

Secular Forum

May 2007

PIMCO's Secular Forum: Looking Beyond the Business Cycle

"The Forum is the soul of our investment philosophy: a long-term orientation, above and beyond the business cycle, aimed at identifying the powerful, even if glacially-slow, structural changes that will shape the fate of economies and markets."

-Paul McCulley, PIMCO Managing Director

In the day-to-day world of investing, the fundamental trends that drive financial markets for years at a time are often overlooked in the rush to assimilate shorter-term news and events that temporarily sway markets from their underlying value.

At PIMCO, understanding these secular, or long-term trends is the foundation of our investment strategy. We go to great lengths to identify economic, political and social forces that will influence interest rates and financial markets over the next three to five years, both within individual countries and globally. Examples of secular trends that have framed PIMCO's investment strategy in recent years include:

- Globalization and its effect on pricing power and competition
- Technological advancements and their effect on productivity
- Government and defence expenditures and how they influence inflation
- Demographics and the aging of the baby boomer generation
- Financial engineering and its impact on the economy and the corporate sector

We believe that focusing on secular trends offers the greatest opportunity to add value relative to the overall market, which is largely preoccupied with pricing in short-term factors and considerably less mindful of long-term trends. By maintaining a disciplined focus on our secular views, we are better able to identify long-term value and prevent our trading decisions from being overly influenced by emotion and short-term market sentiment.

Our process for identifying secular trends is the annual Secular Forum. Every year, our investment professionals from around the world gather with industry experts for a three-day discussion about the future of the global economy and financial markets. The goal of the Secular Forum is to look beyond the current business cycle and determine how secular forces could play out over the next three to five years.

The 2007 Secular Forum Agenda

The Secular Forum typically begins with presentations by our guest speakers. Guest speakers at previous Secular Forums have included Nobel Laureate economists, policymakers, regulators, demographers, historians and commodity experts. Our purpose in inviting these outside experts is to inject new thinking into our process and avoid institutionalizing our views on some of the long-term themes that run consistently through our forums. We also invite specialists to enhance our understanding of specific factors we expect to affect the secular outlook.

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For the 2007 Secular Forum, PIMCO has invited four guest speakers to offer their views on topics we have identified as central to the secular outlook.

- An expert on global economic and financial trends will discuss the impact of globalization on the world's supply chain.
- A noted author and expert on political and military affairs in the Middle East will discuss the state of geopolitical and military play in the region.
- A world-renowned economist will discuss the evolution of the global economic and financial architecture in the years ahead.
- An authority on China's economy and monetary policy will discuss the country's growth momentum and the long-term challenges China faces.

Guest speakers are typically scheduled for the first two days of the Secular Forum. Each presentation is followed by discussion and debate among PIMCO's investment professionals and our guest expert about the issues raised and their implications for financial markets. The final day of the Secular Forum is reserved for an intensive internal debate and discussion about how secular themes will interact with each other in the global financial markets.

Structuring Portfolios for the Long-Term Improves Consistency

The Secular Forum is not an academic exercise. Our purpose is to identify opportunities to profit from secular trends. As Bill Gross often notes, PIMCO cannot invest in GDP futures or productivity options.

"When all is said and done, the task of the Forum is to tell us where to invest our clients' money—domestically or internationally, long duration or short, high quality or high yield. If we can't translate an economic outlook into a portfolio of bonds then the three days of discussion could better have been spent on the golf course."—Bill Gross, *Investment Outlook*, May/June 2001

Based on the conclusions drawn at the Secular Forum, PIMCO's Investment Committee develops the major strategies that serve as a model for all portfolios. We firmly believe that structuring portfolios around these secular trends, rather than short-term forecasts, may improve our ability to consistently add value over the long term.

While PIMCO has a strong record when it comes to forecasting economic fundamentals over short time horizons, the mechanisms that translate those fundamentals into interest rate changes are less predictable and they are influenced by random events, market sentiment, often-unreliable economic statistics and other temporary factors. This randomness makes it difficult to add value consistently through strategies based simply on short-term factors.

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Maintaining a disciplined focus on our long-term expectations and structuring our portfolios around secular trends helps to remove emotion from the equation. In so doing, it increases our ability to recognize value when short-term trends diverge from the market's long-term course, and can allow us to capture the broad, long-term market moves that constitute a key aspect of value creation in portfolios.

Examples of our focus on secular trends include:

- **1989: The Fall of the Berlin Wall**

When the Berlin Wall fell in late 1989, the financial markets anticipated that a shortage of capital for development in East Germany and other Soviet Bloc states would lead to rising debt issuance and higher interest rates. PIMCO took a different view. Our secular analysis suggested that property rights issues in the Soviet Bloc would hinder development and that demand for capital would be less than expected. PIMCO also recognized that the end of the Cold War was a secular event that would accelerate the trend of globalization and its disinflationary consequences, creating a favourable environment for bonds over the long term. Thus, while the market's initial reaction to the fall of the Berlin Wall was to sell bonds, PIMCO was less bearish due to our focus on the secular implications of the end of the Cold War. We positioned PIMCO portfolios accordingly, and the long-term bull market in bonds resumed in late 1990.

- **1997: The Spread of Capitalism**

Following the Cold War, the global economy moved steadily in the direction of free trade and worldwide competition. The spread of capitalism brought rapid economic growth, higher productivity, disinflation and asset prices that seemed to reflect expectations that the "Goldilocks" global economy would continue indefinitely. However, PIMCO's Secular Outlook suggested growing structural problems, including an oversupply of goods and services financed with too much short-term debt, and crony capitalism in developing markets. Bill Gross noted the potential for icebergs in an apparently calm sea in his May 1997 Investment Outlook ("Titanic?") summarizing PIMCO's secular views. Based on these secular concerns, PIMCO reduced its exposure to corporate bonds and positioned portfolios for an increase in volatility. In July 1997, Thailand devalued its currency, marking the start of the Asian financial crisis, a sharp rise in volatility and a bear market in corporate bonds.

Secular vs. Cyclical Forces

Secular forces determine market direction over the long term, but there are clearly times when cyclical forces dominate, either reinforcing or contradicting the secular trend. For this reason, PIMCO supplements our secular views with quarterly Economic Forums that examine cyclical factors and help to fine-tune our strategy over shorter time periods. The Secular Forum establishes our outlook for the global economy and the broad direction of bond markets over the next several years. The Economic Forums

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provide forecasts for economic growth, inflation and interest rates over the next several quarters.

PIMCO's portfolios and strategies are rooted within our secular views, with the flexibility to fine tune our strategies based on the shorter-term views developed at our cyclical forums. We would not reverse course or alter our secular views without the full examination of long-term structural forces that our Secular Forum provides. For example, we may trim exposure to a bond market sector that we believe to be temporarily overvalued, such as mortgage-backed bonds, even though we take a strongly favourable view of that sector for the long run.

A Disciplined Long-Term Approach is the Foundation of Our Success

There are many factors that contribute to PIMCO's potential to add value to our clients' portfolios, from our corporate structure to our state-of-the-art technology. But our growth, reputation and success have been fundamentally built on our secular approach. A short-term orientation can dazzle one year and disappoint the next. Our goal is to consistently add value and enhance returns for our clients. We believe that our track record is evidence that a secular orientation, combined with a disciplined yet flexible approach, is critical to achieving that goal.

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