

Viewpoints

June 2006

The Role of Bonds in an Asset Allocation Strategy

Bonds can play an essential role in asset allocation by diversifying risk, generating income, and preserving wealth across a range of economic and financial market conditions that can cause wide fluctuations in stocks and other asset classes.

PIMCO believes that current economic fundamentals and other longer-term factors are creating a favorable outlook for bond investors. On the economic front, the Federal Reserve is near the end of a long interest rate-increasing cycle, and bonds could benefit if the economy slows. From a structural standpoint, bonds could find continued support as institutions use fixed-income investments for long-term asset and liability management. But history has proven that no matter what the economy has in store, there are always good reasons to hold bonds in a diversified portfolio. The main benefits of a healthy allocation of bonds are summarized below:

- **Bonds are key to diversification.** A diversified portfolio remains important because it can offset risk, especially if an expected slowdown in U.S. growth puts pressure on stocks. Historically, bonds tend to perform well in periods of economic weakness, and can potentially offset the impact of an economic downturn on equities and other asset classes.
- **Bonds help preserve wealth.** Fixed income allocations are typically less volatile than stocks and periods of negative returns tend to be short-lived and relatively modest.
- **Bonds provide attractive return potential.** Federal Reserve hikes to short-term interest rates in recent years, and more recently a move up in longer rates, have increased the income associated with bond investments. Active management of a bond portfolio can potentially enhance total returns.

Portfolio Diversification Can Smooth Out Long-Term Performance

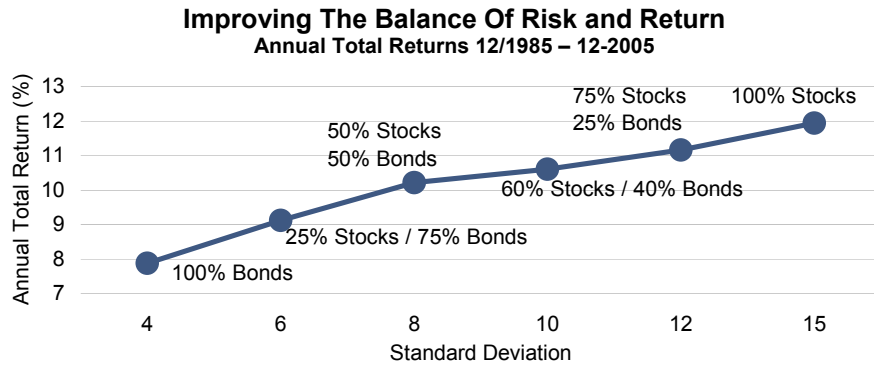
Predicting the future performance of any one asset class is impossible, and a diversified portfolio is the most effective way to minimize risks associated with each type of investment.

Diversification is important because prices of assets do not all move in the same direction at the same time, or for the same reasons. A diversified portfolio will include asset classes that react differently to economic fundamentals -- some respond well to economic growth, others perform better when growth slows, and still others respond to variables such as inflation. Diversification does not ensure against loss, but it can help steady a portfolio's performance and is the most effective strategy for shifting the tradeoff between risk and return in an investor's favor.

History shows that a core allocation of higher-quality, intermediate-term bonds can substantially reduce portfolio volatility with only a modest impact on overall returns. A look at stock and bond returns over the past 20 years illustrates that point. Over that 20-year period starting in December 1985, a portfolio containing 60% stocks tracking the S&P 500 and 40% bonds tracking the Lehman Aggregate Bond Index provided 89% of the returns of an all-stock portfolio, with 36% less volatility.

