Bill
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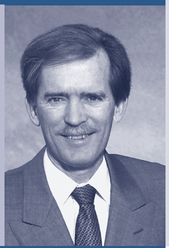


Investment Outlook

PIMCO

October 2001

Buying and Selling Hope

All the interest of my reason comes together
in the following three questions:
(1) What can I know?
(2) What ought I to do?
(3) What may I hope?

Immanuel Kant
Critique of Pure Reason

Some twenty years ago I was summoned to sing for my supper at a seminar held by a large East Coast institutional client. Surrounded by eight or nine fellow money managers at a rectangular dining room table, we were asked en masse what the most important thing our respective firms "sold." It was a strange but remarkably intuitive question and it threw most of the managers for a quick loop from which they – being the "salesmen" that they were – immediately recovered and began pontificating on the strengths of their various firms. The first opined that his company was selling research and the ability to pick and choose between stocks and market sectors. Another pointed to his people, their experience, and the prospects for continuity in future years. International contacts were mentioned by one, as was the inevitable reference to quantitative modeling. Finally, and exasperatingly it was my turn. All of the good and seemingly obvious things had been mentioned by the eight equity managers who had spoken before me. It seemed there was nothing left that a poor bond guy could have for "sale" that could be anything other than redundant. Bonds in 1981 were an afterthought in everyone's minds anyway, and here I was, the caboose behind an equity train of brilliant strategists, who had managed to steal my thunder before I had even a chance to speak. I thought quickly however, and irreverently as is my wont, and spewed forth the shocker of the night, at least as far as yours truly was concerned: "We're all selling hope," I said. That was it. Like a nightclub comedian, I paused just long enough to let the words sink in and to allow the audience to react, if only with their eyes, which were sending signals of disbelief if not betrayal. Ten years from now, I continued, very few of us will be sitting at this same table, if only because we'll have been replaced. Your research, I said pointing to one manager, and your quantitative models, pointing to another, are probably good but no better than anyone else's in this business. If so, then sometime in the future you'll hit an unlucky three year performance patch just like the recent lucky one that has you seated here tonight – and you'll be gone. Or perhaps it will be me – although like you – I prefer to think of myself as above instead of within the pack. And what will our host have to show for it all? Market performance, less exorbitant fees – that's what. Ten years from now, he or his successor will be sitting at this same table asking a similar question, except it should be one that he turns around on himself. "What am I buying?" should be his (and other investor's) primary query when it comes to their money managers. "What am I paying for? Am I receiving good value?" No, will be the likely conclusion. There are very few customers' yachts, you see. You're buying, we're selling – hope: come and get it.

Well that speech was a tad strong I suppose. Only P.T. Barnum could insult a client and get away with it, although 20 years later, that East Coast dinner client is still a treasured PIMCO customer. Value in the form of performance, not "salesmanship" must be the explanation. Seems PIMCO at least, has been selling more than hope for sometime now. Still, any investor, anytime must ask the question "What am I buying?" – not just in relation to the money manager but to the investments themselves. Am I buying hope or am I buying value? That question is especially important in the wake of the September 11th attacks, because it's only natural to combine patriotism, with hope for a better tomorrow, and come to incorrect conclusions about valuations. But when it comes to investing, it pays to use one's head instead of one's heart. The heart should be responsible for writing a check to the Red Cross to assist surviving families in NYC, Washington D.C. and those killed in Pennsylvania. The head should be in charge of deciding whether bonds or stocks make sense at today's prices in an increasingly risky global economic and sociopolitical environment. To me, Fidelity's recent TV ad using hall of fame manager Peter Lynch falls under the category of using your heart instead of your head. "Betting against America has been a bad bet in the past," Mr. Lynch intones, "it will be a bad bet in the future." Well yes I think that too, but there is a rational price for every bet, and an investor will be a sucker every time if he pays too high a one. The question is not whether we should bet on America but in which markets and at what price we should place our bets; because stocks, as well as bonds, are not always fairly valued, especially in an environment of increasing risk.

Well hopefully this has been an honest, open, and not too mean-spirited entrée to answering that critical question posed in last month's *Investment Outlook*: What should we buy now and what is the proper price for hope? – especially in the aftermath of the attacks, and in anticipation of perhaps more horror to come. Eighteenth century philosopher Immanuel Kant wrote in his Critique of Pure Reason some sage advice for any investor, quoted at the beginning of this piece. His questions, at least for today will be my questions, beginning with...

1) What can I know?

I know several things. I know that in the early part of September the U.S. economy was already in recession, suffering from post bubble syndrome that inhibited business investment, led to rising unemployment and weakness in consumer spending. In the aftermath of September 11th, these trends accelerated to the downside as our travel declined by 20-30% and associated industries such as hotels, car rental, and restaurants suffered from American's more somber attitudes and increasing caution. I am not sure how long this behavior will continue, but we are monitoring it daily. If it does persist, recovery will be postponed deep into 2002.

