

## Product Focus

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### PIMCO's StocksPLUS Strategies

Improving on the performance of broad equity indexes can be a significant challenge in today's highly efficient markets, where information spreads quickly and is incorporated into stock prices virtually instantaneously.

But maximizing the return from equities may be particularly important because stocks typically comprise a meaningful percentage of investor portfolios. Active equity management is one possible solution, but it is notoriously difficult to consistently beat the market through individual stock (or sector) selection. Deviating from the equity strategy of "owning the market" also introduces new risks that are difficult to quantify, raising the risk of underperforming the market by a potentially significant amount at a time when equity and other asset class returns may be lower overall.

To help meet the challenge of outperforming highly efficient equity markets on behalf of our investors, PIMCO developed the original StocksPLUS strategy over 20 years ago, and since then has expanded the product line to include a number of variations of StocksPLUS designed to meet different investor preferences and objectives.

PIMCO's StocksPLUS strategies seek to add value to the equity market return by employing PIMCO's full set of skills as a global fixed income manager, including the ability to capitalize on structural inefficiencies in the fixed income markets. Importantly, the value added proposition is largely independent of the equity index benchmark selected and can be applied to a number of major equity indexes around the world.

### PIMCO's Approach: Equity Futures Backed by Actively Managed Fixed Income

The StocksPLUS strategies fit into what is more broadly known as "portable alpha," a term that is generally applied to strategies in which the desired asset class exposure, often referred to as "beta"\* , is obtained synthetically thereby allowing risk-adjusted excess returns or "alpha" to be sourced from an entirely distinct asset class or active management strategy. PIMCO's StocksPLUS strategies avoid the risks associated with individual stock selection by "owning the market" through equity index futures contracts and/or swaps.

Equity futures and/or swaps provide the portfolio with exposure to the underlying index as if all of the portfolio's assets were invested in the individual securities that make up the index, but only require a modest initial margin deposit up front to obtain the index exposure. This leaves the majority of the cash available to be invested in an actively managed fixed income portfolio.

Because the equity futures and swap contracts are priced such that a combination of futures and money market investments (which provide a return that offsets the financing cost of the futures) should produce a return equal to that of the index, PIMCO

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\* Beta measures the volatility, or systematic risk, of a security or a portfolio in comparison to the broad market. A beta of 1.0 means that the portfolio's value moved with the market, a beta greater than (less than) 1.0 indicates that a portfolio's volatility was greater than (less than) that of the market.

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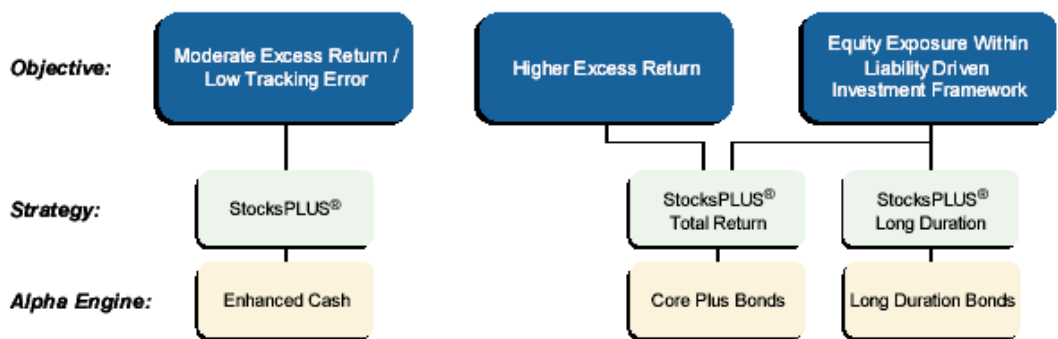
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seeks to achieve a total return on the fixed income portfolio that exceeds money market rates, thereby generating an incremental return over the equity market index.

As can be expected with any strategy that assumes active risk in an attempt to outperform, StocksPLUS strategies may deliver below index returns in certain environments. For example, sharply rising short-term interest rates, a flat or inverted yield curve or widening yield spreads on corporate and mortgage-backed securities can affect PIMCO's ability to add value in the StocksPLUS strategies.

