

## Product Focus

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### Chris Dialynas Discusses PIMCO's Unconstrained Bond Strategy



#### Chris P. Dialynas

Mr. Dialynas is a Managing Director, portfolio manager, a senior member of PIMCO's investment strategy group, and a member of PIMCO's investment committee. He joined PIMCO in 1980. Mr. Dialynas has written extensively and lectured on the topic of fixed income investing. He served on the Editorial Board of *The Journal of Portfolio Management* and was a member of Fixed Income Curriculum Committee of the Association for Investment Management and Research. He has thirty years of investment experience and holds a bachelor's degree in economics from Pomona College, and holds an MBA in finance from The University of Chicago Graduate School of Business.

*PIMCO's Unconstrained Bond Strategy is an absolute return-oriented, investment grade fixed income-based approach that embodies PIMCO's proven investment process. In the following interview, Portfolio Manager Chris Dialynas answers questions about the strategy.*

#### **Q: What is the PIMCO Unconstrained Bond Strategy?**

**Dialynas:** The PIMCO Unconstrained Bond Strategy puts PIMCO's investment process and active management skills to work in an approach that is not tethered to benchmark-specific guidelines or related tracking error limitations. Our goal for the strategy is to deliver attractive positive return and preserve capital over a full market cycle.

The unconstrained nature of our approach with this strategy allows us to adjust duration, allocate across sectors, express our global economic views and otherwise tap into our toolkit to a greater degree than benchmark-constrained strategies. As a result, we have the ability to assume more risk in areas where we have a strong positive conviction and to reduce or eliminate exposures where we see less value or heightened downside risk. Of course, the Unconstrained Bond Strategy is guided by PIMCO's long-term secular and short-term cyclical economic outlooks, our disciplined, integrated investment process and the full benefit of our broad and deep global bond market expertise.

#### **Q: For investors, what is the appeal of the Unconstrained Bond Strategy?**

**Dialynas:** The strategy is primarily for clients who are willing to grant very broad investment discretion to managers with demonstrated skill, in the interest of realizing higher alpha or risk-adjusted return potential over the long-term.

The strategy may appeal to investors who do not necessarily want their investment performance to closely track a specified bond index and those who are willing to give up relatively strict investment limitations in exchange for potentially higher returns and proactive downside risk mitigation. The Unconstrained Bond Strategy also provides a potential solution for investors who appreciate the value and diversification offered by the global fixed income markets over the long-term but prefer an approach that actively selects and adjusts the magnitude of risk exposures based on the opportunity set and

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market outlook with an absolute return goal, as opposed to a bond index-related performance objective.

We believe that PIMCO's almost four decades of experience, global fixed income expertise, long-term focus and stringent risk management culture provides us with the requisite combination of qualifications to successfully manage this type of mandate.

### **Q: What is the investment benchmark for this strategy?**

**Dialynas:** By design, the strategy is not managed relative to a specified market index benchmark – and this is an important difference between the Unconstrained Bond Strategy and traditional active fixed income mandates. The sector weights, duration and other risk exposures are likely to vary to a (much) greater degree over time when compared to traditional fixed income portfolios that are generally expected to exhibit relatively moderate and stable tracking error versus a specified market index benchmark.

However, there is a U.S. LIBOR reference point used, which is common for absolute return oriented strategies. The use of LIBOR as a reference point dovetails with the idea that, even though the goal is to generate a positive return that is not tied to a market index, a money market rate is an appropriate minimum hurdle across most periods of reasonable length, as a proxy for the theoretical risk-free investment option.

Importantly, however, the LIBOR benchmark is not intended to be indicative of the risk or other characteristics of the strategy. As such, the Lehman Aggregate Bond Index (LBAG) is specified as a secondary benchmark. While the Unconstrained Bond Strategy is not designed to track the LBAG, the LBAG may be a reasonable proxy for the downside risk exposure of the Unconstrained Bond Strategy and therefore may serve as a useful reference point in this regard.

### **Q: What types of investment strategies are employed in the Unconstrained Bond Strategy?**

**Dialynas:** The strategies employed are absolute return oriented and fixed income-based, without any material constraints specific to the global opportunity set. Portfolio construction is guided by our goal of providing investors with the traditional benefits that investors associate with the bond market – including capital preservation, liquidity and diversification – *plus* the potential for more attractive risk-adjusted returns over the long-term and active downside risk mitigation.