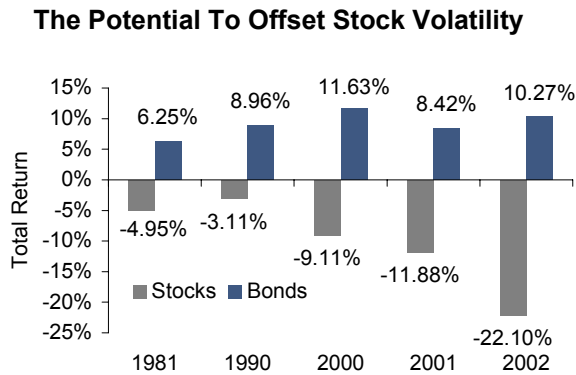
Viewpoints
June 2006

The graph below plots annualized total returns versus volatility over 20 years for various asset allocations, and illustrates that a diversified portfolio of stocks and bonds can offer a better balance of risk and return than a portfolio of either on its own. For example, a portfolio of 60% stocks and 40% bonds posted annualized returns of 10.6%, only a bit lower than 11.9% for an all-stock portfolio. But the all-stock investor faced greater volatility, risking market swings of often more than 15%, while the 60%-40% investor risked swings typically less than 10%. For investors, the lower the volatility of their portfolio, the lower the risk of a loss over any given time period.



Source: Thomson financial. Bonds represented by the Lehman Aggregate Bond Index; stocks represented by the S&P 500 Composite Index.

The lower volatility of a diversified portfolio stems partly from the fact that bonds are typically less volatile than stocks. But more importantly, long-term performance of a diversified portfolio is smoothed by the fact that stocks and bonds often move in opposite directions. Positive returns in bonds can help soften the blow when stocks are falling. In fact, bonds rose an average 9.11% during each of the five worst years for stocks since 1980. In 2002, the single worst year for equities in recent decades, the 22.10% drop in the S&P 500 was substantially offset by a 10.27% return in the Lehman Aggregate Bond Index, as seen in the chart below.



Worst Years For Stocks: 12/1980 – 12/2005
Source: Thomson Financial. Stocks and bonds represented by the S&P 500 and Lehman Aggregate Bond Index, respectively

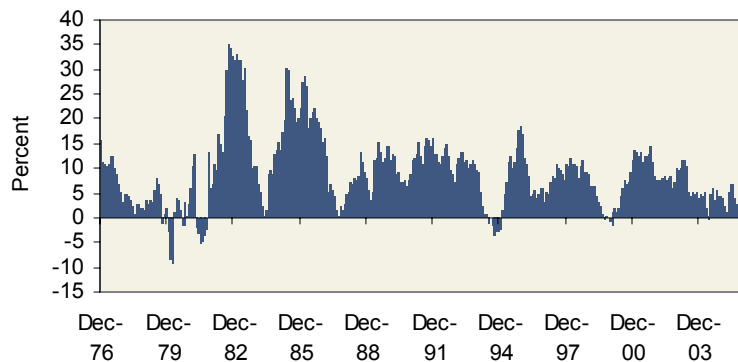
Viewpoints
June 2006

Bonds Preserve Capital and Negative Periods Tend to be Short-Lived and Modest

Bonds have historically been much less volatile than stocks, and they generally provide higher total return than lower-risk cash-equivalent investments. As an example, between 1995 and 2005, the Lehman Brothers Aggregate Index outperformed the Citigroup 3-Month T-Bill Index, a common measure of cash performance. As a result, bonds are one of the best ways to preserve capital in a portfolio, since the chance of a sharp or sustained price drop has historically been far less than it has in stocks.

Historically, periods of negative returns for the bond market have tended to be brief and relatively modest. The chart below shows that the single worst bond market decline for any 12-month rolling period from December 1975 to December 2005 was -9.20%, far milder than the worst 12-month period for stocks, which was -26.62%. Moreover, over that same period, bond returns in the 12 months after a down year have averaged 13.02%, typically outweighing the preceding loss.

Bond Market Rolling 12-Month Returns 1976-2005



Source: Thomson Financial. The bond market is represented by the Lehman Aggregate Bond Index, an unmanaged index that is considered to be representative of the U.S. taxable fixed-income universe.

Over the same time period, bonds have a track record of producing positive results most of the time. In fact, since 1975, returns from intermediate-term bonds have been positive in 93% of all 1-year periods and 99% of three-year periods. The threshold period at which returns became consistently positive was only 3.5 years.