**A Variety of StocksPLUS Strategies for Different Needs**

As noted above, PIMCO offers several versions of StocksPLUS to suit investors with different return goals and risk tolerances. In terms of fixed income-based sources of alpha, we offer several different strategies, summarized below.



All of the StocksPLUS strategies seek to capitalize on two of PIMCO's core strengths: the efficient management of derivatives positions and the effective management of a fixed income portfolio. PIMCO is among the most sophisticated investors in derivative instruments and has invested in fixed income since the firm's inception in 1971.

PIMCO has also expanded the variety of equity index exposures available to investors as part of the strategy. The product was introduced in 1986, when trading in equity index futures was developing. At that time, the S&P 500 contract was the prevalent means of obtaining index exposure through derivatives. The S&P 500 remains a key component of many StocksPLUS strategies, but the product line has since grown to include the following equity index exposures:

- **Small Cap Stocks:** The Russell 2000 Index
- **Large Cap Stocks:** The Russell 1000 Index
- **All Cap Stocks:** The Russell 3000 Index
- **International Stocks:** The Morgan Stanley Capital International EAFE Index
- **European Stocks:** The Dow Jones EURO STOXX 50 Index
- **Japan Stocks:** The Tokyo Stock Exchange TOPIX Index

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In addition, PIMCO now also offers exposure to a proprietary portfolio of stocks selected by sub-advisor Research Affiliates with the goal of generating excess returns relative to both the FTSE RAFI 1000 index and the S&P 500. Research Affiliates uses an enhanced form of the fundamental factor-based stock selection process that underlies their fundamental indexation research. The end result with PIMCO's Fundamental IndexPLUS strategies is one of the first portable alpha equity strategies to offer investors two independent sources of alpha – stock selection and active fixed income management – for every unit of capital invested. The Enhanced Fundamental Index equity exposure is available in combination with all of the different PIMCO fixed income-based alpha engines:

- Fundamental IndexPLUS (Enhanced Cash)
- Fundamental IndexPLUS TR (Core Plus Bonds)
- Fundamental IndexPLUS Long Duration

The stock selection alpha engine and the PIMCO fixed-income based alpha engine are likely to exhibit no material correlation, resulting in an additional excess return diversification benefit.

### **The Advantages of PIMCO's StocksPLUS Approach**

PIMCO's StocksPLUS approach can offer several specific advantages over active equity management.

For starters, StocksPLUS offers the potential for excess returns based on structural advantages which exist in the bond market, rather than stock-picking prowess. Unlike highly efficient equity markets, fixed income markets persistently offer a number of structural advantages which can translate into excess returns. The four most common bond market inefficiencies include the term premium, credit premium, liquidity premium and volatility premium. For each, investors with a longer time horizon or higher risk tolerance than money market investors may be rewarded for stepping out of the money market universe and accepting the incremental risk and return associated with each of these premia. Excess return generation from structural advantages may be more reliable over longer-term horizons than an approach which relies on continuously picking the winning stocks of tomorrow.

By contrast, active equity managers face the efficient markets hurdle, the cash vs. full exposure dilemma, higher transaction costs and presumably the need to outperform their fees. All of these factors make it difficult for active equity managers to add value consistently in all market conditions.

StocksPLUS strategies may benefit further from capturing both the dividend yield of the equity index and yield provided by the underlying fixed income portfolio—and yield may be a particularly important component to returns in a prospective environment if price gains are relatively modest and equity dividend rates are at historic lows.

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A key characteristic of the StocksPLUS approach is that the strategy seeks to offer these excess returns with a very stable beta to the desired equity index. In contrast, many stock-selection based strategies and portable alpha strategies which employ alpha engines with significant equity market correlations may deliver betas materially different than 1.0, and possibly during inopportune environments. The StocksPLUS strategies may maintain a consistent beta across different market environments due to the general lack of correlation between equity markets and fixed income markets.

Similarly, StocksPLUS alpha will likely exhibit low or even negative correlation with any alpha generated by traditional active equity management strategies. Investors would not expect the fixed income oriented StocksPLUS alpha to have any relationship to benchmark-relative returns derived from stock-selection.

For investors focused on liability management, both StocksPLUS Total Return and StocksPLUS Long Duration may deliver excess returns with a positive correlation with pension plan or other longer-dated liabilities. As a result, returns could be higher when liabilities are increasing and lower when liabilities are falling.

