

Product Focus

February 2007

Sabrina Callin Discusses PIMCO's Growing Line Of StocksPLUS Products



Sabrina C. Callin, CFA
Executive Vice President

Ms. Callin is an Executive Vice President and the head of the StocksPLUS product management team responsible for PIMCO's global portable alpha-based equity business. Prior to joining PIMCO in 1998, she was a manager in the assurance and business advisory services group at KPMG Peat Marwick, LLP. She has fourteen years of investment experience and holds two bachelor's degrees with majors in finance, accounting and economics from Texas Christian University, and an MBA from the Stanford University Graduate School of Business. She is also a Certified Public Accountant.

PIMCO's StocksPLUS strategies combine derivatives-based equity exposure with an actively managed fixed income portfolio with the goal of providing clients with attractive risk-adjusted excess returns. Since the original StocksPLUS was introduced in the early 1980's, PIMCO has expanded the lineup of products in order to meet different clients' needs and objectives. We recently spoke with Sabrina Callin, PIMCO's head of StocksPLUS product management, about the evolution of the product.

Q: What is StocksPLUS, and when was it launched?

Callin: StocksPLUS is PIMCO's approach to equity investing, in which we obtain exposure to an equity index through futures and sometimes swap contracts and seek to provide excess returns relative to the market through active management of a fixed income portfolio. StocksPLUS fits into an investment area more broadly known today as "portable alpha," a term 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 launched StocksPLUS in the mid 1980's, shortly after equity index futures were introduced. At that time, PIMCO recognized a unique opportunity to obtain equity market exposure using equity index futures collateralized by a short-term fixed income portfolio. The futures contracts are designed to provide the total return of the associated equity market index, less a short-term money market interest rate cost. As a result, the goal in actively managing the short-term bond portfolio is to outperform money market rates and therefore the equity index. The concept was very novel at the time, since it enabled investors to potentially outperform the equity market while maintaining a very similar risk profile by tapping an alpha source that had very little correlation with the equity market itself. Today, StocksPLUS is often put forth as proof of the portable alpha concept, given that it is often referenced as one of the longest standing and most well known portable alpha products.

Product Focus

February 2007

Q: How has StocksPLUS evolved over time?

Callin: In response to the different needs and objectives of our clients, the StocksPLUS product line has evolved in terms of both the equity exposures that are available and the fixed income-based alpha sources. If we fast forward from the early 1980's, further development of the derivatives markets offered increasing opportunities to gain equity index exposures beyond the S&P 500. Though there is still a lot of interest in the S&P 500, there has also been a migration toward international equities, broad market equities, small cap equities and, most recently, even proprietary equity indexes. Currently, PIMCO offers approximately 20 different equity benchmarks or equity market exposures that we're seeking to enhance.

The second mode of innovation in StocksPLUS has been the introduction of different fixed-income-based alpha sources designed to achieve different equity market risk/return profiles. As we discussed, the alpha source for the original StocksPLUS is a very short-term bond portfolio, often referred to as an enhanced cash strategy. The low-risk nature of the alpha source (short-term high quality bond portfolio) obviously limits the magnitude of potential outperformance. Not surprisingly, around the time of weak equity markets starting in 2000, our clients increasingly asked us to consider higher returning versions of StocksPLUS.

As is always very important with portable alpha strategies, we carefully considered not only different alpha sources but also the resulting risk/return profile from combining the alpha sources with equity market derivatives. We quickly reached the conclusion that collateralizing equity derivatives with an actively managed core bond portfolio allowed us to capitalize to a greater degree on PIMCO's deep, broad fixed income skill set. This approach also fit well with the longer-term horizons of equity investors, offering the potential for higher returns relative to a passive equity investment. Importantly, the benefits of investing in a core bond portfolio as the collateral for equity derivatives exposure should be familiar to most investors since they already likely invest in bonds for long-term capital preservation, liquidity and diversification – particularly during periods of equity market stress. Core bond portfolios also incorporate structural alpha that is derived from the higher yields that may be realized in core bond portfolios relative to money market instruments over the long-term.

An even more recent phase in the evolution of StocksPLUS has been driven by demand from clients engaging in liability-driven investing, whereby the investment objective is typically very closely tied to a liability benchmark. Specifically, clients with long-term liabilities, like pension plans, are seeking out strategies like our StocksPLUS Total Return strategy and a new strategy, StocksPLUS Long Duration, both of which are designed to exhibit a high correlation of excess returns with liabilities. This means that equity market excess returns may be greatest when these clients need excess returns the most – when liabilities are rising. As a result, both strategies offer a potentially material reduction in risk and a potential increase in return relative to liabilities, than would otherwise be available via traditional passive or active equity strategies.

Product Focus

February 2007

Q: What are some of the most recent additions to the StocksPLUS line-up and what has been the rationale for adding them?

Callin: On the fixed income alpha source side, we've incorporated PIMCO's absolute return strategies, in which case the alpha source is also fixed-income based, but is designed to have a market-neutral profile and also allow for broader investment discretion than is typically associated with traditional active fixed income management. While these versions of StocksPLUS may produce higher tracking error than the original StocksPLUS strategy, they importantly offer the potential for particularly high levels of equity market outperformance while also seeking to maintain an attractive risk/reward profile.

On the equity side of the equation, we recently introduced what we believe may be the first mainstream portable alpha strategy that combines exposure to a proprietary stock portfolio with an entirely distinct additional alpha source – specifically our different StocksPLUS fixed-income based strategies. The proprietary stock portfolio is selected by our sub-adviser Research Affiliates with the goal of outperforming both the S&P 500 and the FTSE RAFI 1000 index, the latter of which is the passive version of the Fundamental Index™ introduced by Research Affiliates a few years ago. The end result is two independent alpha sources – both of which are structurally based and likely to be particularly strong during weak equity markets – and not only potentially attractive excess returns but also a risk-profile or volatility that is likely to be very similar to that of the equity market.

