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PIMCO's Approach to Emerging Local Market Bonds

Over the next three to five years, PIMCO believes emerging market (EM) securities issued in local currencies are among the most attractive opportunities in the global fixed income universe. Emerging local market debt offers the potential to profit from both the ongoing global economic expansion and the maturation of world's developing economies.

The emerging market asset class has matured significantly over the last decade, improving in average credit quality and becoming more balanced. Local bond markets in these countries represent the next step in the evolution of the emerging markets asset class, offering an increasingly wide array of securities, including fixed-rate, floating-rate and inflation-linked bonds, interest-rate swaps, options and currency forwards. This growth in local-currency debt offerings may provide many opportunities, but also presents the challenge of identifying which emerging economies and currencies are still improving and stand to benefit the most from global growth trends. We believe that PIMCO's global team of EM portfolio managers and disciplined, well-tested approach to managing investments in emerging markets leaves us well positioned to face this challenge.

To help investors find opportunities in this landscape, PIMCO created the Developing Local Markets (DLM) and Emerging Local Bond (ELB) strategies. The DLM strategy invests primarily in developing market currencies and short duration/money-market instruments denominated in local currencies, while the ELB strategy invests primarily in longer duration, intermediate maturity bonds denominated in EM currencies. These strategies capitalize on PIMCO's long experience in emerging markets and our global market presence. Our emerging markets team has more than 100 years of combined experience, with members based in Europe, Asia and the United States.

A Global Growth Opportunity

The global economy is expanding rapidly, fueled largely by growth in emerging market countries. PIMCO expects the emerging markets to continue to fuel global growth over the next three to five years as the developing countries transition from the world's suppliers to an increasingly important source of global demand for raw materials and consumer goods.

For bond investors seeking opportunities to profit from the emerging markets' growing role as a key driver of global growth, PIMCO believes developing local market bonds, issued in local currency, may be among the most attractive assets in the global fixed income markets over the three to five year secular horizon.

First, emerging local market bonds currently offer some of the most attractive yields in the global fixed income market. The average yield in local markets currently stands at approximately 7.1%, while external emerging market debt yield averages roughly 6.8%.¹

¹ Source: J.P. Morgan, as of June 30, 2007

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Second, emerging local market bonds may offer greater potential for capital gains from falling yields compared to either external emerging market debt or developed market bonds. Over the long term, PIMCO expects global growth to lead to rising inflation, reversing a decades-long trend of disinflation. While disinflation led to lower developed market bond yields and higher prices, the inflationary trend PIMCO forecasts over the next three to five years suggests that major bond market yields are more likely to rise than fall. External emerging market debt, while still fundamentally attractive, has already experienced a surge of investment and a significant drop in spreads, suggesting that future capital gains may not be as sizable as those experienced in the past. On the other hand, emerging local market bonds should increasingly attract the interest of global investors seeking higher return potential and opportunities to benefit from the growth and fundamental improvements in emerging countries. And while global inflation may increase over the next three to five years, inflation in emerging market countries should continue to decline as productivity increases and proactive monetary and fiscal policies reduce inflationary pressures. Thus, PIMCO believes that local yields in emerging countries have room to decline from current levels, leading to the potential for capital gains.

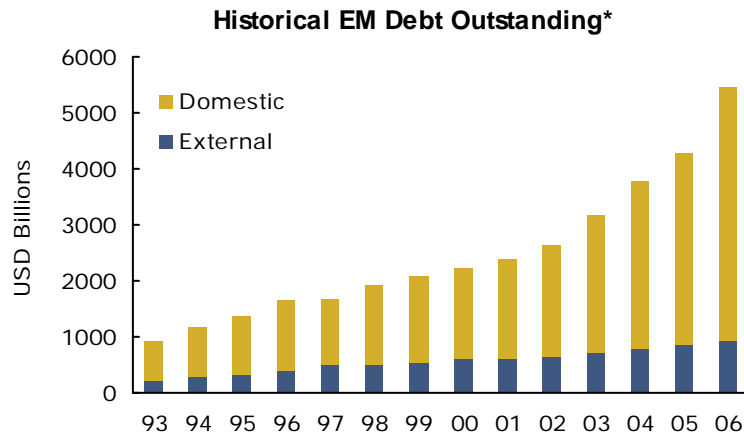
Third, local EM markets offer exposure to currencies that are likely to benefit from a secular decline in the U.S. dollar. A strong dollar has been mutually beneficial to both U.S. consumers and developing economies that rely on exports to the U.S. for growth. Thus, China and other developing countries have invested heavily in Treasuries and other high quality, dollar-denominated bonds in an effort to keep their own currencies from appreciating versus the dollar. But global growth trends suggest future consumption will be less concentrated in the U.S., and developing countries are beginning to diversify their investments and pursue strategies with higher return potential. PIMCO believes these trends will produce a secular decline in the U.S. dollar, and that emerging market currencies will be among the biggest beneficiaries.

