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Uncertain Markets Call for Flexible Investment Strategies



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Recent dislocations in the fixed income markets brought on by political, economic and social changes are likely to persist for the next few years. During this period of prolonged uncertainty – which PIMCO calls the New Normal – bond strategies that avoid the structural biases of many traditional fixed income benchmarks or have the flexibility to take significant deviations from their benchmarks could prove especially beneficial.

Sovereign interest rates are currently at historic lows, and it is likely that the government components of many fixed income benchmarks will become larger as developed nations, hobbled by the financial crisis and recession, continue to issue massive amounts of debt. Indexes with higher duration, or sensitivity to interest rates, are particularly likely to underperform investment strategies that can maintain lower duration if interest rates begin to rise. So the ability to manage duration more actively could be a key to portfolio returns.

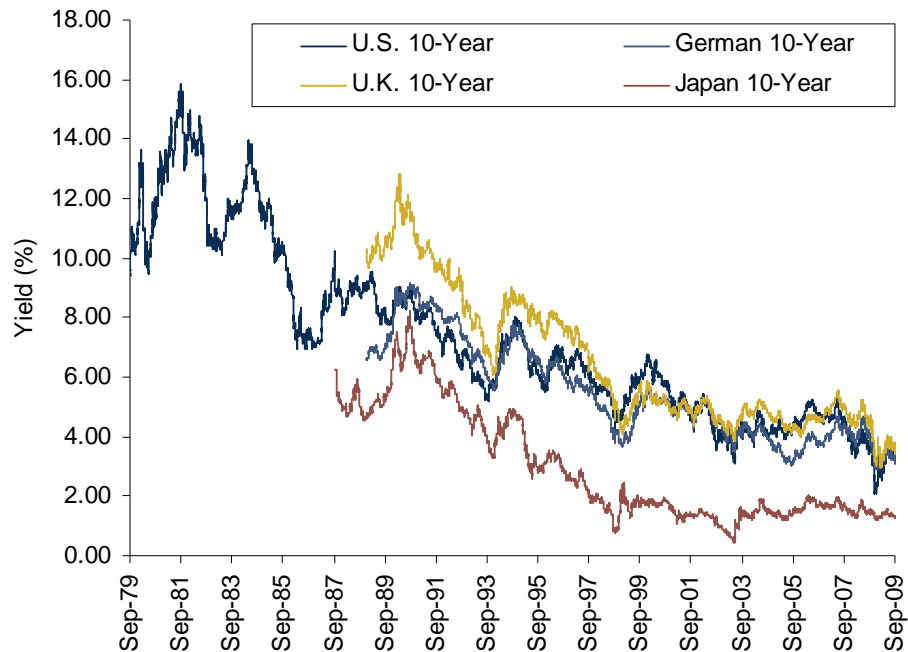
The dramatic shifts that PIMCO expects in the global economy in the New Normal mean the potential for flexibility in a portfolio could be more important than ever. Slower growth and higher unemployment in developed countries alongside stronger steady growth in the emerging market countries that have balanced financial and economic conditions suggest more opportunities in emerging market investments. Financial sector consolidation, increased government presence in the private sector and potential for policy mistakes make it vital to account for the increased differentiation in regions and sectors. It will be increasingly important to have the resources and flexibility identify the “winners” and “losers.” All of this has important implications for the structure of portfolios.

Current interest rates globally are low relative to those of the last 30 years. Chart 1 highlights this general progression of falling yields on government bonds over the last few decades; 10-year yields across most developed economies are now in the 3%–4% range and lower in Japan.

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Historical Yields on 10-Year Government Bonds



