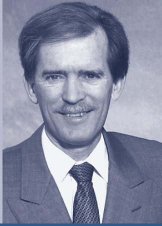


Bill
Gross

# Investment Outlook

PIMCO

March 2002

## Buffetting Corporate America

*They have healed the wound of my people lightly, saying,*
*"Peace, peace," when there is no peace.*
— Jeremiah

No one ever accused me of taking ax to cherry tree and then heading straight towards the confessional, but I've always thought that honesty was the best policy if only from the common-sensical slant of self-interest. Life's charades are ultimately exposed for all to see, and it "pays" to put the facts up front, because the repercussions of falsehoods are often fatal, whether it be by the guillotine of public opinion á la ENRON, or a death by a thousand cuts. In the investment world there are countless ways to deceive, starting I suppose with Charles Ponzi and winding all the way down to the seemingly innocuous footnote to a financial statement that hints, but doesn't really disclose what is going on. In similar fashion, public spokesmen, whether they be politicians or recognized corporate or investment personalities, often succumb to the temptation of deception on the canard of the greater good of public interest. "The economy is stable," intoned Herbert Hoover. "Stock prices have reached what looks like a permanently high plateau," proselytized Irving Fisher, but they were false prophets, promoting prosperity when there was none, crying peace when there was no peace.

A public figure cannot of course cry fire in a crowded theater, but if there be smoke, he should at least spread the word calmly and quickly. Full disclosure can be "full" without being overwhelming or panic inducing. It should, as well, be consistent and above all perpetual. All of this, as I've said can be justified if only from the standpoint of self-interest. Honesty can be the best policy simply because cheaters rarely win and when they lose, they fall hard.

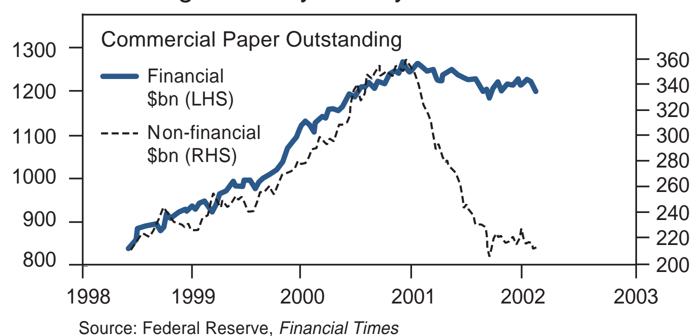
One could not find a more exemplary "Honest Abe" in the financial world than Warren Buffett. His annual reports are legend and they contain not only words of bonafide investment wisdom, but self-recrimination when deemed necessary. His value-based investment style has been what has captured the public's adoration but relatively unnoticed has been his investment structure. Buffett has built a financing machine in addition to a long-term investment portfolio, but its construction has been anything but surreptitious. He and his less well-known partner Charles Munger have reiterated time and time again in verbal dialogue and printed material about the importance of free or at least cheap "float" to their investment

performance. What Buffett and Munger have done is to utilize the long-term near 0% financing of insurance company reserves (GEICO, General Re) and to invest them in similarly long-term, higher yielding stocks and bonds. (Yes, Buffett often is a significant presence in the Treasury zero-coupon market). Berkshire Hathaway's corporate structure resembles a hedge fund from the standpoint of cheap financing but trumps the hedgies because of its relative permanence via the insurance reserve cocoon. Long Term Capital Management would have survived and indeed thrived with such an investment foundation. Instead, they relied on the repo capabilities and beneficence of the "Street," and when Wall turned against them and pulled in their lines of credit, they were literally sunk. Back to the point though – Buffett tells his public who he is and literally gives away the informational key to his castle. "Come get me if you can," he almost seems to be saying to his competition.

