Strategic Markets

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Strategic Markets: The Importance of Real Returns

The goal of investors is to consistently increase the long-term purchasing power of their assets so they can purchase increased amounts of goods and services in the future with their savings. Inflation puts this goal significantly at risk because portfolio returns must first keep up with the rate of inflation in order to increase real purchasing power. For example, a 3% total return (also called nominal return) on assets in an environment of 3.5% inflation actually results in a negative return (-0.5%) when adjusted for inflation. In other words, despite earning a positive return, those savings can only purchase less goods and services in the future since the return did not keep up with inflation.

To address the risk that inflation poses for all investors seeking to enhance their future purchasing power, PIMCO has developed and continues to expand its series of **Strategic Markets** products. The Strategic Markets products can maximize the potential for long-term real returns (inflation-adjusted returns) and growth in purchasing power, and reduce the risk of negative real returns, while capitalizing on our core asset management competencies: fixed income management, derivatives management, and creative solutions to practical investment problems. Further, PIMCO's Strategic Markets strategies are specifically designed to replace core allocations to conventional stock and bond holdings, or to help improve investors' diversification around these traditional investments.

What Is PIMCO's Strategic Markets Series?

PIMCO's Strategic Markets series is a diverse family of investment strategies with a common investment goal: the long-term compounded growth of *real* returns. The series includes asset classes such as diversified commodities indexes, real estate (real estate investment trust index) and inflation-indexed bonds, each of which has historically outperformed inflation.

The Strategic Markets series also offers "one-stop" solutions: strategies that seek to achieve real returns by providing diversified exposure to multiple asset classes within a single structure. PIMCO's All Asset strategies employ strategic asset allocation across a broad range of asset classes, including inflation-sensitive assets, to maximize real return potential.

<u>TIPS (Treasury Inflation-Protected Securities):</u> Because the Strategic Markets series is focused on real return generation, the strategies emphasize the use of inflation-indexed, real return bonds. Real return bonds, called TIPS in the U.S., represent a distinct asset class in which both principal and interest payments adjust to track changes in designated inflation indices. For most U.S. real return bonds, the indexed principal amount is adjusted in relation to changes in the Consumer Price Index-All Urban Consumers (CPI-U). This adjustment process provides real return bonds with a hedge against rising inflation and an opportunity to lock in attractive real yields above inflation when the bonds are held to maturity.

Real return bonds provide three key benefits that enable them to play an important role in investors' asset allocations. First, real return bonds have a return that is explicitly linked to inflation. Second, real return bonds tend to have lower total return volatility than conventional bonds and equities. Third, real return bonds exhibit low or negative correlations with equities. This combination of features makes real return bonds attractive within mixed asset class portfolios, not only to meet inflation-sensitive funding requirements, but also to reduce portfolios' long-run overall volatility by improving the portfolio's diversification. Utilizing this insight, PIMCO's Strategic Markets products use TIPS and other inflation-indexed securities either as the primary asset, as in the Real Return Asset Strategy, or as a strategic collateral asset, as in the CommodityRealReturn Strategy and RealEstateRealReturn Strategy.

Commodities: Commodity indices offer a different aspect of real return. Over long-term investment horizons, these portfolios typically have lower correlation to stocks and nominal bonds than any other asset class. This is because factors that affect the returns of commodities are quite different from factors affecting equity or bond performance. For example, weather can have a direct and significant impact on a range of commodities without having any discernable impact on the broad equity or fixed income markets. Also, military action can simultaneously weigh on equities by injecting uncertainty into the market while boosting the price of commodities produced in the affected region. PIMCO implements its CommodityRealReturn Strategy by combining our ability to negotiate and manage derivatives linked to the chosen index with our ability to effectively manage the collateral portfolio of real assets that backs those derivative positions.

We manage this strategy by combining a position in commodity-linked derivative instruments backed primarily by a portfolio of inflation-indexed securities. This provides a "**double real**"™ response to inflation rates and changes in inflation. A "double real" ™ strategy refers to a strategy that provides exposure to two asset classes (commodities and TIPS) that have historically had a positive correlation to inflation. Other fixed income instruments may also be used tactically in the portfolio. The commodity-linked derivatives attempt to capture the price return of the commodity futures market, while our active management of the fixed income assets seeks to add incremental return above those markets, along with additional inflation hedging. If our active management of the fixed income portion of the portfolio outperforms, we generate an incremental return over the commodity markets. In addition, we also seek to generate excess returns within the commodity exposure by implementing strategies that exploit structural opportunities within the commodities markets. This combination of excess return from the collateral management and from the commodities management provides a "**double alpha**"™ opportunity for investors. The CommodityRealReturn Strategy combines the potential benefits of long-term appreciation in the commodity markets with the possibility of consistent real return income.

