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PIMCO's Approach to Short-Term Investing: Putting Cash to Work Intensively

When investors construct portfolios, they usually devote considerable attention to the allocation between stocks and bonds. Decisions about the cash portion of an investment portfolio are seldom subjected to the same degree of scrutiny. However, the performance, preservation of capital and liquidity of cash-like investments are of paramount importance, particularly when markets become volatile or unpredictable.

To make the most of cash investing, PIMCO offers an alternative to money market vehicles, a strategy that can potentially provide higher yields: the Short-Term Bond Strategy. An enhanced cash strategy, Short-Term seeks to provide investors with excess returns relative to traditional money market strategies while maintaining the essential features of money markets: preservation of capital and liquidity. The Short-Term Strategy can also be attractive in varying interest rate environments because of the added yield potential.

Several factors combined make PIMCO's Short-Term Strategy unique, including the support of experienced investment professionals, our long-term perspective and our willingness to utilize most sectors of the global bond markets in an effort to add value.

Money Market Versus Enhanced Cash Strategies

The cash allocation of a portfolio represents money an investor may need in the near future, so it should be invested in readily marketable, low-risk fixed income securities. Even with these constraints and objectives, investors have distinct investment choices.

Money market instruments, such as negotiable CDs, are designed to offer liquidity: they give the investor the ability to redeem an investment at par (face value) at maturity, or liquidate it in the secondary market. This is a valuable benefit, appropriate for assets an investor may need within a short time. Most money market instruments are ideal holdings for traditional money market strategies, which are designed to preserve the value per share "at the buck," that is, with minimal risk of price loss.

However, for assets that are likely to be "parked" in cash for longer periods – generally three months or more – insisting on liquidity may mean sacrificing extra return potential for an unnecessary benefit. For more permanent cash positions, some fluctuation in liquid reserves, say between 98 cents and 102 cents on the dollar, should not really matter as long as the price averages 100 cents on the dollar.

Enhanced cash strategies, such as the Short-Term Strategy, typically have durations of one year or less. This means that the net asset value is expected to fluctuate by not more than one percentage point for each percentage point change in interest rates. Enhanced cash strategies can "break the buck," but this flexibility permits the PIMCO Short-Term Strategy to invest in securities that may have greater price fluctuations and pay higher yields than money market instruments and thus potentially earn excess returns over time. It's important to note that in exchange for increased return potential, short-term bonds expose an investor to additional risk. And, unlike CDs or savings accounts, these bonds are

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not guaranteed for repayment of principal and interest. (For more information, please see [“Bond Basics: Money Market and Enhanced Cash Strategies.”](#))

Short-Term: A Risk-Conscious Strategy for Excess Returns

The Short-Term Strategy strives to earn a yield premium over money market strategies by increasing portfolio duration slightly and investing in a broader universe of short maturity fixed income securities.

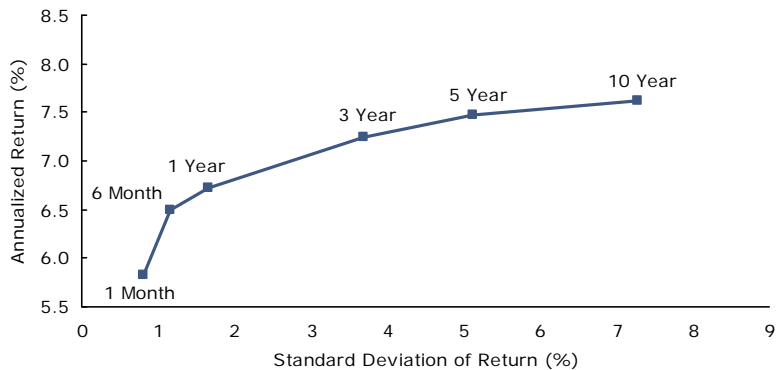
A significant portion of the Short-Term Strategy is invested in the same high-quality, short-term securities that are the standard fare of traditional money market vehicles, such as CDs, Treasury bills and commercial paper. However, the balance of the Strategy is invested in a variety of higher-yielding, longer-term securities and lower-rated credits, including short duration corporate, mortgage and high-yield securities, as well as emerging market and non-U.S. dollar denominated debt.

The Short-Term Strategy seeks to capture excess returns by exploiting four structural inefficiencies found in the short end of the bond yield curve:

- A **term premium** offered by a positively sloped yield curve may accrue to investors who hold securities with slightly longer maturities than those of money market instruments. Increasing the duration of a cash portfolio modestly beyond the typical three-month duration of traditional money market vehicles may improve portfolio performance without materially increasing the likelihood of negative returns. The following chart shows how bond returns increase along with maturity; it also illustrates that the sharpest increase in return per unit of risk is found between maturities of one and six months.

Annualized Return vs. Risk* for Various Maturities (Treasury Yield)

One-Month Holding Periods 01/1968 to 09/2008



*Annualized standard deviation of monthly returns.

