

Product Focus

February 2006

Curtis Mewbourne Discusses Portfolio Strategy for Diversified Income



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Mr. Mewbourne is a portfolio manager and a senior member of PIMCO's portfolio management and strategy groups. He manages fixed income assets across a wide range of Total Return and Credit strategies. Mr. Mewbourne has over 14 years of trading experience in credit markets. He began his career in finance at Lehman Brothers in the early 1990s as a market maker for Emerging Market debt. Prior to joining PIMCO in 1999, Mr. Mewbourne ran Salomon Brothers Emerging Market trading desk in London. Mr. Mewbourne holds an Engineering degree in Computer Science from the University of Pennsylvania.

PIMCO's Diversified Income strategy, introduced in 2003, aims to provide diversified credit exposure by investing in three sectors: emerging markets, high yield and investment-grade corporate bonds. We recently spoke with Portfolio Manager Curtis Mewbourne about current portfolio strategy.

Q. Diversified Income invests in a combination of emerging markets, global high yield corporate bonds and global investment-grade corporate bonds. Which sector(s) do you favor right now and why?

Mewbourne: We currently favor emerging markets over high yield and investment-grade corporate bonds, based on the strong trend in improving credit quality in many of the countries within the emerging market asset class.

Across the investment-grade, high yield, and emerging markets spectrum, we're at a point in the credit cycle where fundamentals are very strong. In the investment-grade asset class, cash balances are as high as they've been in 20 years, and we've seen 12 quarters of record, double-digit profit and earnings growth. Corporate profits as a percentage of GDP are the highest they've been in 20 years.

It's a very similar story in emerging markets. Many countries are benefiting from demand out of China and Asia for commodity exports, and as a result, they have built up large foreign exchange reserve balances and have been paying off their debt to multi-laterals such as the Paris Club and IMF, and/or to the external markets.

The trend in emerging markets, however, is one of *continued* improvement as the asset class follows a secular maturation process. By contrast, the high yield and investment-grade corporate bond markets are more cyclical in nature, and therefore while credit fundamentals are quite strong now, we don't expect to see much further improvement from here and in some sectors, we may even see a downturn in the credit cycle.

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Q: It is interesting that you are expecting a potential divergence in the performance of emerging markets and high yield bonds over the next year. What is your view on high yield specifically?

Mewbourne: At the asset allocation level, the Diversified Income strategy has been roughly neutral to a slight underweight in high yield lately. That decision is based on a short-term view that high yield will have lower-than-normal returns during the first and second quarters of this year due to a pick-up in new issuance activity and the potential for higher defaults.

That said, within high yield, there are certainly several sectors that we favor. For example, given very high commodity prices currently, we like the energy sector—in particular, some of the exploration and production companies and pipelines. We also like some of the telecom companies that are significantly reducing their leverage. So there are areas within high yield that we think may offer good returns for the risk involved, but our allocation to high yield as an asset class remains neutral to underweight.

Q: Have there been any changes to the asset allocation in Diversified Income over the past year?

Mewbourne: On a structural basis, our positioning now is fairly consistent with what it's been over the past two years, and that positioning has worked quite well for us. We have been overweight emerging markets as the strong improvement in credit quality has progressed. We've been roughly neutral to slightly overweight high yield over the last two years so there has been a bit of an adjustment there. In investment-grade credit, we've been underweight for the past two years because we thought the investment opportunities were better within the high yield and emerging market sectors.

In addition to our broad, structural asset allocation, we always attempt to adjust portfolios tactically to take advantage of opportunities within a certain market or relative valuation changes across the markets. Tactical adjustments are typically in the 1%-2% range. Our decision to reduce our high yield holdings to neutral or a slight underweight is an example of a tactical allocation adjustment.

Q: How do you decide on these tactical adjustments?

Mewbourne: The tactical asset allocation decisions are all based on PIMCO's investment process—the same firm-wide investment process that all portfolio managers, including the individual credit teams, are using as their framework. So the asset allocation within Diversified Income is consistent with our overweights and underweights in our other strategies. Our Total Return strategy, for example, currently overweights emerging markets and underweights investment-grade credits and has been reducing its high yield allocation toward a neutral position. That's entirely consistent with the way that we're running the Diversified Income strategy.

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Q: How does a strategy that takes tactical and structural allocations to three different sectors fit into a broader fixed-income portfolio?

Mewbourne: Diversified Income is a way to take credit exposure instead of government bond exposure.

In general, investors should think about diversifying into sectors where returns are not correlated with government bond rates. Diversified Income can complement the existing allocation that clients may have to more traditional fixed-income segments. For investors who think global economic growth will remain reasonably strong, investing in emerging markets, high yield and investment-grade bonds can also offer more upside potential than government bonds.

Q: The Diversified Income strategy was introduced in 2003. Looking back over the past two-plus years, are you pleased with how the strategy is doing?

Mewbourne: We are extremely pleased with the way the performance has played out.

Q: How diverse is a typical portfolio? How many bonds and how many issuers might the strategy invest in?

Mewbourne: We typically hold between 500 and 600 different bonds in a portfolio from 250-300 different credits, or issuers, in over 40 countries. The strategy is truly diversified on a country-by-country basis, a regional basis, and an industry/sector basis.

We are even diversified in terms of credit ratings. We attempt to maintain the strategy with an average credit quality of a strong triple-B, so an overall investment-grade rating, with a distribution across the different rating categories, from triple-A to single-B and below.

Q: You have recently taken on full responsibility as portfolio manager for Diversified Income, as Mohamed El-Erian prepares to leave PIMCO. What is involved in the transition?

Mewbourne: Because I've been involved with the strategy from its inception, the transition is a very natural one.

When clients came to PIMCO looking for a globally diversified credit portfolio back in 2001 and 2002, Mohamed and I worked closely together on the development of the Diversified Income strategy. I helped design the strategy and write the investment guidelines. Since the strategy's launch, I have managed the majority of the Diversified Income portfolios for clients in Europe and Asia, while Mohamed was the primary portfolio manager on the portfolios in the U.S.

Mohamed's departure is a big loss for PIMCO, but so far, we feel the transition has been smooth.

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Singapore

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