A Large and Liquid Opportunity Set

Local markets in EM offer other potential benefits in addition to the opportunity they represent based on the secular trends discussed above. The local fixed income markets are large and liquid, accounting for approximately 80% of all emerging market debt outstanding, as shown in the chart below, and almost half of all emerging market trading volume. The market's size, combined with its regional diversity and the growth of derivatives and other instruments, provides for diverse exposure to the asset class and multiple tools to be used by an active manager to potentially add value.

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Source: Merrill Lynch, Bank for International Settlements

The Risk Scenario

The primary risk to PIMCO's positive outlook for EM local markets would be a pullback in risk appetite, likely due to a cyclical slowdown in the U.S. economy. PIMCO believes U.S. growth remains vulnerable to the ongoing recession in the housing market, which could spread to other sectors of the economy and raise unemployment. A significant cyclical slowdown in the U.S. could lower global investors' risk appetite for a range of asset classes, potentially including developing local markets. Fundamentally, however, the emerging markets are far less vulnerable to a U.S. slowdown than in the past, thanks to the sizable foreign exchange reserves that many developing countries have built up in recent years. The growth in local currency denominated debt as a source of financing also reduces the emerging markets' vulnerability to currency market fluctuations that have been a factor in previous periods of volatility.

PIMCO's Active Approach to Local-Markets Investing

PIMCO's goal in managing emerging local market assets for our clients is to maximize the potential returns from this asset class while limiting exposure to potential risks.

PIMCO's philosophy in analyzing both local and external emerging market bonds is to identify strong and/or improving country credits through a three-pronged approach that focuses on:

- **External Environment:** Our analysis of the external environment focuses on macroeconomic factors such as global growth and inflation prospects in developed countries, the interest-rate outlook and commodity prices. Thus, PIMCO's outlook for continued growth in the global economy, concentrated in developing countries, is the foundation of our positive outlook for emerging markets.
- **Fundamental Analysis:** Within our global macroeconomic framework, the team evaluates the attractiveness of various countries based on their individual

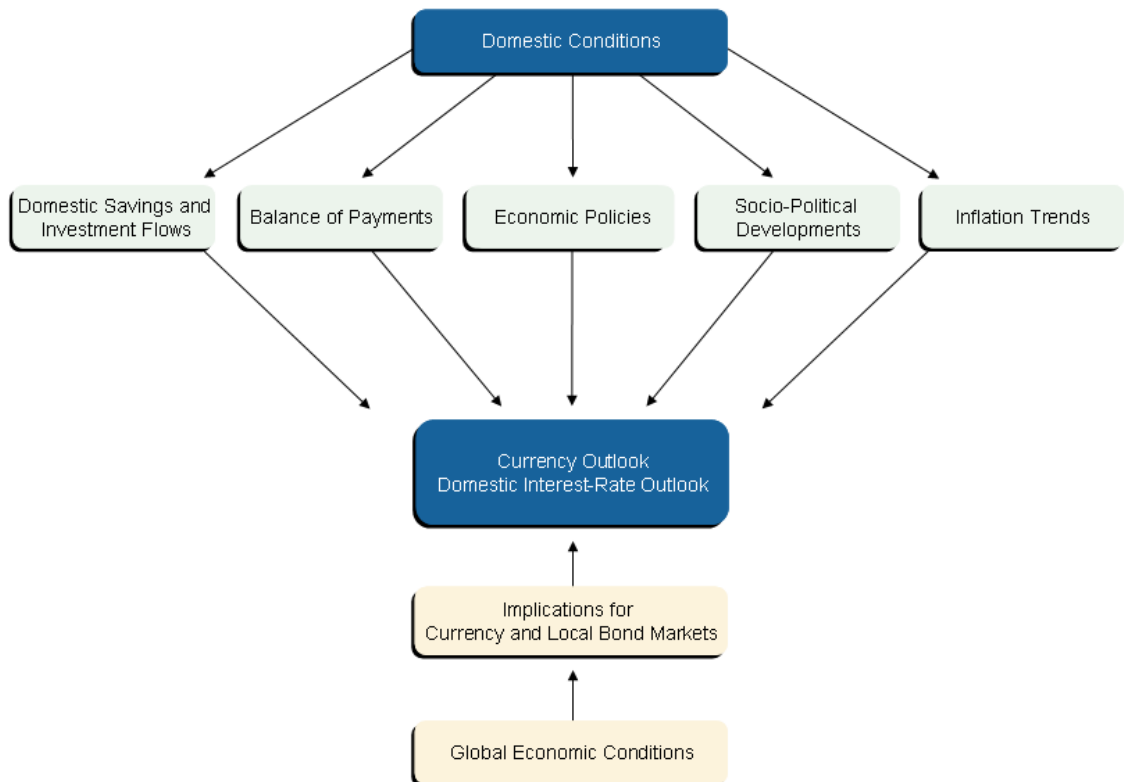
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economic, political and financial fundamentals. In addition to rigorous, independent credit analysis, PIMCO’s portfolio managers make frequent trips to emerging market countries to meet with policymakers, analysts and business executives to assess the local environment.