Those interested in obtaining equity market exposure outside of their local market may benefit from yet another advantage of the StocksPLUS approach. Whereas, in many jurisdictions, dividends paid on stock holdings are subject to withholding taxes of between 15 and 30 percent, the two sources of StocksPLUS returns (equity index futures margin or swap cash flows and interest income) are generally free from withholding taxes. This added benefit could improve return potential without even taking excess returns into account.

Taken together, these advantages suggest PIMCO's StocksPLUS strategies may consistently and systematically outperform an actively managed equity portfolio over the long-term investment horizon employed by institutional investors.

### Conclusion

PIMCO's StocksPLUS strategies are designed to provide the returns of the broad equity market plus a consistent additional return over and above the return of the equity market. We aim to achieve this by using equity futures and/or swaps to provide exposure to the performance of a given equity index with a minimal or no cash investment. The remaining portfolio assets are invested in a fixed income portfolio with the goal of outperforming the money market financing rate of equity derivatives through active management and structural inefficiencies in the bond market. The StocksPLUS approach can be applied to many major equity indices around the world, with varying degrees of risk and expected return available from the range of StocksPLUS strategies.

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Each sector of the bond market entails risk. Mortgage-backed securities are subject to prepayment risk. With corporate bonds there is no assurance that issuers will meet their obligations. Investing in non-U.S. securities may entail risk as a result of non-U.S. economic and political developments, which may be enhanced when investing in emerging markets. Portfolios may use derivative instruments for hedging purposes or as part of the investment strategy. Use of these instruments 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. Swaps are a type of derivative in which a privately negotiated agreement between two parties takes place to exchange or swap investment cash flows or assets at specified intervals in the future. There is no central exchange or market for swap transactions and therefore they are less liquid than exchange-traded instruments.

The correlation of various indices or securities against one another or against inflation is based upon data over a long time period. These correlations may vary substantially in the future or over shorter time periods, resulting in greater volatility. 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. There is no assurance that any portfolio will achieve its investment objective. Duration is a measure of price sensitivity to interest rates and is expressed in years. Diversification does not ensure against loss.

This material is not intended to provide, and should not be relied on for, accounting, legal or tax advice. You should consult your tax or legal advisor regarding such matters. Please contact your account manager for further information.

The Standard & Poor 500 Index (S&P 500) is an unmanaged index generally representative of the U.S. Stock Market, without regard to company size. The FTSE RAFI US 1000 Index is part of the FTSE RAFI Index Series, launched in association with Research Affiliates. As part of FTSE Group's range of nonmarket cap weighted indices, the FTSE RAFI Index Series weights index constituents using four fundamental factors, rather than market capitalization. These factors include dividends, cash flow, sales and book value. The FTSE RAFI US 1000 Index comprises the largest 1000 US-listed companies by fundamental value, selected from the constituents of the FTSE US All Cap Index, part of the FTSE Global Equity Index Series (GEIS). The Russell 1000 Index consists of the 1,000 largest securities in the Russell 3000 Index, which represents approximately 90% of the total market capitalization of the Russell 3000 Index. It is a large-cap, market-oriented index and is highly correlated with the S&P 500 Index. The Russell 2000 Index is an unmanaged index generally representative of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index. The Russell 3000 Growth Index is an unmanaged index comprised of those Russell 3000 companies with higher price-to-book ratios and higher forecasted growth values. The MSCI EAFE (Morgan Stanley Capital International Europe, Australasia, Far East Index) is an unmanaged index of over 900 companies, and is a generally accepted benchmark for major overseas markets. Index weightings represent the relative capitalizations of the major overseas markets included in the index on a U.S. dollar adjusted basis. The Dow Jones EURO STOXX 50 Index is a capitalization-weighted index of 50 European blue-chip stocks from those countries participating in the EMU. Objective is to provide a blue-chip representation of supersector leaders in the Eurozone. The TOPIX (Tokyo Stock Price Index) is a capitalization-weighted composite of all stocks trading on the first section of the Tokyo Stock Exchange ("TSE"), supplemented by size groups that classify first section companies as small, medium, and large and by sub-indices for each of the 33 industry groups. It is not possible to invest in an unmanaged index.

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