

Product Focus

January 2007

PIMCO's Approach to Asset-Backed Securities Entails Rigorous Credit Analysis

Asset-backed securities (ABS) are still a relatively young asset class in Europe. But the ABS market continues to grow as investors become more and more familiar with these products that can offer attractive yields over government bonds and covered bonds. Because most ABS receive the highest credit rating of triple-A, they can fill a need for diversification among high quality investments in a bond portfolio.

PIMCO has participated in the ABS market since it began in the U.S. 30 years ago and we were one of the early players when the market developed in Europe in the late 1990s. Our unique, comprehensive approach to investing in the asset class reflects the expertise we have acquired over time. PIMCO's ABS investment approach combines globally integrated, top-down macroeconomic forecasting with rigorous bottom-up credit analysis. Our analysts independently analyse every asset-backed security we consider for our investment portfolios, regardless of credit rating, and conduct regular surveillance of our existing ABS investments in an effort to detect potential problems early. In this article, we will discuss the steps involved in PIMCO's approach to ABS.

ABS Analysis Involves Several Steps

PIMCO's approach to ABS, which in Europe also include mortgage-backed securities (MBS), starts with a top-down view. Unlike many other investment firms, PIMCO takes a longer-term, secular view of the bond market. We attempt to identify the macroeconomic trends that will affect the bond markets over the next three to five years, as well as the more immediate impact of economic and business cycles. This top-down forecast informs all of our investment decisions across asset classes, providing our "big picture" view on credit, duration and yield curve positioning.

The key to PIMCO's unique approach to ABS is that within this macroeconomic framework, we also perform rigorous bottom-up analysis of individual securities.

Our bottom-up analysis of ABS can be broken down into several steps. First, our ABS specialists look at the collateral supporting the investment to determine its market value. To put it simply, the value of the collateral should cover the value of the bonds. Second, our ABS analysts check the structure of the ABS deal looking at the individual tranches, cash flows and credit enhancements. They conduct cash flow "stress tests" on the transaction to determine how the loans or receivables will perform under less favourable circumstances – for example, in a recession – and how the payment structure will work under various scenarios. For these tests, we use proprietary delinquency, default and loss curves based on historical patterns for each asset class.

When an ABS appears attractive on the basis of the collateral, the cash flows and the payment structure, we analyse all involved parties of the deal as well as the conditions under which the deal has been set up. This includes:

- fundamentals of the industry involved, such as the auto industry;
- quality and history of the loan servicer;

Product Focus

January 2007

- risk that the originator will declare bankruptcy and the potential impact on the ABS;
- regulatory framework; and
- value of the embedded options in the ABS, such as prepayment risk, clean-up calls, interest-rate caps, and other derivative-type components that can affect the value of a security.

Finally, we always want to ensure that we purchase the safest securities for our portfolios with the best relative value globally. For example, when we buy senior class securities, we analyse the allocation of principal payments in the ABS. In general, we prefer transactions in which, as senior noteholders, we are paid first rather than transactions in which we would share principal payments with investors in the subordinate securities.

In all these steps of our ABS analysis, we incorporate a multidisciplinary approach. Our 21 ABS specialists – nine in Europe, eleven in the U.S and one in Asia – work with our corporate analysts when evaluating the industry as well as risks stemming from the originator. Because we consider asset-backed securities a hybrid asset class that can include credit and derivative exposure, ABS specialists also seek input from PIMCO's derivatives teams. The derivative exposure stems from so called embedded options that result for example from a homeowner's option to pay back his mortgage before maturity. The effects from embedded options on MBS – Europe's biggest ABS sector – are less strong than in the U.S., though, because of two major differences. First, floating rate mortgages dominate in the European housing market. Second, homeowners incur relatively high penalties in case of prepayment of their mortgage, which reduces prepayment risk.

PIMCO chooses its investments from the entire spectrum of asset-backed securities in terms of credit quality and asset types. Based on our experience, we know that attention to detail as outlined in our approach can mean the difference between full payment and loss of principal if the loans backing an ABS do not perform as expected.

Surveillance: The Key to Continued Health

To ensure that our ABS portfolio retains its credit quality once we have invested, we apply in-depth surveillance that aims to detect potential problems early. We scrutinise the performance of ABS particularly during the first few months to ensure that the early cash flows are coming into the ABS trust as expected and are being put to use according to the terms of the transaction, usually to build credit support for the securities. Based on this continual performance analysis, we make decisions on when to hold or sell asset-backed securities and thus maintain the health of our portfolio. Discovering problems early in the life of a transaction, allows us to exit, or sell, a position without incurring additional charges in the marketplace.

A big part of our surveillance is now automated. To this avail, PIMCO created a proprietary ABS database that combines historical data with an ongoing stream of

Product Focus

January 2007

current information: cash flow and performance information on individual transactions, rating agency reports, and articles from the press. Based on reports from the database, our analysts can pinpoint the securities that require further scrutiny. This automation frees up resources and allows our ABS analysts to stronger focus on transactions that require more in-depth analysis.

During the last years, the market has experienced very few credit problems, primarily as a result of low interest rates and strong housing markets. This strong performance has led to a great deal of investor complacency, which in turn has led to weaker deal structures, more aggressive underwriting and limited differentiation across issuers and servicers. The next few years will likely see a reversal in these trends, with a renewed appreciation for detailed, top-down and bottom-up credit and structural analysis like PIMCO applies in its ABS approach.

Conclusion

Asset-backed securities can offer attractive yields combined often with the highest credit ratings but rigorous credit analysis is crucial. PIMCO has been active in ABS markets for more than 30 years. Based on this experience, we have developed a comprehensive global approach to the asset class. To find the best relative value and minimise risk, we combine top-down economic forecasts with thorough bottom-up credit analysis of every individual transaction. Our ABS surveillance is designed to detect possible problems early and maintain the health of an ABS portfolio. The extent of automation in surveillance permits an optimal allocation of our resources.

London

PIMCO Europe Ltd
Nations House
103 Wigmore Street
London W1U 1QS
England
44-20-78721300

Munich

PIMCO Europe Ltd Munich Branch
Nymphenburger Straße 112-116
80636 Munich
Germany
49-89-1221-90

Rotterdam

PIMCO Europe Ltd2
Regus Brainpark II
Lichtenauerlaan 102-120
3062 ME Rotterdam
The Netherlands
TEL 31-10-204-5722

PIMCO Europe Ltd., PIMCO Europe Ltd. Munich Branch, and PIMCO Europe Ltd. Rotterdam Branch are authorised and regulated by the Financial Services Authority in the UK. PIMCO Europe Ltd.

Product Focus

January 2007

Munich Branch is additionally regulated by the BaFin in Germany in accordance with Section 53b of the German Banking Act and PIMCO Europe Ltd. Rotterdam Branch is additionally regulated by the AFM in the Netherlands. The services and products provided by PIMCO Europe Ltd. are available only to investors who come within the category of market counterparty or intermediate customer as defined in the Financial Services Authority's Handbook. They are not available to individual investors, who should not rely on this communication."

This article contains the current opinions of the manager and such opinions are subject to change without notice. This article has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

Past performance is no guarantee of future results. Portfolios may use derivative instruments for hedging purposes or as part of the investment strategy. Use of these instruments may involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk and the risk that a portfolio could not close out a position when it would be most advantageous to do so. Portfolios investing in derivatives could lose more than the principal amount invested. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio. Duration is a measure of price sensitivity to interest rates and is expressed in years.

No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Pacific Investment Management Company PEL, Nations House, 103 Wigmore Street, London W1U 1QS, England. ©2007, PIMCO