

**Product Focus**

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**Steve Jones Discusses the Features and Potential Benefits of PIMCO's StocksPLUS Long Duration Strategy**



**Steven L. Jones, CFA**

Mr. Jones is a vice president and product manager for PIMCO's portable alpha-based equity strategies in the Newport Beach office. He was previously on the short-term portfolio management team and also held positions in account management. Prior to joining PIMCO in 2000, he was an analyst at a hedge fund-of-funds investment management firm. He has 11 years of investment experience and holds an MBA from the Paul Merage School of Business at the University of California, Irvine. He received his undergraduate degree from the University of California, Riverside.

*The PIMCO StocksPLUS Long Duration Strategy offers long-term investors a source of attractive potential excess returns that are highly correlated to long-dated liabilities, while maintaining exposure to the equity markets via derivatives. In the following interview, product manager Steve Jones provides an overview of the strategy and discusses its potential long-term benefits relative to traditional equity strategies in a liability-driven investment (LDI) framework.*

**Q: What is the investment objective and overall structure of the PIMCO StocksPLUS Long Duration Strategy, and how does it fit in with the broader suite of StocksPLUS strategies?**

**Jones:** The StocksPLUS Long Duration Strategy is designed to provide equity market returns plus a source of excess return potential that is highly correlated with long-term liabilities. PIMCO launched the strategy in 2007 in response to client and consultant demand for an equity solution that also seeks to provide liability hedging benefits.

StocksPLUS Long Duration is built on PIMCO's long-standing StocksPLUS platform. The StocksPLUS approach employs futures and/or swap contracts to obtain exposure to an equity market index and combines that exposure with an actively managed fixed income portfolio that seeks to generate additional returns, or "alpha." This approach fits into an investment area more broadly known as portable alpha, a label generally applied to strategies in which the desired asset class exposure, often referred to as "beta," is obtained synthetically in the derivatives market, allowing additional return (alpha) to be sourced from a different asset class or active management strategy. PIMCO has managed StocksPLUS portable alpha portfolios since 1986. (For more information, please read ["PIMCO's StocksPLUS Strategies."](#))

The basic structure of the StocksPLUS Long Duration Strategy can be expressed as follows:



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The use of equity index derivatives enables the strategy to maintain full exposure to the equity market without paying for that exposure up front. As is the case with most “buy now, pay later” arrangements, there is a financing cost – typically around LIBOR – for maintaining the equity index exposure. To the extent that the fixed income portfolio return exceeds that of LIBOR, the strategy outperforms the equity index (conversely, if the fixed income portfolio return is less than LIBOR, then the strategy underperforms its index). Bear in mind that fees will impact performance.

While the equity index derivatives track the performance of the desired equity market index, the capital not required for margin is actively managed in a long duration bond portfolio rather than the short-term “enhanced cash”-style fixed income portfolio employed in our traditional StocksPLUS portfolios. Because long duration portfolios are more sensitive to interest rate movements, by design the strategy has the potential to deliver equity market excess returns that are highly correlated with long-dated liabilities.

**Q: Pension plans and other investors focused on long horizons often rely on high allocations to equities in an effort to achieve long-term return objectives. How does the StocksPLUS Long Duration Strategy reconcile participation in the equity market with the desire of many plans to improve their liability match?**

**Jones:** Equities typically dominate institutional investor asset allocations: According to a May 2009 Greenwich Associates survey, 54% of average plan assets are invested in equities. The idea of higher expected returns along with liquidity, transparent pricing and broad institutional acceptance have historically prompted investors to devote meaningful allocations to equities.

However, given equity market volatility, many pension plans are questioning traditional asset allocation strategies. For example, the precipitous decline in funding ratios following the multi-year equity market decline at the beginning of this decade dramatically increased interest in liability-driven investing (LDI) approaches. Many plans find themselves in a similar situation today following the broad decline in equity markets in 2008.

The bottom line is that plan sponsors face two competing objectives: meeting return targets and reducing risks relative to liabilities. Most plans still have overall asset allocations that heavily favor equities, as they attempt to take advantage of higher risk premiums – and potentially higher long-term returns – in equity markets. The problem is that their efforts to maximize long-term results can work against their other objective of minimizing risks relative to liabilities.