I know President Bush and other government officials believe this war will be a long lasting one requiring sacrifices from all Americans.

I know that the monetary spigot has been opened wide and that the fiscal lock box has been broken into. In past recessions, low interest rates and deficit spending have ultimately led to economic recoveries, although the timing and strength of those recoveries has varied. The 1990/91 recession was followed by several years of anemic growth, for instance, while the recovery following 1979/81's recession was sharper when it got going.

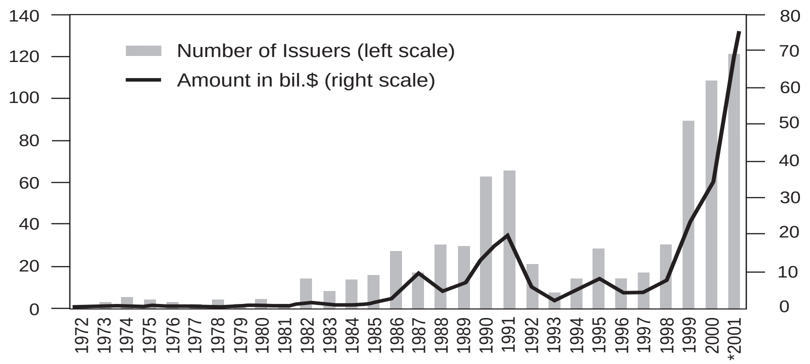
I know that since September 11th the financial environment has become increasingly risky. That must be so, if only because this war is being fought partially on American soil. Terrorism in the air followed by sporadic biological warfare incidents must change consumer and business investment behavior in at least some ways, and those changes almost assuredly will lead to increasing risk premiums – not just for planes and tall buildings, but for financial assets as well.

I know that significant secular trends involving globalization and privatization are at risk of slowing down or even reversing. In the long run, our willingness to expand trade and penetrate foreign markets will crucially determine future economic growth rates and price levels for stocks and interest rates. In turn, the re-ignition of faith in the public as opposed to the private sector to solve many of our future problems will influence deficits, productivity, currency levels, and a myriad of other markets which have grown used to our New Age Economy and its emphasis on individual as opposed to public initiatives. Although I have no definitive answers at this moment, I know that the questions of "wither globalization and privatization?" are two of the biggest questions to ask in future months and years.

2) What ought I to do?

In an environment of increasing economic/financial risk, PIMCO's stance will focus first on protection of principal and secondarily on increasing return. Granted, as Lynch suggests, it has never paid to bet against America, but the current war introduces new variables that will likely change asset relationships for years to come. High yield/corporate spreads, emerging market yields, and the level and shape of the Treasury curve are currently in the process of transformation. High yield interest rates are increasing as the level of corporate bankruptcies accelerates as shown in the chart on the following page. Emerging market debt is being dragged

Global Rated Corporate Bond Defaults



* through October 10, 2001

Source: Standard & Poor's Global Fixed Income Research

down in price by an imminent default in Argentina and perhaps Turkey. The level of long term Treasury yields and short term as well are supersensitive to government trends in fiscal and monetary stimulation.

Victory generally belongs to the risk takers, but a risk taker must pick his spots and his price. Prices are not right at the moment for taking big chances either in bonds or in stocks. We are in the culminating phase of a 20-year Treasury bond bull market with 2-year yields at $2\frac{3}{4}\%$ and 10-year yields at $4\frac{1}{2}\%$. Should an investor risk principal loss for such paltry returns? Hardly. Should a risk averse investor grab for Baa and junk bond yields in an environment where corporate profits are at risk? Hardly. Should that same investor plunge back into the stock market on the basis of prices at "bargain" levels which still reflect P/E ratios of 30x? No, even less so.

Well that doesn't leave much does it? No, bear markets provide few attractive choices. For now, PIMCO will stress high quality, close to market durations, and a healthy dose of European sovereign credits. And if I were a stock investor, I would stress even healthier concentrations of cash.

3) What may I hope?

As my prelude suggested, yours truly and PIMCO are not in the business of selling hope nor in paying too high a price for it on your behalf. We will mourn with you, fight side by side with you, but we suggest you keep your head and wits about you when it comes to investing your money. I <u>hope</u> that America comes back from its current recession quicker than ever. I <u>hope</u> our current war against terrorism is won and won decisively. I <u>hope</u> the American initiatives promoting globalization and privatization are not halted or reversed. But I have serious questions about all of these "hopes" and more. "All the interest of my reason," as perhaps that of Immanuel Kant were he a 21st century investor, suggests the ascendancy of caution, not hope, and the protection of principal at the expense of return.

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