is a framework anchored by PIMCO's three- to five-year secular outlook, which identifies key trends across the global economy and the resulting risks and opportunities for investors. This in turn is supplemented by a cyclical outlook, which specifies a near-term forecast for the level of economic growth and inflation in key regions. The PIMCO investment committee then combines these "top-down" views with "bottom-up" input from each of our sector specialist portfolio management teams. The result is a series of investment views across various global risk factors, which may ultimately drive asset class returns.

Once the PIMCO investment committee has developed relative value views across key global risk factors, our asset allocation committee implements those themes in the Global Multi-Asset Strategy. The asset allocation committee is responsible for optimizing the mix of risk factors and for identifying the most efficient instruments that can be used to obtain the exposure. This creates the "beta" portfolio, or broad mix of macro markets. Then we overlay positions in an effort to produce additional value for investors through relative value opportunities, structural inefficiencies or other tactical positions. Finally, we stress test the portfolio, add the relevant tail-risk hedges and double-check the final portfolio for consistency with the investment committee's views.

The result is a globally diversified, multi-asset portfolio in which holdings are directly aligned with PIMCO's underlying views regarding global risks and opportunities.

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Q: Doesn't PIMCO already offer multi-asset strategies?

EI-Erian: PIMCO offers, and will continue to offer various multi-asset strategies. We recognize that asset allocation is just a tool for meeting an individualized investment objective.

A prime example is PIMCO's well-established All Asset Strategy, which incorporates asset allocation driven by the investment process of our subadvisor, Research Affiliates LLC. While the All Asset and Global Multi-Asset Strategies both employ asset allocation approaches, they have different objectives, processes and resulting characteristics. All Asset is explicitly a "real return" investment strategy focused on delivering performance relative to an inflation benchmark. It uses a model-driven process that reflects Research Affiliates' views on asset classes, and targets modest volatility and a positive correlation to Treasury Inflation-Protected Securities (TIPS), consistent with its real return objective.

In contrast, the Global Multi-Asset Strategy seeks to consistently outperform over a market cycle the traditional 60% stocks / 40% bonds mix that many investors use. It draws on a different set of PIMCO processes that speak to the appropriate maximization of return and the minimization of risk across global asset classes.

More generally, as a provider of global investment solutions, PIMCO is constantly striving to offer compelling products geared to meet investors' needs, and to do so in a forward-looking manner. This latest offering, the Global Multi-Asset Strategy, aims to meet investors' need for a core asset allocation solution that can help them navigate through a transforming global economy and a changing financial landscape. We think investors can benefit by having an integrated asset allocation program that is directly aligned with the complete expression of PIMCO's secular and cyclical views across global risk factors and asset classes.

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. 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. Commodities contain heightened risk including market, political, regulatory, and natural conditions, and may not be suitable for all investors. Inflation-linked bonds (ILBs) issued by a government are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. Treasury Inflation-Protected Securities (TIPS) are ILBs issued by the U.S. Government. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. 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.

The CDX is an index comprised of credit default swaps. Tranches on this index are structured by order of loss from defaults among the underlying components of the index.

iTraxx is the brand-name for the family of credit default swap index products covering regions of Europe, Japan and non-Japan Asia. The indices are constructed on a set of rules with the overriding criterion being that of liquidity of the underlying Credit Default Swaps (CDS). VIX measures the speed of price movement on the S&P 100 index (OEX), and mainly tells traders the average premium levels of the OEX options traded. It is not possible to invest directly in an unmanaged index.

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