



Shaq Attack

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A retired money manager who shall remain anonymous, confided to me on his way out the door, "I still love to invest, I just grew tired of the business of investing." Of course the considerable stack of chips he was lugging to the cashier on the way out of the casino gave him the luxury of such profundity, but he illuminated a valuable distinction. Investing and the business of investing are not always the same. Managing to an index, managing to rigorous compliance standards, managing to minimize dispersion amongst accounts, managing to outperform one's peers on a consistent yet significantly observable margin can often mean something other than exclusively employing your best "ideas." We manage a hedge fund but we are not hedge fund managers. We are bond managers in the business of investing. In contrast to my departed, disenchanted acquaintance, most of us here at PIMCO both financially and psychologically thrive within the business of investing. The money's near exorbitant, the attention and the

fame slightly intoxicating. But adding relative dollars to clients' assets is likewise rewarding. All of you here today represent vibrant corporations, foundations, retirement funds, and even governments. If we assist you, we give a boost to economic society not just by making money but by allocating it rationally and productively over time. A money manager in the business of investing is a more significant guardian of capitalism than operating on his own, if only because she manages more of the lean green upon which it depends.

It is size itself, however that can become self limiting and ultimately destructive if not addressed appropriately. Size does matter in the business of investing and one of your primary "need to know" questions from me or any other PIMCO representative at this conference is probably how can we continue performing, how can we keep on keepin' on at 300 billion dollars plus. That is a lot of responsibility and a lot of money to move around. Let me try to answer that commonsensical question which, by the way, has been asked of many of us now for the past 15 years.

It is key to address size from the critical angle of investing money. We do it in two primary ways. The first has turned out to be a more or less happy coincidence. From day one, even before we had a dime to manage, our investment philosophy revolved around long-term secular positioning. If we had begun as a trading, arbitrage-oriented firm, we couldn't have outperformed the competition as we multiplied assets under management almost geometrically. PIMCO's secular 3 – 5 year economic and investment strategy gave us the chance to grow into a giant that resembled Shaquille O'Neal – big, brawny, but with enough flexibility and agility to get it in the hoop. Remember we have to shoot the rock less than our competitors because we are oriented long-term. We've still gotta shoot straight of course – there are no slam dunks in this business, but size is no constraint on accuracy – if anything it allows us to hire and keep some of the best and the brightest in order to zero in on the target better than most.

Still, a secular orientation cannot possibly be the only weapon that PIMCO has in its arsenal that allows it to compensate for its Shaq-like size. It is not. I am here today to introduce you to, to alert you to, to reacquaint you with PIMCO's investment philosophy that is oriented around structure. Structure is the secular philosophy's twin – not identical mind you, but a twin that

suggests half and equal partner in the construction of investment strategies that are amenable to large money management firms. Yet few large managers, if any, besides PIMCO make use of it. Although I haven't made the grand rounds of the manager universe as most of you have, I suspect that we are near unique in this emphasis on structure. Like the casino's edge at the craps or blackjack table, it is what gives us the odds at winning in almost every year we choose to compete. Successful investors and investment firms, especially large ones, need to depend upon more than strategy, even if it is long term. There are just too many opportunities to be wrong and when the errors pile up, an investment franchise is at risk since clients usually only extend three or four years of rope with which to hang yourself.

In addition to strategy, then, an investor or an investment firm must have a successful investment structure. I refer here, not to an organization chart or to the number of international offices a company has but to the foundation upon which its strategies are laid. I refer to long lasting principles be they financially or psychologically oriented which persist under most economic scenarios for decades at a time. “Borrow short, lend long” is a financial structure upon which the entire banking industry is laid. “Borrow at the risk free rate, lend riskier” is

another. These structures of course can be taken to the extreme and therefore to ruin, but the savings industry as a whole has been able to “bank” on them for centuries now. The modern invention of hedge funds depends on similar structures: they are unregulated banks in disguise, borrowing short/risk-free and investing in riskier long-term investments, which offer much higher returns. The insurance industry has a structure as well, which allows it to borrow at a near risk-free rate but with longer-term liabilities in the form of mandatory reserves. They in turn invest long-term and “riskier,” but because of the long-term nature of their liabilities, they exhibit more stability than their banking or hedge fund counterparts. This industry’s structure has formed the foundation for success for none other than Warren Buffett and companies such as Cincinnati Financial, which have used their low interest rate reserves to invest in long-term equities at what has amounted to a huge spread.