While some investors expect equity market outperformance over the very long term, the impact of volatility in the interim may be significant. Consider the following example:

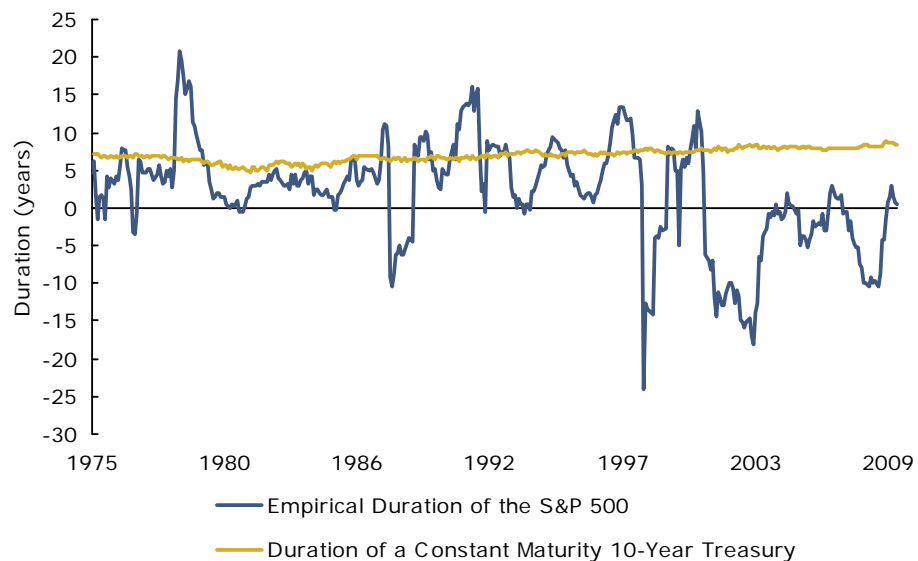
Over the five-year period from June 2004 through June 2009, a \$100 million pension plan invested entirely in the S&P 500 would have seen its asset value fall to \$89 million and its liabilities (proxied by the Ryan Labs Liabilities Index) grow to \$153 million. Assuming the plan was fully funded at the beginning of the five-year period, it would only be 58% funded at the end.

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The following example helps illustrate how the duration of the equity markets has fluctuated widely over time. Chart 1 below depicts the “empirical duration” of the S&P 500: changes in the value of an investment in the S&P 500 as a function of changes in value of a U.S. 10-Year Treasury note over rolling one-year periods (monthly from February 1974 to June 2009). While the empirical duration of the S&P 500 during this period averaged +2.1 years, it swung widely, ranging from -24 to +21 years.

### Empirical Duration of S&P 500: Fluctuations from 1974–2009



Source: Standard & Poor's, U.S. Treasury. Data through June 2009.

#### Chart 1

That degree of volatility may be more than many plan sponsors are willing to tolerate, despite the potential returns on equities. The StocksPLUS Long Duration Strategy gives investors another choice: By combining stock market returns with returns on a long duration bond portfolio, StocksPLUS Long Duration may offer investors the potentially higher returns of the equity risk premium, and also lower risks relative to liabilities.

#### **Q: How significant could the results potentially be if StocksPLUS Long Duration is implemented in a pension plan?**

**Jones:** The results will depend on market conditions and the extent and manner of the strategy's use within the plan. While the equity market return – obtained via derivatives – is likely to be a dominant driver of performance, the fixed income component of the strategy may impart the following characteristics relative to a traditional passive or actively managed equity strategy:

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- **Higher correlation with liabilities:** StocksPLUS Long Duration aims to generate alpha by investing assets in a long duration bond portfolio. The strategy is designed to outperform the equity market index when the long duration bond portfolio outperforms the financing cost of the equity index derivatives (generally approximately LIBOR). By the same accord, when the long duration bond underperforms LIBOR, the strategy will underperform the index. Because of the inherent long duration bond exposure, StocksPLUS Long Duration is fundamentally designed to provide a higher correlation with liabilities than traditional equity mandates.
- **Reduced tracking error relative to liabilities:** Equities can be a significant source of tracking error relative to plan liabilities. StocksPLUS Long Duration helps reduce tracking error by introducing long duration exposure within the equity allocation. The result is potentially lower tracking error relative to liabilities than a traditional equity mandate.

### **Q: Would it be possible to construct a similar approach using equity or interest rate swap overlays together with a more typical portfolio?**

**Jones:** Yes, although one of the most significant potential benefits of the PIMCO StocksPLUS Long Duration Strategy may be that it allows investors to participate in both the equity and long duration fixed income markets in a single portfolio. While it is possible to use either equity or interest rate swap overlays to accomplish something similar to StocksPLUS Long Duration, there may be very real efficiencies gained from having both the bond and equity exposure in a unified and actively managed portfolio. StocksPLUS Long Duration eliminates the need for an overlay provider and thus the need for additional communication and coordination regarding target exposures, liquidity and customized aggregated risk and performance reports. Investors can also avoid the duplicate work of risk monitoring, reporting, selection and oversight of separate alpha strategy managers and overlay managers.