In stark contrast, however, has been the deceptive and in some cases, illegal information disseminated by some of our New Age corporate elite. *The Economist* in a February 23rd issue reported that the companies in the NASDAQ 100 for the first three quarters of 2001 reported combined losses to the SEC of nearly $82 billion, while at the same time promoting profits of $20 billion to their stockholders. *The Economist* explained the discrepancy by the companies' use of generally accepted accounting principles for regulators, and the distinctly more favorable New Age "pro forma" accounting for owners of their shares. Charles Ponzi would undoubtedly have approved.

Bondholders, of course, are not immune to the good times, good feel banter of modern-day corporate America. I was struck by the quote of GE Capital's Marissa Moretti in the March 14th edition of *The Wall Street Journal*. Explaining the logic behind her company's near record $11 billion offering of debt she claimed that, "absolute yields are at historic lows... so we think now is the right time to be doing an offering like this." Historic lows? Maybe three months and 100 basis points ago, but not now I'm afraid. What Ms. Moretti was trying to mask, I believe, was that the commercial paper market is quite sensitive these days and is drying up for some heretofore stellar corporate credits that are then required to fund in the longer-term credit markets.

The Age of Easy Money Ends




Source: Federal Reserve, *Financial Times*

While GE Capital enjoys the benefit of a Aaa rating, they nonetheless have commercial paper outstanding which totals three times the size of their bank lines which back them up. Normally companies which borrow in the CP market are required to have bank lines at least equal to their commercial paper, but GE Capital has been allowed to accumulate $50 billion of unbacked CP because of the lack of market discipline. By issuing $11 billion in debt, GE was sensing its vulnerability to the current mercurial opinion of analysts and managers alike, which says that any company had better clean up their act or else suffer the consequences. But Ms. Moretti put a "pro forma" face on it – "rates are historically low" she tried to convince the *Journal*. Honest Abeline, she is not.

Nor do I think, have Jack Welch and his successor Jeffrey Immelt been totally forthcoming in the explanation for why GE has been able to grow earnings at nearly 15% per year for the last several decades. The fact is that GE is a conglomerate financed by a money machine – its subsidiary GE Capital – but unlike Berkshire Hathaway, its foundation is vulnerable because its survival depends upon the confidence of outside investors. It grows earnings not so much by the brilliance of management or the diversity of their operations, as Welch and Immelt claim, but through the acquisition of companies (more than 100 companies in each of the last five years) using high-powered, high P/E multiple GE stock or cheap near Treasury Bill yielding commercial paper. In the use of that CP, GE Capital is using near hedge fund leverage of 7-8 times at what appears to be (based on its Aaa rating) non-hedge fund risk. But investor comfort and confidence these days is fragile indeed. The $11 billion debt offering was an intelligent recognition of that, but they have tens of billions of unbacked commercial paper that remain. Without the benefit of this leverage afforded to them by the Street, their operations to me resemble more closely the failed conglomerates of yesteryear such as Gulf + Western and LTV. PIMCO will own no GE commercial paper in the foreseeable future.

What would I have them do? Aren't GE and other companies making efforts to improve disclosure and to even bury investors in a deluge of statistical detail? Perhaps. But as Gretchen Morgenson of *The New York Times* reported in their March 17th Sunday edition, "it is not clear that this year's disclosure (GE's 2001 annual report) is much better than the last." And as Ms. Moretti's comment reveals, the corporation's honesty remains in doubt. GE is still no Berkshire Hathaway. I want companies to face up to their owners and yes – their creditors. I want management to focus not on their options, but on mine and that of other investors. We have the option to buy or to not buy your securities. And that option should be based not just on the increasingly revealing financial

statistics that have had to be dragged kicking and screaming out of the bowels of corporate back-offices, but on the investor friendly/investor honest/investor first attitudes of management. My fear is that this newborn faux hostility in the investment attitudes of lenders and stockholders will go the way of many other short-term jiggles in the inevitable march of capitalistic excess. I sense we are not yet "mad as hell" nor are we to the point of "not taking it anymore." But we should be. It's our money – or in the case of PIMCO – the money of our clients whom we represent. Sure it's got to go somewhere, but we should require some Buffett-like answers. Value and honesty should dominate corporate decision-making just like it does at Berkshire Hathaway.