- **Technical Factors:** When analyzing technical factors, we focus on the many details that could influence the market aside from fundamentals. Examples include: liquidity and leverage, changes in the investor base, asset-liability matching flows, speculative flows into crowded trades or political pressures affecting debt supply.

PIMCO takes an expanded set of factors into consideration when analyzing local market debt, as illustrated below. We pay particular attention to domestic factors such as savings and investment flows, economic policies and inflation trends. We also examine the implications of global economic and market trends for each country’s currency. Our goal is to find countries where the maximum number of factors are supportive, including the potential for currency appreciation, and then find the most cost effective strategy for implementing that view, whether in currency forwards, interest rate swaps, government bonds or other instruments. (For an example of PIMCO’s process in practice, see the case study on page 6.)



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Analysis and Disciplined Risk Management Are Keys to Local Market Success

In conclusion, PIMCO believes emerging local markets are among the most attractive opportunities to benefit from the current secular environment of strong global growth concentrated in developing economies. Investing in developing local markets requires deep insight into economics, politics, currencies and credits, making it one of the most demanding segments of the market. PIMCO's dedicated experts use on-the-ground expertise and our proven investment process to manage risk while seeking attractive and innovative sources of return.

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Case Study: Indonesia August 2005 Overweight

Situation: The Indonesian Rupiah (IDR) came under heavy selling pressure as market worries escalated over the impact of high oil prices on the cost of government subsidies. This was exacerbated by the reluctance of the central bank to tighten policy.

Choices: Maintain, Reduce or Increase Exposure

Decision Making Process: Three-pronged approach to credit selection provides platform for action.

- **Rigorous Fundamental Analysis:**
 - Disciplined, independent, daily market monitoring reveals policymakers’ commitment to pro-market policy principles and acknowledgement of policy misstep
 - Immediate visit to Indonesia provides on-the-ground exposure to local conditions
 - One-on-one discussions with key officials point to near-term draconian, but necessary, measures to stem currency decline
 - Insight into the process of bilateral (Japan and Singapore) as well as multilateral (IMF) support, if needed, reinforces conviction
- **Assessment of External Environment:**
 - Headwinds from continued rise in crude prices raise the urgency of policy response
- **Evaluation of Market Technicals:**
 - IDR is significantly oversold by both onshore and foreign investors

Result: Identify Indonesia early as a classic case of EM currency overshoot. **Increase exposure.**



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Each sector of the bond market entails risk. Investing in emerging markets is more volatile than an investment in U.S. securities. The securities of emerging markets may be less liquid and subject to the risks of currency fluctuations and political developments. Currency rates in non-U.S. countries may fluctuate significantly over short periods of time and may reduce the returns of a portfolio.

The use of derivative instruments such as swaps agreements, options, and futures contracts for hedging purposes or as part of the investment strategy may involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk and the risk that a portfolio could not close out a position when it would be most advantageous to do so. Portfolios investing in derivatives could lose more than the principal amount invested.

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