

Spotlight

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Chris Dialynas Discusses PIMCO's Unconstrained Bond Strategy



Chris P. Dialynas

Mr. Dialynas is a managing director in the Newport Beach office, a portfolio manager, and a senior member of PIMCO's investment strategy group. He has written extensively and lectured on the topic of fixed-income investing. Mr. Dialynas served on the editorial board of *The Journal of Portfolio Management* and was a member of the Fixed Income Curriculum Committee of the Association for Investment Management and Research. He has 30 years of investment experience and holds an MBA from the University of Chicago Graduate School of Business. He received his undergraduate degree from Pomona College. He joined PIMCO in 1980.

PIMCO's Unconstrained Bond Strategy invests in an investment grade fixed-income universe with an absolute return-oriented approach that embodies PIMCO's unique investment process. In the following interview, Portfolio Manager Chris Dialynas answers questions about the strategy.

Q: What is PIMCO's Unconstrained Bond Strategy?

Dialynas: The Unconstrained Bond Strategy puts PIMCO's investment process and active management skills to work in an approach that is not tethered to benchmark-specific guidelines or related tracking error limitations. Our goal for the strategy is to deliver attractive positive return and preserve capital over a full market cycle.

The unconstrained nature of our approach with this strategy allows us to adjust duration, allocate across fixed-income sectors, express our global economic views and otherwise tap into our toolkit to a greater degree than benchmark-constrained strategies. As a result, we have the ability to assume more risk in areas where we have a strong positive conviction and to reduce or eliminate exposures where we see less value or heightened downside risk. Of course, the Unconstrained Bond Strategy is guided by PIMCO's long-term secular and shorter-term cyclical economic outlooks, our disciplined, integrated investment process and the full benefit of our broad and deep global bond market expertise.

Q: For investors, what is the appeal of the Unconstrained Bond Strategy?

Dialynas: The strategy is primarily for clients who are willing to grant broad investment discretion to managers with demonstrated skill, in the interest of realizing higher alpha or risk-adjusted return potential over the long-term.

The strategy may appeal to investors who do not necessarily want their investment performance to closely track a specified bond index and those who are willing to give up relatively strict investment limitations in exchange for potentially higher returns and proactive downside risk mitigation. The Unconstrained Bond Strategy also provides a potential solution for investors who appreciate the value and diversification offered by the global fixed-income markets over the long-term but prefer an approach that actively selects and adjusts the magnitude of risk exposures based on the opportunity set and

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market outlook with an absolute-return goal, as opposed to a bond index-related performance objective.

We believe that PIMCO's almost four decades of experience, global fixed-income expertise, long-term focus and stringent risk management culture provides us with the requisite combination of qualifications to successfully manage this type of mandate.

Q: What is the investment benchmark for this strategy?

Dialynas: By design, the strategy is not managed relative to a specified market index benchmark – and this is an important difference between the Unconstrained Bond Strategy and traditional active fixed-income mandates. The sector weights, duration and other risk exposures are likely to vary to a (much) greater degree over time when compared to traditional fixed-income portfolios that are generally expected to exhibit relatively moderate and stable tracking error versus a specified market index benchmark.

However, there is a LIBOR reference point used, which is common for absolute-return oriented strategies. The use of LIBOR as a reference point dovetails with the idea that, even though the goal is to generate a positive return that is not tied to a market index, a money market rate is an appropriate minimum hurdle across most periods of reasonable length, as a proxy for the theoretical risk-free investment option.

Importantly, however, the LIBOR benchmark is not intended to be indicative of the risk or other characteristics of the strategy. Instead, a currency hedged Global Aggregate Bond Index is specified as a secondary benchmark. While the Unconstrained Bond Strategy is not designed to actually track the Global Bond market, the index may be a reasonable proxy for the downside risk exposure of the Unconstrained Bond Strategy.

Q: What types of investment strategies are employed in the Unconstrained Bond Strategy?