PIMCO has relied on different but similarly successful structures. Our most obvious and well-known one is the “Bonds +” structure, which later morphed into a specific product labeled by us as “StocksPLUS.” Guess we like those “+” sounding structures. They have been more than additive to our clients’ bottom lines over many years now. Both products involve the use of financial futures or future

related investments and the successful employment of the residual cash into higher yielding, slightly longer dated investments. As with banks, we borrow short at nearly the risk-free rate and lend slightly longer, but unlike banks our quality tends to be much higher – Aa+ on average. Actually, by employing futures, mortgage rolls, and swaps PIMCO is not actually borrowing money but investing in bond-like assets that reflect slightly less than risk-free/LIBOR-based financing rates. Because they absorb little actual cash, the “reserves” or “float” as Buffett would call them, are free to be invested in 6-12 month higher yielding paper with yield pickups of 50 basis points or more and near Aaa quality. It is this 50 basis point spread that provides a “structural” advantage to our bond and S&P Index portfolios under almost all yield curve scenarios save that of an extended negative yield curve à la 1979-81. If we use a 40% combination of Treasury futures, mortgage forwards, and swaps in our portfolios, our performance is enhanced by $(.40 \times .50)$ or 20 basis points a year without even breathing hard.

Our second primary structure involves the selling of unlevered volatility. I say unlevered from the outset because it was the selling of levered volatility, which was a primary structure of Long Term Capital Management. While strategies based upon the sale of volatility made sense for LTCM

just as they do at PIMCO, LTCM's massive leverage and vulnerability to financing sources made for a potent and deadly mix. We are not a hedge fund (although PIMCO manages a small one for interested clients) and therefore are not hedge fund vulnerable to financing sources, which helped pull the plug on LTCM.

But the sale of unlevered volatility has been a fundamental part of PIMCO's structure for years now. A recent speech by undersecretary of the Treasury and potential Greenspan successor Peter Fisher suggested what I have been outlining for the past few pages: "Market structure matters," he said and the price involved in the buying/selling of volatility can be an inherent part of that structure. Indeed it can be. We outlined this to clients in print as early as 1988, in an *Investment Outlook* entitled "Selling the Noise," an *Outlook* later elaborated on in detail in my book published in 1997 and my newest book distributed to you on your arrival. In addition to the "noise" content of volatility that allows for overpricing, there are other inherent features of volatility based option prices which lead to structural overvaluation and therefore to profitable structural sales. "Two major players hold positions," Fisher says "that require the rest of the market systematically to be short volatility. One is the Federal government and the other is the American homeowner

through the mortgage market." Fisher's statement turned upside down with a PIMCO slant tacked on says that since the U.S. government and homeowner are systematic buyers of volatility with little recognition of the price which they are paying, then others can profit structurally by taking the other side of the bet.

How does one get in line to do this? First of all it can be done by owning a disproportionately large percentage of mortgages relative to an index. Owning a mortgage is nearly the same thing as owning an Agency Note and selling the attached prepayment option to the individual homeowner. It results in a higher yield while carrying the risk of prepayment, or conversely duration extension, at exactly the wrong times in the interest rate cycle. While Fisher argued in his speech that the mortgage volatility market was not necessarily "complete with regard to pricing discovery," PIMCO feels even more strongly that historical returns as well as sociological factors involved in the pricing of the mortgage "option" overwhelmingly favor the holder of the mortgage-backed security and therefore the explicit seller of prepayment options. Long-term performance numbers for mortgages vs. straight Agencies, for instance, favor mortgages over almost any five-year or longer time period since the origination of the GNMA pass-through in the mid-1970s. The

mis/overpricing of the prepayment option is the fundamental explanation. The American homeowner, it appears, knows little about the worth of his prepayment option yet is more than willing to pay for it via higher interest rates. The opportunity to prepay seems to be an inherent component of an American homeowner's cultural ethic. No amount of massive buying on the part of PIMCO or the Agencies themselves over the past decade or so seems to have "arbed" away the overpricing of this option. Over the years, our overweighting of mortgages has added perhaps 10 basis points annually to performance.

Volatility can be sold in other forms as well. PIMCO executes explicit sales of put and call options on Treasury futures and swaps in order to add incremental return to clients' portfolios. Typically 10% of the notional value of permitting portfolios are optioned via "out of the money strangles" at any point in time during the year. The logic here, in contrast to the fleecing of the 30-year mortgagee, has to do not only with selling the "noise" which exaggerates volatility, but with "reversion to the mean" and "lottery ticket" principles long established in psychology, sociology, and history text books. This is not to say that markets always revert to the mean or that lottery tickets never hit the big one, but the odds favor option sellers as opposed to option buyers. In

contrast, option pricing in these markets follows the random walk theology of academicians, as opposed to the real-world, real-time experience of astute portfolio managers. We estimate that these option sales add between 5-10 basis points of performance annually.

