

Product Focus

October 2009

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. At the same time, investing in a passive equity strategy may not be optimal for many investors, as passive indexing offers (at best) the return of the passive index minus management fees.

Maximizing the return from equities may be particularly important because stocks often constitute 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.

Another common solution is passive indexing, which is a popular choice particularly for U.S. large cap equity exposure and other segments of the global equity markets where active managers struggle to consistently add value. Passive indexing typically offers advantages including low costs, liquidity, capacity, diversification and ease of use. PIMCO's StocksPLUS is designed to offer many of these same benefits using a highly transparent investment process that seeks outperformance and additional diversification benefits.

PIMCO developed the original StocksPLUS strategy over 20 years ago to help meet the challenge of outperforming highly efficient equity markets and offer another choice beyond traditional active and passive management. Since then we have 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 seek to 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

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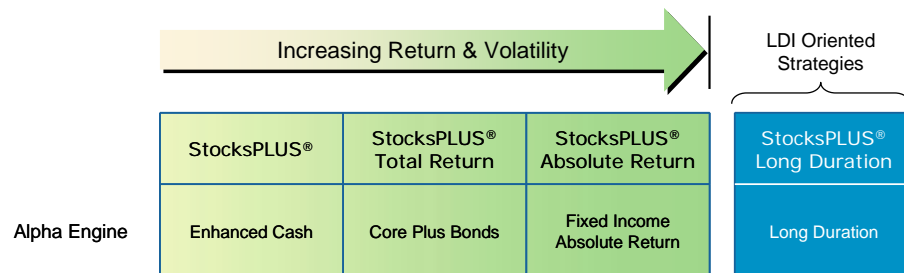
exposure. This leaves the majority of the cash available to be invested in an actively managed fixed income portfolio.

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 seeks to achieve a total return on the fixed income portfolio that is designed to exceed money market rates in an effort to generate 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 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

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 StocksPLUS strategy. When we introduced the strategy in 1986, 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:** MSCI EAFE and All Country World Index (ACWI)

Note: other indexes are available. Please contact us with any specific inquiries.

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In addition, PIMCO also offers exposure via derivatives 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 – RAFI performance relative to cap-weighted indexes 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.

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

The Advantages of PIMCO's StocksPLUS Approach

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

First, StocksPLUS offers the potential for excess returns based on structural advantages that 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 that 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. We believe excess return generation from structural advantages may be more reliable over longer-term horizons than an approach that relies on continuously picking the winning stocks of tomorrow.

By contrast, active equity managers face the efficient markets hurdle, the cash versus full exposure dilemma, and higher transaction costs. In addition, like all managers, active equity managers also have the need to outperform their fees. These factors make it difficult for them to add value consistently in all market conditions.

Second, 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 an environment where price gains are relatively modest, and with equity dividend rates below long term averages.

A key characteristic of the StocksPLUS approach is that the strategy seeks to offer these excess returns with a stable beta to the desired equity index. (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.) In contrast, many stock selection-based strategies and

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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 carefully constructed, investment grade fixed income portfolios. Another distinguishing characteristic is our proprietary portfolio liquidity tiering process, which has facilitated high-precision maintenance of equity market exposure across several different market events (including the 1987 stock market crash and the 2008 financial market crisis).

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 the benchmark-relative returns that active equity strategies derive from stock selection.

For investors focused on liability management, the StocksPLUS Long Duration Strategy is specifically designed to 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.

Taken together, these advantages suggest PIMCO's StocksPLUS strategies have the potential to 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 an additional return 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 indexes around the world, and varying degrees of risk and expected return are available across the range of StocksPLUS strategies.

Past performance is no guarantee 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. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. 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. 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. Swaps are a type of privately negotiated derivative; there is no central exchange or market for swap transactions and therefore they are less liquid than exchange-traded instruments. Diversification does not ensure against loss.

The correlation of various indices or securities against one another or against inflation is based upon data over a certain time period. These correlations may vary substantially in the future or over different time periods that can result in greater volatility. There is no guarantee that these investment strategies will work under all market conditions and each investor should evaluate their ability to invest for a long-term especially

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during periods of downturn in the market. 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. Duration is a measure of price sensitivity to interest rates and is expressed in years.

The S&P 500 Index is an unmanaged market index generally considered representative of the stock market as a whole. The index focuses on the Large-Cap segment of the U.S. equities market. The FTSE RAFI™ U.S. 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™ 1000 Index comprises the largest 1000 publicly traded U.S. companies by fundamental value, selected from the constituents of the FTSE U.S. All Cap Index, part of the FTSE Global Equity Index Series (GEIS). The total return index calculations add the income a stock's dividend provides to the performance of the index. 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 Index is an unmanaged index generally representative of the U.S. market for large domestic stocks as determined by total market capitalization, which represents approximately 98% of the investable U.S. equity market. The Morgan Stanley Capital International All Country World Index ("MSCI ACWI") is a market capitalization weighted index composed of over 2000 companies, and is representative of the market structure of 22 developed countries in North America, Europe, and the Pacific Rim. The index is calculated separately; without dividends, with gross dividends reinvested and estimated tax withheld, and with gross dividends reinvested, in both U.S. Dollars and local currency. 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. It is not possible to invest directly in an unmanaged index.

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