Source: Bloomberg

Chart 1

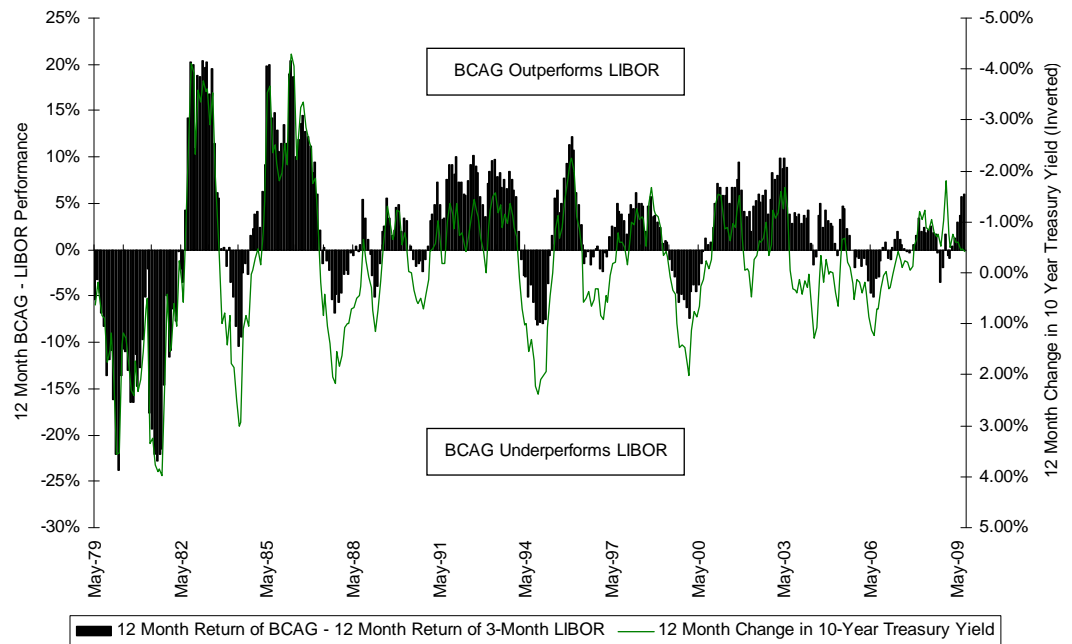
This trend indicates the potential for future capital gains could be limited relative to historical experience. (Many investors had benefited from robust returns on their fixed income assets as Paul Volcker's inflation-fighting policies took hold, driving down yields and pushing up bond prices.) Also, high index allocations to low-yielding government bonds provide less income for investors, which may not be sufficient to offset the capital losses that rising rates can pose for those same bonds.

Additionally, in an environment where benchmark interest rates are historically low, and therefore have more potential to rise than to fall further, portfolios that have a benchmark with significant positive duration as well as limited discretion to deviate from that benchmark may underperform portfolios that have benchmarks with less sensitivity to interest rates or that are not constrained by a benchmark. As shown in Chart 2, over the past 30 years, the performance differential between the Barclays Capital U.S. Aggregate Index (which has significant duration) and three-month LIBOR (which has very low duration) is highly correlated to changes in the overall level of interest rates. In 12-month periods where the 10-year U.S. Treasury yield fell, typically the Barclays Capital Aggregate Index would outperform three-month LIBOR (and vice versa). The correlation

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of U.S. Treasury yield changes and the performance differential between these two indexes was 0.95 over this time period – indicating a strong relationship.

Performance Differential of Barclays Capital U.S. Aggregate and LIBOR



Source: Barclays Capital, Bloomberg

Chart 2

If investors believe (1) lower current yields will provide a reduced income offset to mark-to-market principal losses if rates rise and (2) the potential for changes in yields is asymmetrical toward higher rates (given current rate levels as well as PIMCO’s long-term outlook), then duration should be more actively managed than in years past. Managers with flexibility to broadly adjust duration, including the ability to be short duration exposure if necessary, may have the potential to outperform managers that lack that discretion.

Meanwhile, the percentage of low-yielding government bonds in most index portfolios is expected to rise significantly as sovereigns issue massive amounts of debt to pay for fiscal stimulus programs. These government efforts are almost startling: Outstanding U.S. Treasuries increased by US\$713 billion in 2008 (an increase of 16.9% year-over-year), and the U.K. gilt market grew by the equivalent of US\$220 billion in 2008, an explosive year-over-year increase of 37.6% (source: Merrill Lynch Bond Index Almanac). Government debt already constitutes a substantial part of most broad fixed income benchmarks, and its share is likely to continue to increase. Chart 3 highlights how many

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investment grade benchmarks, and particularly those outside of the U.S., already exhibit a material tilt toward sovereign risk.

Percentage of Government Debt in Major Barclays Capital Indexes

Index Breakdown as of 9/30/2009	U.S. Aggregate	Euro Aggregate	Sterling Aggregate	Japan Aggregate	Global Aggregate
Government¹	39%	70%	73%	94%	64%
Corporate	19%	18%	24%	6%	16%
Securitized	42%	12%	3%	0%	19%
Total	100%	100%	100%	100%	100%

Source: Barclays Capital

¹ Government includes both direct sovereign debt and government-related debt.