Incidence of Positive Returns, Rolling Monthly Periods 12/1975-12/2005

Period Length	3-Month	1-Year	3-Year	3.5-Year*
% Positive	81%	93%	99%	100%

* Annualized returns

Source: Thomson Financial. The bond market is represented by the Lehman Brothers Aggregate Bond Index

Viewpoints

June 2006

Bonds Provide Attractive Return Potential

Diversification and capital preservation are important aspects of fixed-income investing, but bonds also help serve a prime goal shared by all investors: to put money to work and make it grow. Bonds help to create wealth in two distinct ways:

- **Bonds generate a steady stream of income.**
- **Active portfolio management can enhance returns.**

Traditionally, investors bought stocks for growth and bonds for income. Because a bond is a loan that the investor makes to the issuer, the investor can expect to receive a steady stream of interest payments for the life of the loan, as long as the issuer is not in default. The predictability of those payments has always been a central attraction for institutional investors such as pension funds, since they can use the income to meet similarly predictable liabilities. Other types of investors can use the income from bonds to fund operations, meet liabilities or to reinvest and increase the overall size of the portfolio over time.

Reinvesting the interest paid in bonds can increase capital over time, and will result in compounding or the ability to *earn interest on interest*.

Rising U.S. rates have improved the level of income generated by newly purchased bonds. In the initial stages of the Federal Reserve's efforts to raise short-term interest rates, the benefit for investors was muted as long-term rates remained stubbornly low due to heavy global demand for U.S. bonds. But in the later stages of the Fed's cycle, longer-term interest rates have risen as well, improving returns across the yield curve. As is always the case after rates have risen, higher income increases the effectiveness of reinvesting and compounding in bond portfolios, since it establishes an even larger base of assets on which income can be generated.

Improving income, compounding and favorable structural trends helped the bond market to weather a cycle of Federal Reserve interest rate increases in recent years without producing negative returns. Rising rates tend to be damaging for bond prices, but even as the Federal Reserve boosted its benchmark short-term rate to near 5% from a multi-decade low of 1%, the Lehman Brothers Aggregate Bond Index returned 4.34% in 2004 and 2.43% in 2005.

In general, any negative impact of rising rates on bond total returns is usually short lived. The next table illustrates the potential for bonds to generate positive returns over time even as interest rates rise, as the benefit of reinvesting and compounding can outweigh any short-term drop in bond prices. The table shows that even with a sharp 200-basis point increase in interest rates, total returns within five years approach those that may have been achieved if rates had stayed steady or fallen. Moreover, for time horizons of seven years or greater, rising rates lead to higher total returns due to the effects of higher income and compounding interest.

Viewpoints

June 2006

Hypothetical Illustration of Annualized Index Returns Over Various Time Horizons ¹						
Change in Interest Rates	1-Year	3-Year	5-Year	7-Year	10-Year	30-Year
+200 bps	-2.39%	4.03%	5.27%	5.76%	6.09%	6.45%
+100 bps	1.53	4.77	5.39	5.64	5.80	5.98
0 bps ²	5.58	5.51	5.52	5.52	5.52	5.51
-100 bps	9.55	6.21	5.63	5.40	5.23	5.04
-200 bps	13.07	6.77	5.68	5.24	4.93	4.57

Source: Citigroup Yield Book

Hypothetical example for illustrative purposes only.

No representation is being made that any account, product, or strategy will or is likely to achieve profits, losses, or results similar to those shown. Hypothetical or simulated performance results have several inherent limitations. Unlike an actual performance record, simulated results do not represent actual performance and are generally prepared with the benefit of hindsight. There are frequently sharp differences between simulated performance results and the actual results subsequently achieved by any particular account, product, or strategy. In addition, since trades have not actually been executed, simulated results cannot account for the impact of certain market risks such as lack of liquidity. There are numerous other factors related to the markets in general or the implementation of any specific investment strategy, which cannot be fully accounted for in the preparation of simulated results and all of which can adversely affect actual results.

