

## Spotlight

September 2009

### Chris Dialynas and Lisa Kim Discuss PIMCO's Unconstrained Bond Strategy



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Portfolio Manager



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*PIMCO's Unconstrained Bond Strategy is designed to provide investors with the traditional benefits of bond investing – capital preservation, liquidity and diversification – plus the potential for more attractive risk-adjusted returns over the long term and proactive, downside risk mitigation. Unlike traditional fixed income approaches, the Unconstrained Bond Strategy does not track specific bond indexes and therefore has greater investment flexibility to achieve these goals. In the interview below, Portfolio Manager Chris Dialynas and Product Engineer Lisa Kim discuss the investment approach for the Unconstrained Bond Strategy, when and by how much the strategy may exercise its broader investment discretion and how the strategy can fit into an asset allocation plan.*

**Q: How does the Unconstrained Bond Strategy differ from PIMCO's Total Return Strategy?**

**Kim:** The same PIMCO investment process and philosophy that underpin our top-down secular and cyclical outlooks and rigorous bottom-up analysis create the base for both of the strategies. Essentially, their “inputs” are the same. However, the specific approaches, investment guidelines and risk tolerances vary for the strategies (as we have summarised in the table below).

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	<b>Total Return Strategy</b>	<b>Unconstrained Bond Strategy</b>
<b>Strategy Description</b>	An actively managed, diversified, intermediate duration portfolio of high-quality bonds that seeks total return by embodying PIMCO's process and philosophy	An absolute return-oriented, investment grade fixed income strategy that embodies PIMCO's secular thinking, global themes and integrated process
<b>Opportunity Set</b>	<ul style="list-style-type: none"> <li>Government bonds</li> <li>Mortgage-backed securities</li> <li>Investment grade credit</li> <li>High yield (0% to 10% range)</li> <li>Non-US developed (0% to 30% range)</li> <li>Emerging market (0% to 15% range)</li> <li>Currency (0% to 20% range)</li> </ul>	<ul style="list-style-type: none"> <li>Government bonds</li> <li>Mortgage-backed securities</li> <li>Investment grade credit</li> <li>High yield (0% to 40% range)</li> <li>Non-US developed</li> <li>Emerging market (0% to 50% range)</li> <li>Currency (0% to 35% range)</li> </ul>
<b>Duration Range</b>	+/- 2 years of the duration of the Barclays Capital US Aggregate Index	-3 to +8 years

**Q: Can you describe the overall objective and design of the Unconstrained Bond Strategy?**

**Dialynas:** The strategy aims to deliver attractive returns and preserve capital over a full market cycle using an approach that is not tethered to benchmark-specific guidelines or related tracking error limitations. The strategy is absolute return-oriented, fixed income-based and investment grade overall. It is designed to have the flexibility to adjust duration, allocate across sectors and express global economic views to a greater degree than a benchmark-constrained strategy. Therefore, the strategy can assume more risk in areas where PIMCO sees significant opportunities, and it can have little or no exposure to areas where we see less value or heightened downside risk.

In general, risk exposures are likely to vary to a much greater degree over time than in traditionally benchmarked fixed income portfolios. Though the strategy is not explicitly insured against downside risk, the capability to tactically manage risk positions free from benchmark limitations may allow for the opportunity to add value even under challenging bond market conditions.

**Kim:** While LIBOR does serve as a reference point for the strategy, which is a common practice for absolute return-oriented approaches, this is simply a proxy for the theoretical cash equivalent investment option. The LIBOR benchmark is not intended to be indicative of the risk or return profile of the strategy.

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The investment guidelines for the Unconstrained Bond Strategy include a portfolio duration range between -3 and +8 years. It may invest without limitation in securities denominated in foreign currencies and in US dollar-denominated securities of foreign issuers but will normally limit its foreign currency exposure to 35%. The strategy also has limits of 40% for high yield bonds, 50% for emerging markets, and up to 10% for preferred stocks. These limits intend to ensure that the average quality of the portfolio is investment grade and also that the portfolio's downside risk profile is more broadly bond-like than credit-centric or equity-like.

**Q: Given the strategy's broad bandwidth for duration, from -3 through +8 years, under what scenarios would the Unconstrained Bond Strategy potentially move to a negative duration position?**

**Dialynas:** The strategy's discretion may be particularly valuable during rising interest rate environments: We would look to defensively reduce or eliminate our interest rate exposure, or even opportunistically benefit from some aspects of that environment, with negative duration. However, while the strategy has the flexibility to be defensively postured and potentially reach neutral or even negative overall portfolio duration, it is not designed to be an explicit hedge against rising interest rates. A hedge looks to offset a particular risk; by contrast, the strategy's duration bandwidth discretion is simply one component of the overall approach to assessing and managing the full risk spectrum.