Dialynas: The strategies employed are absolute return-oriented and fixed income-based, without any material constraints specific to the global opportunity set. Portfolio construction is guided by our goal of providing investors with the traditional benefits that investors associate with the bond market – including capital preservation, liquidity and diversification – *plus* the potential for more attractive risk-adjusted returns over the long term and active downside risk mitigation.

As the portfolio will be constructed without tracking a specified bond market index, the specific exposures and the degree of variance will depend largely on our views of relative value and risk across the fixed-income markets globally. The additional discretion may be particularly valuable, for example, during rising rate environments as we can eliminate our interest rate exposure, or opportunistically benefit from the bond-unfriendly aspects of a rising interest rate environment. Likewise, the strategy allows us to opportunistically assume much greater exposure to the so-called tactical fixed-income sectors or strategies than would be reasonably possible in a strategy that is constrained by a core bond market index.

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We do expect that there may be periods where the Unconstrained Bond Strategy underperforms the bond market, either due to a reduced risk posture or otherwise due to our structuring the portfolio in a way that we believe to be most beneficial for investors over the long term. For the same reason, we anticipate that there will be periods where the Unconstrained Bond Strategy exhibits either a materially higher or materially lower volatility than a core bond index. As such, it is important for investors to evaluate the strategy over a three-to-five year time horizon and to keep in mind the dual objective of providing attractive long-term return and downside risk mitigation.

Q: Are there investment restrictions for the strategy?

Dialynas: Recommended guidelines include a portfolio duration range between -3 and +8 years, with maximum high-yield bond and emerging market bond holdings of 40% and 50%, respectively.

Q: What is the reason for the restrictions if the strategy is intended to be “unconstrained”?

Dialynas: “Unconstrained” refers to the lack of a traditional benchmark and the flexibility the strategy has, to not automatically assume risk entailed in a benchmark that we may feel is unattractive. The investment guidelines for the Unconstrained Bond Strategy ensure that the average quality of the portfolio is investment grade and that the downside risk characteristics of the portfolio are more bond-like than equity-like, even in circumstances where the market may move against our active risk positions.

The limits also provide reasonable assurance that the strategy will not be likely to exhibit a meaningfully positive correlation with the equity market. This is an important consideration for most investors as “traditional” portfolios with 55-70% of the investment capital allocated to equities and 30-45% in bonds have historically exhibited an almost perfect correlation with the equity market. Therefore, strategies that provide material equity market risk diversification are particularly valuable to these investors.

Importantly, the guidelines don’t signal the likely risk exposures of the portfolio over time. For example, while the recommended guidelines allow for up to 40% below investment-grade exposure, it would not be correct to assume that the average high-yield exposure will be 20% at the mid-point of the allowable range. Rather, the risk exposures will move within this range, depending entirely on PIMCO’s active views.

Q: How does the Unconstrained Bond Strategy fit into an investor’s asset allocation? Is it most closely related to alternative investments or to traditional core bond mandates?

Dialynas: The use of the Unconstrained Bond Strategy within an overall portfolio will likely vary from investor to investor, depending on the approach to portfolio construction employed. The Unconstrained Bond Strategy is, by design, an absolute return-oriented strategy and may be considered an alternative investment approach in the sense that the active management discretion and alpha potential is materially greater than that associated with traditional active fixed-income management strategies. The strategy is also likely to provide noteworthy diversification at the portfolio level as it should not

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exhibit a materially positive correlation with the equity market, which is a key benefit that many associate with alternatives. However, from a downside risk perspective, the Unconstrained Bond Strategy may be most closely related to a core fixed-income allocation.

No matter how the strategy is categorised, it is critical that investors consider it as a long-term approach with downside risk protection and higher alpha potential. Over shorter periods, these objectives may seem to conflict. However, over the longer term we expect these aims to be complementary and beneficial for investors.

Q: Thank you, Chris.

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