But before I leave this topic of structural investing, let me use a poker analogy to sum up what I hope you've heard over the past few minutes. Warren Buffett is fond of saying that if you sit down at a poker table and you can't look around and find the fish, then you be the fish. The same thing should apply in investing although in this day and age it would be unwise to assume that any investor, especially any institutional one, is a fish. If WAMCO, Blackrock, and other formidable bond shops be fish, then they be sharks just like PIMCO. Still from a structural standpoint, there may be market participants that due to their inherent character or role that they play, provide profits to structural investors taking the other side of the bet. Those fish, as I've been explaining over the past few minutes, are probably most easily identified as (1) the American homeowner and (2) the investor in short-term cash and money markets that requires near overnight liquidity and perpetual overnight peace of mind. These are the fish that our "Bonds +" and volatility sales programs depend upon and which

form the schools of structural plankton upon which mighty whales depend.

In sum, the industry wide strategy known as “Core +” has a rather unique interpretation when viewed from PIMCO’s eyes. Instead of a disguised form of “yield tilt” which many managers employed to their dismay in 2002, PIMCO’s “Core +” rests on a more stable foundation, employing long-term secular strategizing and near perpetual structural positioning to outperform. In term of Buffett’s poker analogy, it is a marvelous hand – aces full – and we intend to bet it for as long as the environment and you, the client, allow.

I close with a cautionary admission and admonition, much I suppose, like Dwight Eisenhower’s final speech that warned of the dangers of an industrial/military complex in the United States. That by the way is not a commercial or a lead-in to anything other than to suggest that large countries and big companies have a duty to look inward in a perennial self examination in order to ensure not only their ethics but their survival. By so doing they hopefully secure their rank in the grand scheme of things, such as they are. To illustrate how such inward investigations apply to companies, I cite the words of Fox News Chairman Roger Ailes when he said, “It is five times harder to be No. 1 than it is No. 2. That’s because success brings big egos, limousines, expense accounts and

a tendency to sit around congratulating one another.” PIMCO can be no different in terms of its susceptibility to the disease of size and success. We have our egos and if not limousines, our fancy automobiles. The garage underneath our offices resembles a new car dealership. Still there should be nothing wrong with driving a car with aromatic leather as long as a substantial tithe is directed to those less fortunate. And there should be nothing wrong with feeling good about yourself and proud of your firm as long as that exuberance doesn’t – in those famous adjectives – become “excessive” or “irrational.” Because irrational exuberance in the case of companies and human beings can be identified at the moment they occur, even if according to Alan Greenspan – they cannot be known with certainty in the financial markets. The signs of PIMCO’s corporate irrational exuberance that will be obvious to me are as follows: 1) an impulse to conserve and protect instead of grow – or conversely an obsessive concern for – the bottom line which results in diverging from our investment philosophy; 2) a failure to remember who we are really working for and a growing tendency to turn a deaf ear to client’s concerns and requirements; and 3) an inattention to our bond market stewardship role and its inherent responsibility that we have begun to assume as part guardians of our economic society. These are some of the signs to look for in gauging the

beginnings of hegemonic decay at PIMCO. It will not be size itself that brings down this firm. It will be the accoutrements and trappings of size. It will be the assumed privileges of the rank and station of belonging to one of the best and most successful money management firms this country has ever known. PIMCO is less likely to explode externally from the ingestion of too many assets than it is to implode internally from a self induced ulcer. As Midwestern boys with the fear of failure branded indelibly inside our skulls, Bill Thompson and I pledge to you our best efforts to remember our roots while we drive home to the beach in our shiny new cars.

And oh yeah – for those of you who sat down expecting an Investment Outlook, I will satisfy, because you after all are the reason we're here. Perhaps one phrase says it all – the rest of the conference will be spent reinforcing it – and that phrase is as follows:

“The salad days are over.”

Although the global economy is wallowing in the aftermath of bubbles, trade deficit imbalances, and anemic demand in Europe and Japan, government yields worldwide are close to rock bottom. The phrase, “the salad days are over” really means that capital gains that formed a goodly portion of the past two decades total returns, have

run out of room to appreciate. Coupon clipping is for now the order of the day, and should current reflationary efforts take hold, price protection will be the order of tomorrow.

Hopefully 30 years from now, my salad days requiem will be applied to the bond market and not to PIMCO. We can avoid that fate if we remember that there are no larger than life figures here despite the big screen behind me and the recent Barron's cover of yours truly. That cover by the way was sort of apropos because it was a caricature, a cartoon. It hopefully suggested that we can be poked fun at or certainly criticized if need be.

Please let me or any of us know if we're starting to believe our own headlines and not listening with our ear to the ground. Until then, let me leave you the client and all of you PIMCO professionals with a rallying cry and a formidable objective:

30 more years!

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