The simulation assumes the index portfolio is static despite interest rate movements.

1 The interest rate shifts are assumed to occur instantaneously rather than over time and are then held static over the entire period. This illustration does not reflect fees that will be charged by PIMCO.

2 In the unchanged interest rate scenario (0 bps), reinvestment dynamics increase the return of the index above the initial yield to maturity. Over time, the return of the index in the unchanged interest rate scenario would converge toward the initial yield to maturity of the index.

Importantly, the hypothetical returns in the table above are based on a passively managed portfolio, tracking an index that does not necessarily change with economic conditions or other factors. Active management of a bond portfolio can further optimize performance by taking advantage of factors like interest rates, the economic environment, sector-specific performance or favorable structural trends.

Through a total return strategy, active managers can seek opportunities for bond price appreciation, which can add significant return potential while only modestly changing the risk profile of the portfolio. Investment decisions might be based on a host of factors, such as expected interest rate movements, the shape of the yield curve, structural premiums and long-term secular trends that can favor bonds.

One of the biggest advantages for active managers is the ability to position a portfolio to reflect expected movements in interest rates. For example, a manager might adopt a defensive stance by reducing duration, or interest rate sensitivity, when rates are moving up, or profit by extending duration when rates are going down. Since different maturities don't necessarily react to economic fundamentals at the same pace, managers can also target expected changes in the shape of the yield curve, based on anticipated trends in investor preferences, the effects of bond issuance, and the effect of the business cycle on Fed policy rates.

Viewpoints

June 2006

Economic fundamentals can also affect different fixed income sectors in different ways. A core holding of higher quality, intermediate-term bonds can form the foundation for most bond allocations. But within that guideline, managers can potentially enhance returns by focusing on favored bond sectors, the full spectrum of credits, and global bond markets. The chart below shows the annual total return of the U.S. bond market in general and eight representative domestic and foreign bond sectors, with the best performing fixed income sector highlighted for each year.

Different Bond Sectors Outperform At Different Times

	2000	2001	2002	2003	2004	2005
U.S. Bond Market	11.63%	8.44%	10.26%	4.10%	4.34%	2.43%
Long-Term Treasuries	20.27%	4.21%	16.79%	2.48%	7.70%	6.50%
Short-Term Treasuries	7.99%	8.30%	5.76%	1.90%	0.91%	1.67%
Investment Grade Corporate	9.39%	10.39%	10.53%	7.70%	5.24%	1.96%
High Yield	-5.12%	4.48%	-1.89%	28.15%	10.87%	2.74%
Unhedged Foreign	-2.48%	-3.58%	22.99%	18.63%	12.04%	-9.24%
Mortgages	11.16%	8.22%	8.75%	3.07%	4.70%	2.61%
Emerging Markets	14.41%	1.36%	13.12%	25.65%	11.73%	10.73%
Inflation-Indexed	13.18%	7.90%	16.56%	8.40%	8.46%	1.56%

Source: Thompson Financial

Past performance is no guarantee of future results. Bond sectors are represented by the following indexes: U.S. Bond Market = Lehman Brothers Aggregate Bond, considered representative of the domestic, investment-grade, fixed-rate, taxable bond market; Short-Term Treasuries = Merrill Lynch 1-3 Year Treasury, which tracks US Treasury obligations having maturities from 1 to 2.99 years; Long-Term Treasuries = Lehman Long Treasury, which is composed of Treasury bonds with maturities greater than 10 years; Investment Grade Corporate = Lehman Credit, which tracks publicly issued, fixed-rate, non-convertible investment grade corporate debt; High Yield = Merrill Lynch U.S. High Yield Master II which tracks the performance of below investment grade (BBB) but not in default US dollar-denominated corporate bonds publicly issued in the domestic market; Unhedged Foreign = JPMorgan Non-U.S. Global Government Bond (Unhedged) Index, which is an unmanaged market index representative of the total return performance in U.S. dollars on an unhedged basis of major non-U.S. bond markets. ; Mortgages = Lehman Mortgage-Backed Securities which is composed of mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC); Emerging Markets = JPMorgan Emerging Markets Global, which tracks total return for U.S.-dollar-denominated debt instruments issued by selected emerging market countries.; Inflation-Indexed = Lehman Global Real: U.S. TIPS, which is composed of U.S. Treasury Inflation Protection securities. The indexes are unmanaged; it is not possible to invest directly in an unmanaged index.