As the portfolio will be constructed without reference to a specified bond market index, the exposures and strategies employed are likely to vary to a considerable degree, with the specific exposures and degree of variance dependent on our views of relative value and risk across the fixed income markets globally. The additional discretion may be particularly valuable during rising rate environments as we can eliminate our interest rate exposure, or opportunistically benefit from the bond-unfriendly aspects of a rising interest rate environment, for example. Likewise, the strategy allows portfolios to opportunistically assume much greater exposure to the so-called tactical fixed income sectors or

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strategies than would be reasonably possible in a strategy that is constrained by a U.S. core bond market index.

We do expect that there will be periods of time where the Unconstrained Bond Strategy underperforms the bond market, either due to a reduced risk posture or otherwise due to our structuring the portfolio in a way that we believe to be most beneficial for investors over the long term. For the same reason, we anticipate that there will be time periods where the Unconstrained Bond Strategy exhibits either a materially higher or materially lower volatility than a core bond index reference point. As such, it is important for investors to evaluate the strategy over a three-to-five year time horizon and also to keep in mind the dual objective of providing attractive long-term return and downside risk mitigation.

**Q: What are some of the investment restrictions for the strategy and what is the reason for the restrictions, if the strategy is intended to be “unconstrained?”**

**Dialynas:** Recommended guidelines include a portfolio duration range between -3 and +8 years, with maximum high yield bond and emerging market bond holdings of 40% and 50%, respectively.

The investment guidelines for the Unconstrained Bond Strategy exist to provide a reasonable basis for investors for purposes of constructing their broader investment portfolios and asset allocations. Specifically, the limits ensure that the average quality of the portfolio is investment grade and also that the portfolio is more bond-like than equity-like in terms of the downside risk exposure, even in circumstances where the market may move against our active risk positions.

This does not mean that Unconstrained Bond Strategy portfolios will necessarily have an identical volatility to a reference bond market index in any given period (the volatility may be higher or lower). However, we do have the ability, due to the unconstrained nature of the strategy, and also the intent to provide even greater downside risk mitigation (capital preservation) than a bond market index or traditional core bond mandate over the long term.

The limits also provide reasonable assurance that the strategy will not be likely to exhibit a meaningfully positive correlation with the equity market. This is an important consideration for most investors as “traditional portfolios” – i.e., portfolios with 55-70% of the investment capital allocated to equities and 30-45% of the capital allocated to bonds – have historically exhibited an almost perfect correlation with the equity market. As such, strategies that provide material equity market risk diversification are particularly valuable.

Importantly, it is not our intent for the guidelines to signal the likely risk exposures over time. For example, while the recommended guidelines allow for up to 40% below investment grade exposure, it would not be correct to assume that the average high yield exposure will be the mid-point of the allowable range (20%). Rather, the risk exposures will depend entirely on PIMCO's active views with the sole exception of the risk exposure maximums noted, for the reason detailed above.

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**Q: How does the Unconstrained Bond Strategy fit into an asset allocation? Is it most closely related to alternative investments or to traditional core bond mandates?**

**Dialynas:** The category will likely vary from investor to investor, depending on the approach to portfolio construction employed. The Unconstrained Bond Strategy is, by design, an absolute return strategy and may be considered an alternative investment approach in the sense that the active management discretion and alpha potential is materially greater than that associated with traditional active fixed income management strategies. The strategy is also likely to provide noteworthy diversification at the portfolio level as it should not exhibit a materially positive correlation with the equity market, which is a key benefit that many associate with alternatives. However, from a downside risk perspective, the Unconstrained Bond Strategy may be most closely related to a core fixed income allocation.

No matter how the strategy is categorized, it is critical that investors understand it is a long-term approach by design which seeks downside risk protection and higher alpha potential. Over shorter time periods these objectives may seem to be in conflict; however, we believe that they should be quite complementary and beneficial for investors over the longer term.

**Q: Thank you, Chris.**

**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. 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 their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their 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. Diversification does not insure against loss. Duration is the measure of a bond's price sensitivity to interest rates and is expressed in years.

The Lehman Brothers Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. LIBOR (London Interbank Offering Rate) is the rate banks charge each other for short-term Eurodollar loans. It is not possible to invest directly in an unmanaged index.

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