William H. Gross
Managing Director

P I M C O

840 Newport Center Drive
P.O. Box 6430
Newport Beach, CA
92658-6430
949.720.6000

***Past performance is no guarantee of future results.*** *All data as of 2/28/02, unless otherwise noted and is subject to change. The return on both individual securities and mutual fund investments will fluctuate and the value of an investor's shares will fluctuate and may be worth more or less than original cost when redeemed. This article contains the current options of the manager and does not represent a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. This article is distributed for educational purposes and should not be considered investment advice. 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 Fund's price sensitivity expressed in years. The chart "The Age of easy Money" is not indicative of the past or future performance of any Pimco Fund. The NASDQ 100 Index is an unmanaged index that is representing 100 of the largest non-financial and non-U.S. companies listed on the National Market tier of the NASDAQ Stock Market, the Nasdaq-100 Index reflects NASDAQ's largest companies across major industry groups, including computer hardware and software, telecommunications, retail/wholesale trade and biotechnology. It is not possible to invest directly in an unmanaged index.*

*Mr. Gross is the manager of PIMCO Total Return Fund. The stock securities mentioned in the article are not holdings in the PIMCO Total Return Fund. The Fund may invest up to 20% in foreign securities, which may entail greater risk due to foreign economic and political developments. Investment in high-yield, lower-rated securities generally involves greater risk in principle than investment in higher-rated securities. Mortgage-backed securities may be sensitive to changes in prevailing interest rates, when they rise the value generally declines. There is no assurance that the private guarantors or insurers will meet their obligations. All holdings will be subject to change. PIMCO Total Return Fund's Top Ten holdings as of 12/31/01: GNMA I TBA 6.5% JAN (21.51%), FIN FUT US 30YR CBT 3/19/02 (4.86%), US TRESURY NT (3.40%), GNMA I TBA 7.00% JAN (3.81), FNMA TBA 6.0% FEB 15YR (3.11%), GNMA I TBA 8.00% JAN (2.70%), GNMA I TBA 7.50% JAN (1.86%), US TRESURY INFLAT PROTECT (1.77%), US TRESURY INFLAT PROTECTED (1.14%) and BSARM 2001-9-IA M31 WC6.67 (1.04%).*

*Each sector of the bond market entails some risk. Treasuries & Government Bonds guarantee timely repayment of interest and does not eliminate market risk, shares of the funds are not guaranteed. Mortgage-backed securities & Corporate Bonds may be sensitive to interest rates, when they rise the value generally declines and there is no assurance that private guarantors or insurers will meet principle and interest payments. Zero Coupons are sold at a discount from face value, full face value is paid only if held to maturity, and if they are sold before maturity you could realize a gain or loss based on the market value. Taxes must be paid on interest each year as if you had received the interest payment.*

***For additional details on PIMCO Funds, contact your financial advisor to receive a prospectus that contains more complete information, including changes and expenses. Please read the prospectus carefully before you invest or send money.*** *PIMCO Funds Distributors LLC, 2187 Atlantic Street, Stamford, CT 06902, 1-888-87-PIMCO, www.pimcofunds.com. An investment in a (the) fund is not a deposit of a bank and is not guaranteed or insures by the Federal Deposit Insurance Corporation or any other government agency. In addition, it is possible to lose money on investments in a (the) fund. The Morningstar Fund Manager of the Year Award winners are chosen based upon Morningstar's own research and in-depth evaluation by its senior editorial staff*. "Largest bond fund" claim is based on total net assets by FRC as of 2/8/02.*

*No part of this publication may be produced in any form, or referred to in any other publication, without express written permission. This is not a recommendation offer of any particular security, strategy or investment product, but is distributed for educational purposes. ©2002, Pacific Investment Management Company.*
*PA824.3/02*