

Bond Basics

November 2008

Investing Cash: Money Market and Enhanced Cash Strategies

Cash needs to be readily available, so it is usually invested in short-term, highly liquid assets. Historically, this meant bank demand deposits, such as checking accounts, or time deposits, such as savings accounts. Today, investors have two options that offer potential for higher yields: money market vehicles and enhanced cash strategies, such as PIMCO's Short-Term Bond Strategy. Both investment vehicles attempt to preserve capital and provide liquidity, but money markets aim to offer near-perfect liquidity while enhanced cash strategies attempt to offer higher yields than money market rates with slightly less liquidity.

Money Markets Aim to Provide Near-Perfect Liquidity

The money market itself refers to the short-maturity segment of the fixed income marketplace, where government agencies and corporations raise short-term funds. It is distinguished from the long-term fixed income capital market where U.S. Treasury and agency notes and bonds, municipal bonds, mortgage securities and corporate bonds are underwritten, issued and traded.

Money market strategies mainly hold some combination of the following assets:

- **U.S. Treasury bills:** These short-term U.S. Government obligations are the most liquid money market instrument. An investor purchases Treasury bills at a discount from the stated or par value and receives the face value of the bill at maturity. Bills usually have four-week, 13-week, or 26-week maturities.
- **Bank Certificates of Deposit (CDs):** These are time deposits with a bank, issued in denominations greater than \$100,000 for institutional investors (individual CDs start as low as \$100). They cannot be withdrawn on demand without a penalty, although negotiable CDs can be sold at market rates in a secondary market. The principal and interest payments are made by the bank to the depositor only at the end of a specified term.
- **Commercial Paper:** These are short-term unsecured notes issued by large corporations as an alternative to direct bank borrowings. Commercial paper programs often are backed by lines of credit, which can be used if needed to pay down the paper at maturity. Maturities range up to 270 days.
- **Bankers' Acceptances:** These securities originate as an order to a bank from a customer to pay a specified amount of money in the future, typically within six months. When the bank endorses the order for payment as "accepted," it assumes responsibility for the payment to the holder of the acceptance. At this stage, the acceptance may be traded in the secondary market.

In addition, less regulated, non-2(a)7 funds trade an array of other instruments based on eurodollars, which are dollar-denominated deposits at foreign banks or foreign branches of U.S. banks, and repurchase agreements, known as "repos" or "RPs." Repurchase agreements are usually overnight borrowings, in which the holder of

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securities sells the securities to an investor with an agreement to repurchase them at a fixed price on a specified date.

Money market strategies are designed to meet investors' needs for preservation of capital and a high degree of liquidity. Withdrawals from money market strategies can in general be made anytime, on demand, without penalty. In fact, some money market investments are termed "cash equivalents" because of their near-perfect liquidity. Money market vehicles aim to maintain a steady price of 100 cents on the dollar, although it is possible to fall below a dollar.

Enhanced Cash Funds Can Offer Higher Yield

Enhanced cash strategies, including PIMCO's Short-Term Bond Strategy, are variations on traditional money market vehicles. They are designed to provide liquidity and principal preservation, but with more of an emphasis on seeking returns that are superior to those of traditional money market offerings.

A significant portion of the enhanced cash portfolio may be invested in the same high-quality, short-term securities seen in traditional money market vehicles, such as CDs, Treasury bills and commercial paper. However, the balance of the enhanced cash portfolio is invested in a variety of higher-yielding, longer-term securities and slightly lower-rated credits, including short duration corporate, mortgage and high-yield securities, and possibly emerging market and non-U.S. dollar denominated debt.

Because these investments can fluctuate in value, enhanced cash strategies can also fluctuate above and below 100 cents on the dollar. They are therefore regarded as slightly less liquid than money market investments.

Enhanced cash strategies are not intended to replace money market strategies. Because of the tradeoff between somewhat higher yields and modestly lower liquidity, they often are most suitable for what are, in effect, more permanent cash positions, or as a component of a portfolio's cash allocation. In general, cash that is not needed for immediate needs can be invested in enhanced cash strategies; some applications for institutional investors would include: the more permanent tier of operating and pension cash, insurance reserves, foundation cash, and duration matching of short-term liabilities.

Conclusion

Money market vehicles and enhanced cash strategies, which include PIMCO's Short-Term Bond Strategy, aim to preserve capital and provide liquidity. By investing in short-term securities with the highest credit ratings, such as U.S. Treasury bills, money market vehicles can provide near-perfect liquidity under normal market conditions. Enhanced cash strategies offer slightly less liquidity but aim to earn higher total returns than money market vehicles through a slight increase in duration and active investment in a broader range of high-quality, short-term investments.

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Past performance is not a guarantee or a reliable indicator of future results. Money market strategies are not insured or guaranteed by FDIC or any other government agency and although they seek to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the strategy. 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. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and while generally supported by a government, government-agency or private guarantor there is no assurance that the guarantor will meet its obligations. High-yield, lower-rated, securities involve greater risk than higher-rated securities. U.S. government securities are backed by the full faith of the government; portfolios that invest in them are not guaranteed and will fluctuate in value. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks.

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