Real Estate: Recognized as a hedge against inflation, real estate and real estate indexes—like commodities—have very low correlations with more traditional asset classes, including equities and bonds. Real Estate Investment Trusts (REITs) have also historically provided attractive and steady current income—averaging 8.18% annually from 1981 through 2006, according to data from the National Association of Real Estate Investment Trusts (NAREIT)—which can help cushion returns against downturns in other markets. PIMCO's RealEstateRealReturn strategy provides exposure to equity real estate by taking positions in REIT index derivatives backed primarily by a portfolio of inflation-indexed securities. Like our CommodityRealReturn strategy above, RealEstateRealReturn thus offers a "double real"™ return, providing real returns in the form of potential gains from the REIT index exposure and seeking consistent real return income from the inflation-linked securities.

Broadened Asset Allocation: Even if conventional stocks and bonds generally are expected to provide mediocre returns over the next several years, we can expect that various sectors will do well at different times. An ability to utilize a broadened list of asset categories, including inflation sensitive assets, identify undervalued asset classes, and capitalize on those determinations can create good long-run inflation-adjusted returns. To do this, PIMCO has developed the All Asset Strategies. These two strategies, All Asset and All Asset All Authority, capitalize on PIMCO's skills at managing specialized bond portfolios. They add to those skills a capability to allocate among an exceptionally wide variety of investment sectors, including equities, through the StocksPLUS strategies, based on current and updated relative value.

Conclusion

While there are no guarantees when investing, the Strategic Markets series offers investors an opportunity to potentially earn compounded long run real returns while better managing and minimizing risk. This is particularly relevant should we experience an upcoming environment of disappointing returns in conventional assets, which is a possibility given their above-average historical valuation levels and low current yields. This is also relevant should we experience an upcoming environment of higher inflation, which would erode the purchasing power of investors' savings. Strategic Markets investments by PIMCO can offer investors the chance to diversify their portfolios and build toward their long-term purchasing power targets. In an era where individuals and institutions alike must not simply grow the future value of their assets, but rather must grow the future purchasing power of their assets, PIMCO's Strategic Markets series can help provide those real returns, regardless of how traditional stocks and bonds perform in the years to come.

their obligations. Investing in non-U.S. securities may entail risk due to non-U.S. economic and political developments which may be enhanced when investing in emerging markets. Inflation-indexed bonds issued by the U.S. Government, also known as TIPS, are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation. Like any other bonds, TIPS are subject to capital gains or losses in the marketplace prior to maturity; TIPS may be particularly sensitive to capital losses during deflationary environments. Interest payments on TIPS are based on the inflation adjusted principal value of the bond, which can adjust below the bond's face value before maturity for the purpose of calculating interest payments; so in deflationary environments interest payments can potentially decrease. The U.S. Government guarantees repayment of either the inflation adjusted or original principal amount (whichever is greater) at maturity. Neither the current market value of inflation-indexed bonds nor the value a portfolio that invests in inflation-indexed bonds is guaranteed, and either or both may fluctuate. The credit quality of the investment in the portfolio does not apply to the stability or safety of the investment. Duration is a measure of the portfolio's price sensitivity expressed in years. Diversification does not ensure against loss.

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. A portfolio’s investments in commodity-linked derivative instruments may subject the portfolio to greater volatility than investments in traditional securities. The value of commodity-linked derivative instruments may be affected by changes in overall market movements, changes in interest rates, and other factors such as weather, disease, embargoes, and international economic and political developments, as well as the trading activity of speculators and arbitrageurs in the underlying commodities. Real Estate-linked derivative instruments are subject to additional risks, such as loss to casualty or condemnation, and changes in supply and demand, interest rates, zoning laws, regulatory limitations on rents, property taxes and operating expenses. Investment in a real estate-linked derivative instrument that is linked to the value of a REIT is subject to additional risks such as poor performance by REIT manager, adverse changes to the tax laws or failure to qualify for tax-free pass-through of income.

The CommodityRealReturn Strategy is intended for long-term investors and assets allocated to the strategy should be no more than a small part of a typical diversified portfolio. This strategy is expected to experience greater volatility than most other strategies managed by PIMCO.