Chart 3

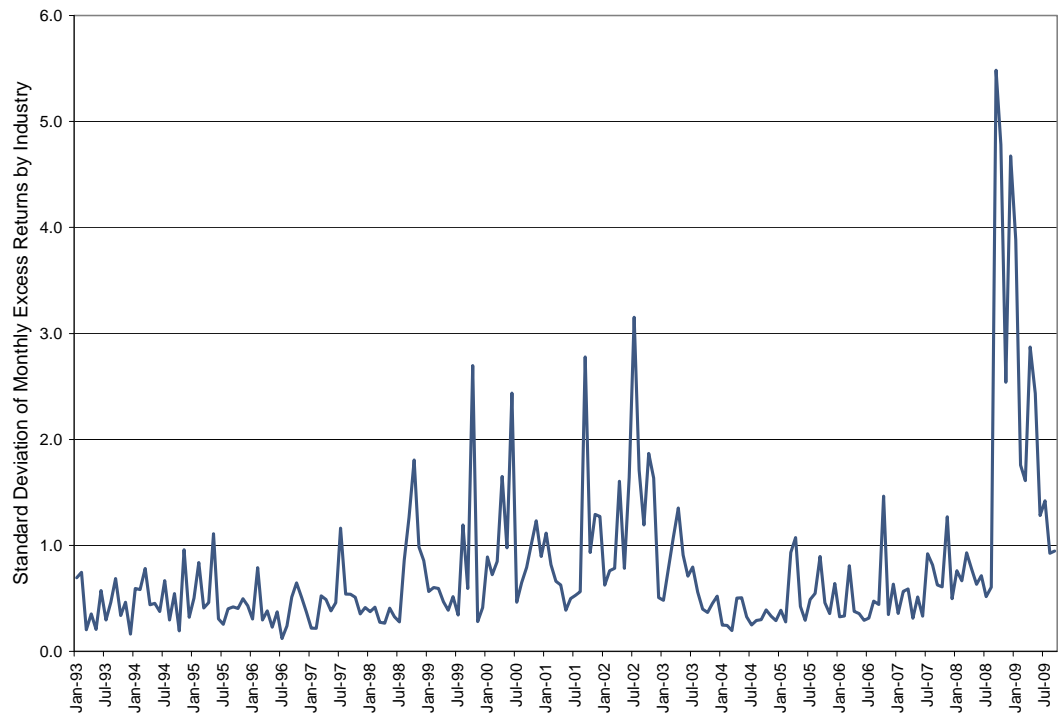
The financial crisis has also increased the differentiation between market “winners” and “losers.” This would be expected in the direct aftermath of the Lehman Brothers bankruptcy, yet it appears to be a continuing reality: Chart 4 highlights the standard deviation of monthly returns across the 27 corporate industries in the Barclays Capital U.S. Aggregate Index going back to 1993 and indicates how large the dispersion has become among the various industries. The spike in the standard deviation illustrates the dramatic difference in returns that we are now seeing across the different industries that previously had more closely related returns. For example, if industrials, financials and utilities all rise, but they rise by the same amount, the standard deviation is 0. Likewise, if those same three industries fell, but, again, they all fell by same amount, the standard deviation is 0. However, if financials fall by 5% while industrials rise by 1% and utilities rise by 3%, the standard deviation between industries rises to 4.2%. In the third scenario, having a manager with discretion could make a big difference.

Since September 2008, returns have varied dramatically – not just across asset classes, but also among industries, issuers and, in fact, even cash and synthetic securities from the same issuer – to an extent not seen in the last 15 years. Moreover, the increasing involvement of regulators and governments in financial markets makes it likely that this differentiation will continue. For example, the automotive industry and the banking sector are highly dependent on government policy and political decisions. This is compounded by the current economic situation, with tepid growth across developed economies squeezing corporate profitability and challenging business models. In this environment, the ability to both identify who will be the winners and losers and to move easily between them as they shift over time will be vital to maintaining capital and achieving desired returns.

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Standard Deviation Between the Returns of Each of the 27 Industry Sectors of the Barclays Capital U.S. Aggregate



Source: Barclays Capital

Chart 4

All these factors have some investors concerned about portfolios managed with very tight tracking errors against traditional fixed income benchmarks. In a market where capital gains and protection against rising rates are constrained due to relatively low sovereign yields and where many traditional benchmarks offer a substantial and potentially growing bias toward sovereign risk, a different approach has the potential to be highly beneficial: an approach that is unconstrained by individual benchmark limitations, one that targets a risk profile commensurate with a global fixed income benchmark but isn't forced in the direction of its biases – duration risk, sector or individual issuer exposure or country risk. Of course, if investors relax portfolio guidelines for a manager that is not equipped to navigate the complex and dynamic global economy in the New Normal, performance could be challenged by all of the very same issues. However, with the right guidance, this “untethered” approach may not only help investors avoid unattractive risk inherent in benchmark-constrained strategies, but should also provide the agility to shift across sectors tactically and strategically as conditions in the economy and the markets evolve.

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The 3-Month LIBOR (London Interbank Offered Rate) Index is an average interest rate, determined by the British Bankers Association, that banks charge one another for the use of short-term money (3 months) in England's Eurodollar market. Barclays Capital Global Aggregate Index provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian Government securities, and USD investment grade 144A securities. Prior to November 1, 2008, this index was published by Lehman Brothers. It is not possible to invest directly in an unmanaged index.

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