For a more in-depth discussion about the merits of bundled implementation of a long duration plus equity overlay structure, such as the StocksPLUS Long Duration Strategy, please read [PIMCO Viewpoints: "Rethinking LDI Overlay Strategies: Getting to the Source of the Duration,"](#) by Rene Martel.

### **Q: How does PIMCO's experience and investment management process work to add value to the StocksPLUS Long Duration Strategy?**

**Jones:** Derivatives-based equity beta management is neither easy nor straightforward. In particular, combining two relatively volatile asset classes (equities and long duration bonds) requires routine realignment of the equity exposure as the underlying fixed income asset values change. This process of equity exposure realignment is a focused effort at PIMCO across all of our StocksPLUS strategies. Similarly, appreciation or depreciation of the equity market will result in margin payments, requiring the investment of cash or the sale of bonds to raise cash. As a result, PIMCO closely monitors fixed income risk exposures relative to desired levels, given the strategy's higher level of portfolio volatility than a standalone long duration portfolio.

Liquidity management is another important consideration in a portfolio of this type. PIMCO has robust margin and collateral management procedures that have facilitated

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seamless equity exposure management in several difficult market environments over the years (including the 1987 stock market crash and the late 2008 financial market meltdown). Even in the absence of a substantial decline in the equity market, active cash flow management in a StocksPLUS Long Duration portfolio is one of the key factors behind the optimal implementation of the overall strategy. PIMCO withdraws excess margin flow daily to ensure that only the minimum required amount is maintained on deposit with clearing members. This allows us to properly invest margin proceeds consistent with our current strategies and current market opportunities. Likewise, when margin payments are required, we are prepared to readily meet those payments and make restructuring decisions at the appropriate time to create additional liquidity in the overall portfolio.

PIMCO has more than 20 years of experience using equity index derivatives in our StocksPLUS portfolios, and we believe our experience allows us to more efficiently gain synthetic exposure to various equity indexes than many other market participants. We have significant resources dedicated to obtaining the most attractively priced financing when rolling our futures contracts from one expiration to the next; our derivatives desk continuously monitors the market and uses proprietary futures valuation models.

The StocksPLUS Long Duration Strategy can be tailored to various equity indexes: U.S., international and global. It is also possible to periodically change the level of equity exposure to accommodate plan-level asset allocation and rebalancing adjustments. This flexibility may provide important cost savings as it does not require disruption of the underlying fixed income portfolio; in addition, buying and selling futures is often more cost effective than trading a portfolio of stocks.

### **Q: Does the StocksPLUS Long Duration Strategy offer any additional benefits related to risk management, diversification or potential excess returns?**

**Jones:** StocksPLUS Long Duration offers unique downside risk management benefits relative to passive and active equity strategies, as well as to other types of portable alpha equity strategies. Historically, high-quality long duration fixed income portfolios have typically exhibited a strong negative correlation with equities during weak equity market environments, when many investors typically embark on a “flight to quality” that benefits high-quality fixed income instruments. Therefore, StocksPLUS Long Duration may be viewed as an equity strategy that has the potential to deliver strong excess returns during weak equity markets. Additionally, there may be a potential benefit of diversification of equity market excess returns for investors with allocations to both StocksPLUS Long Duration and traditional active equity strategies.

The most common source of potential outperformance in a typical equity mandate is stock selection. Active equity managers employ many techniques to build and maintain a stock portfolio that delivers a total return that exceeds the total return of the associated equity index benchmark. However, there is not typically a structural return benefit associated with stock selection strategies – the manager must pick the right stocks period after period, in all market environments, in addition to overcoming what can be high transaction costs for certain types of strategies.

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In contrast, the alpha source in the StocksPLUS Long Duration Strategy is fixed income–based, and our ability to generate potential equity market excess returns is a function of our ability to produce return on the fixed income portfolio that is higher than the money market interest rate cost associated with equity index derivatives. Because money market instruments are generally the lowest yielding in the fixed income universe, a long duration portfolio has the potential to generate an attractive positive incremental yield premium and associated excess return relative to money markets – and therefore the equity market index – over time.

While specifically designed for equity investors with long-term liabilities, the StocksPLUS Long Duration Strategy strives to provide attractive additional return benefits, both absolute and relative to liabilities, in comparison to traditional equity mandates.

**Thank you, Steve.**

**Past performance is not a guarantee or a reliable indicator of future returns.** 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. 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. Swaps are a type of privately negotiated derivative; there is no central exchange or market for swap transactions and therefore they are less liquid than exchange-traded instruments. Duration is the measure of a bond's price sensitivity to interest rates and is expressed in years.

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.

The Ryan Labs Liability index is based on the Treasury STRIP curve equal weighted average. It is not possible to invest directly in an unmanaged index.

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