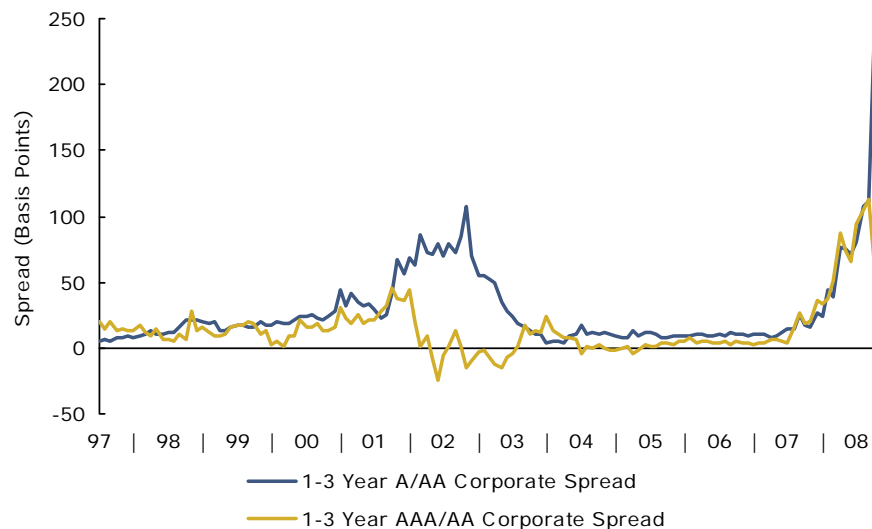
Sources: Bloomberg Financial Markets, PIMCO

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- A **liquidity premium** may offer incremental yield for holding bonds with wider bid/ask spreads. Securities that are less readily bought and sold in a secondary market, such as floating rate securities, adjustable rate mortgages and callable corporate securities, pay investors a yield premium in exchange for accepting reduced liquidity. Because these securities are short in duration and constitute only a portion of the portfolio, they can be held to maturity with some added risk.
- A **credit premium** may be obtained by diversifying holdings to include a variety of high-quality securities with somewhat lower credit quality. Blending carefully selected bonds with ratings below AA into the portfolio allows the strategy the potential to increase yield and improve diversification. The chart below shows the potential for higher yields from securities with slightly lower credit ratings.

Credit Premiums May Enhance Short-Term Yield



Source: Merrill Lynch, as of 9/30/2008

Note: A/AA line is the spread of A-rated securities to AA-rated securities. The AAA/AA line is the spread of AAA-rated to AA-rated securities.

- A **volatility premium** may be available to investors who can tolerate increased principal fluctuations. Many investors pay an excess premium for price stability; this is supported by the fact that implied short-term market volatility generally is higher than actual realized volatility. PIMCO strategies take advantage of this market inefficiency by “selling volatility,” either through securities with embedded options,

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or outright, through derivatives. For example, the Strategy may sell market volatility by purchasing callable instruments such as mortgage-backed securities.

PIMCO's Unique Approach to Short-Term Investing

The effectiveness of the Short-Term Strategy reflects PIMCO's unique economic forecasting capabilities, insights into Federal Reserve Bank policies, and fixed income trading capabilities, which enable us to assemble portfolios that are not limited to the very short-term assets that are generally used in money market strategies. The long-term outlook we develop each year at our Secular Forum informs all of our investment strategies and drives our understanding of important structural changes that are occurring in global economies, markets, government policy and regulation that can have significant impact on investment opportunities. A dedicated team of portfolio managers with an average of more than 20 years of investment experience directly supports the Short-Term Strategy.

Our value-added approach to managing the Short-Term Strategy is further distinguished by several characteristics:

- **A long-term perspective:** PIMCO's secular macroeconomic view minimizes the risk of over-reaction to day-to-day shifts in market sentiment that can expose portfolios to unnecessary volatility and trading costs.
- **Multiple concurrent strategies:** PIMCO's added value is derived from multiple sources. This diversification of value-added strategies is intended to produce consistent returns and minimize risk over time relative to strategies that rely heavily on single-source approaches to generating excess return.
- **Proprietary quantitative models:** We have developed our own analytical models to increase our understanding of risk/reward tradeoffs for individual bonds, bond sectors and portfolios. Our modeling consists of interactive stress tests that allow us to understand portfolio performance in a variety of economic scenarios and take advantage of new fixed income products and structures.
- **Scope:** PIMCO utilizes almost all sectors of the global bond markets in our search for value. Evaluating relative value across multiple sectors enhances our capability to operate in any individual sector. Our ability to establish sector value rankings also allows us to anticipate the cash flows into and out of market segments that can directly influence sector returns.

Conclusion

Enhanced returns, stability and liquidity are three goals that PIMCO never loses sight of when managing money for cash investors. To make the most of cash investing, PIMCO's Short-Term Bond Strategy – an enhanced cash strategy – is designed to offer a potentially higher-yielding alternative to money market investments. It aims to yield more by increasing duration slightly and investing in a broader universe of short-term securities than money market strategies. PIMCO's Short-Term Strategy stands out from others because of our long-term, or secular, outlook, our use of several different strategies to seek added value,

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our proprietary risk management models and the wide scope of short-term investments we utilize.

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; investments may be worth more or less than the original cost when redeemed. Money Market instruments are not insured or guaranteed by FDIC or any other government agency and although the instrument seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the instrument. 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. 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. 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.

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