Actively managed bond portfolios can also account for the effects of secular trends such as overseas demand for U.S. bonds from central banks in export-driven countries such as China, or oil producing Middle East nations. Globally, regulatory changes in pension accounting have also favored bonds as reform has focused on closer management of assets and liabilities. Such long-term trends open up opportunities for portfolio managers who can successfully predict how any changes will affect the markets.

PIMCO also believes there are four structural premiums available to active bond managers that passively managed portfolios are unable to capitalize on: term premiums, liquidity premiums, credit premiums and volatility premiums.

Viewpoints

June 2006

Term premiums are found primarily at the front end of a positively sloped yield curve. An active manager has the ability to emphasize this area of the yield curve when term premiums are attractive, while passive managers mimic the curve structure of the index. Passive managers similarly restrict themselves to the more liquid index securities, while active bond managers can earn a premium for accepting slightly less liquidity. Active managers can also earn a credit premium by selectively accepting increased or more targeted credit risk than investors who limit credit exposure only to that of the index. Active managers can also seek to protect portfolio value by underweighting credit risk when the supporting fundamentals are unattractive. Volatility premiums, meanwhile, can be collected when managers use options or securities with option-like characteristics to “sell volatility” and take advantage of quiet periods in the markets.

Conclusion

Bonds play an integral role in asset allocation strategies, helping investors to diversify their risks, generate income, and preserve capital. An allocation of bonds is always desirable, but it is particularly important at times of economic uncertainty. Currently, with the Federal Reserve near the end of a long stream of short-term interest rate hikes, the U.S. housing market showing signs of cooling, and the U.S. economy likely to slow, PIMCO believes that conditions are improving for the bond market.

The income generated by bonds is a major attraction for investors, and it can be reinvested to increase capital over time. Income from bonds has improved recently as interest rates have risen from historically low levels. Through active management of bond portfolios, investors can seek to outperform the broader market by targeting shifts in the level of rates, shape of the yield curve, favored fixed income sectors, and structural changes in the market.

Additionally, bonds tend to be less volatile and more predictable than stocks, making bond allocations well suited for the increasingly intense focus on asset and liability management amid regulatory changes in pension accounting. For all these reasons, PIMCO believes that bonds remain a key asset class for achieving long-term investment objectives and generating attractive risk-adjusted returns.

This publication contains the current opinions of the author but not necessarily those of Pacific Investment Management Company LLC. Such opinions are subject to change without notice. This publication has been distributed for educational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

Past performance is no guarantee of future results. Diversification does not ensure against loss. Each sector of the bond market entails risk. Some bonds may realize gains and may incur a tax liability from time to time. Any guarantee on government bonds is to the timely repayment of principal and interest, shares of a portfolio that invest in them are not guaranteed. Mortgage-backed securities are subject to prepayment risk. With corporate bonds there is no assurance that issuers will meet their obligations. An investment in high-yield securities generally involves greater risk to principal than an investment in higher-rated bonds. Investing in securities denominated in currencies other than your own may entail risk due to economic and political developments, which may be enhanced when investing in emerging markets. In an environment where interest rates may trend upward, rising rates will negatively impact fixed income securities. Bonds with a longer duration (a measure of the expected life of a security) tend to be more sensitive to changes in interest rates, usually making them more volatile than securities with shorter durations.

Viewpoints

June 2006

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Pacific Investment Management Company LLC, 840 Newport Center Drive, Newport Beach, CA 92660. ©2006, PIMCO.