Other recent additions to the lineup include small cap and international equity exposure in combination with our different StocksPLUS fixed income-based alpha sources. As international and small cap equities have experienced considerable asset inflows over the past few years, a number of actively managed strategies have closed to new investment, particularly on the small cap side. We have also observed potential liquidity issues on the small cap side and potentially diminishing opportunities to outperform through stock selection, which can make it tough for investors to access consistent alpha in some cases. As a result, we are very happy to now be able to offer investors liquid investment alternatives on both the small cap and international equity front that also seeks to provide the benefit of consistent outperformance with an attractive risk/return profile over the long-term.

Q: Is StocksPLUS an equity product or a bond product?

Callin: StocksPLUS is absolutely an equity product. The fixed income collateral provides potentially valuable diversification benefits and may provide excess return over time. But the overall risk/return characteristics definitely are that of an equity portfolio, and for a large number of clients, StocksPLUS strategies are a part of their core equity allocation.

Specifically, the expected volatility for the different versions of StocksPLUS in most cases is designed to be similar to the volatility of the equity market. In other words, while the different fixed income strategies are not risk-less, the fact that most are relatively low-risk fixed income strategies to start with and also tend to exhibit a low to negative correlation with equities may result in a very similar risk profile to a passive equity market investment while at the same time generating potentially attractive excess returns over time.

Product Focus

February 2007

Q: Why are excess returns different for stock-based and bond-based alpha sources? Is there a diversification benefit to StocksPLUS, where excess returns are generated from a bond portfolio?

Callin: Yes, StocksPLUS offers diversification potential, both in terms of the resulting risk/return profile relative to passive equity strategies, active equity strategies and other types of portable alpha equity strategies and also in terms of diversification of equity market excess returns to the extent that an investor invests in both a StocksPLUS strategy and a traditional active equity strategy.

The most common source of potential outperformance in an equity mandate is, of course, stock selection. Active equity managers employ a wide variety of techniques with the ultimate goal of holding a portfolio of stocks that delivers a total return that exceeds the total return of the associated equity index benchmark. Unlike our StocksPLUS strategies, there is not typically a structural return benefit associated with stock selection-based strategies – the manager must pick the right stocks period after period, in addition to overcoming what can be high transaction costs for certain types of strategies. In some cases, managers may also venture to a material degree from the stipulated equity market benchmark or mandate in an attempt to generate excess returns. While this may be acceptable to clients so long as they are informed as to the style drift, it also may cause certain challenges for clients, especially if the result is a material increase in the risk profile of the mandate as may be the case with a developed market international equity manager who holds a significant portion of his or her portfolio in emerging market stocks as an example.

The PIMCO alpha sources in our StocksPLUS strategies are all fixed income-based and our ability to generate equity market excess returns is a function of our ability to produce a return on the fixed income portfolio that is higher than the money market interest rate cost associated with owning equity market exposure using futures or swaps. Given the fact that money market instruments are generally deemed to be the most liquid instruments in the fixed income universe, most other fixed income securities should generate a higher yield and return over time. The structural alpha that may be generated by holding non-money market securities in StocksPLUS portfolios may provide an important tailwind for the strategy that is designed to support consistent outperformance over 3-5 year periods that is very unique among available equity strategies.

The use of a bond-based alpha source for equity market outperformance also has a particularly important potential benefit during periods of equity market stress. If you look across asset classes and across investment strategies during periods of financial market stress – for example when the equity market is experiencing a material price decline - many investments exhibit a high correlation with equities. The exception is high quality bond portfolios, which typically benefit from a flight to quality during such periods. The end result may be excess returns when clients need them the most, in sharp contrast to many traditional active equity strategies and also portable alpha equity strategies that often

Product Focus

February 2007

source alpha from riskier investment strategies that may exhibit a materially high correlation with equities during periods of equity market stress.

Of note, our Fundamental IndexPLUS strategies combine a stock-selection alpha source with our fixed income based alpha sources – compounding the diversification benefits within one investment whereby a client receives two independent and uncorrelated sources of alpha for every unit of capital invested. This strategy utilizes total return swaps to gain exposure to a proprietary basket of stocks selected by sub-advisor Research Affiliates “Enhanced RAFI”. The Enhanced RAFI index is designed to capture equity-market based structural alpha and builds on the fundamental indexing concept, which seeks to eliminate the performance drag caused by systematic overweighting of overpriced stocks and underweighting of underpriced stocks in capitalization-weighted indices. The fundamental factor selection process also has historically delivered particularly strong excess returns during weak equity markets, so the combination can be compelling for investors who are seeking attractive equity market outperformance – particularly during weak equity markets – without a material increase in risk¹.

Q: Thanks, Sabrina.

Past performance is no guarantee of future results. Performance results may be limited by the date ranges referenced. Different time periods may produce different results. Each sector of the bond market entails risk. Mortgage-backed securities are subject 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. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

¹ From 11/30/1965 to 12/31/2006 the Fundamental Index (“FTSE RAFI”) outperformed the S&P 500 by an average of 5.1% during rolling 12 month periods, when the total return of the S&P 500 index return was negative. During periods of positive 12 month return of the S&P 500, FTSE RAFI posted an excess return of 1.2% on average, over the same time period. FTSE RAFI performance data is available on Bloomberg under ticker FR10XTR.

Product Focus

February 2007

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).

This article 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 article 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. 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. ©2007, PIMCO.