Before we'd consider shifting the strategy into a neutral or negative duration position, we would need to have very strong convictions on several factors: a conclusive trend toward recovery from the near-term cyclical weakness, which would likely indicate inflation over the horizon; bearish cyclical and secular outlooks for interest rates; and a long-term outlook for significant depreciation in the value of the US dollar.

**Q: How does the Unconstrained Bond Strategy's flexibility to invest broadly across many sectors affect its investment approach, and under what conditions could the strategy reach its sector limits?**

**Dialynas:** The strategy's ability to take active risk positions across sectors where PIMCO sees value is one of its great benefits. However, before approaching the guidelines' limits in any sector, we would need to have very strong positive convictions about the opportunities there, and in any case, the overall portfolio composition would remain investment grade quality.

For example, if in the future we become extremely bullish in specific areas in high yield or in certain emerging economies, we would actively increase the portfolio's positions in these markets. But to approach the guideline maximum, we would have to see egregiously mispriced pockets of value together with a limited risk of permanent price impairment, and we would need to be prepared to tolerate fairly significant price volatility. So realistically, it would be unlikely for the strategy to reach its limits in these sectors.

The strategy has broad discretion to invest outside the US and could potentially include large exposures to the global fixed income markets if we see attractive relative opportunities. Investments in non-dollar currencies, however, are unlikely to approach the guideline limits mainly due to their volatility, though if we held a strong view on any single currency with a clear direction of relative value, we would likely add a sizable position.

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Currently, we are building a position in a select basket of currencies that are expected to appreciate versus the dollar over the secular horizon.

**Q: How has the Unconstrained Bond Strategy handled the market turmoil of the past year?**

**Kim:** Despite the enormity of the financial crisis, the Unconstrained Bond Strategy has met and exceeded our overall expectations. Truncating the downside risk in an environment of financial crisis has been a challenge over the past year, but the strategy has done well in harnessing the opportunities under very uncertain market conditions and heightened volatility.

**Q: How should investors define the Unconstrained Bond Strategy when evaluating overall asset or risk allocation strategies? Is it considered an alternative investment or does it more closely resemble a traditional core bond strategy, such as PIMCO's Total Return?**

**Kim:** Depending on an investor's approach to portfolio construction and allocation, the categorical fit for the Unconstrained Bond Strategy may vary. By design, it is an absolute return strategy and may be considered an alternative investment approach in the sense that the active management discretion and alpha potential may be materially greater than in many traditional, active, fixed income management strategies. By design, the strategy is also likely to exhibit low correlation with the equity markets, which may provide positive diversification benefits.<sup>1</sup>

However, from a downside risk perspective, the Unconstrained Bond Strategy may more closely resemble a core fixed income allocation. The guideline limits for various sectors, such as high yield and emerging markets, also may help investors determine where the strategy fits into an asset or risk allocation plan.

We've found most investors are using the Unconstrained Bond Strategy as an alternative allocation. While the same secular and cyclical outlooks that inform PIMCO's core bond strategies, such as Total Return, also shape the Unconstrained Strategy, its greater discretion allows the strategy to take a more aggressive stance in areas where PIMCO sees opportunity. It is designed for investors who are willing to grant very broad discretion to managers with demonstrated skill, in the interest of realizing higher risk-adjusted return potential over the long term.

**Thank you, Chris and Lisa.**

<sup>1</sup>Historically, the strategy has exhibited a correlation of .28 to the equity market as represented by the S&P 500 (from 9/30/08 to 7/31/09).

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### About the authors:

**Chris Dialynas** is a managing director in the Newport Beach office, a portfolio manager, and a member of PIMCO's Investment Committee. 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 31 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.

**Lisa Kim** is a vice president and product engineer in the Newport Beach office, responsible for alternative and absolute return products. Prior to joining PIMCO in 2003, she worked as an investment analyst at Stanford Management Company for Stanford University's endowment in fixed-income portfolio management. She has 10 years of investment experience and holds an undergraduate degree from the University of California, Berkeley.

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**Past performance is not a guarantee or a reliable indicator of future results.** Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. High-yield, lower-rated, securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. Diversification does not insure against loss.

There is no guarantee that these investment strategies will work under all market conditions and each investor should evaluate their ability to invest for a long-term especially during periods of downturn in the market. No representation is being made that any account, product, or strategy will or is likely to achieve profits, losses, or results similar to those shown.

LIBOR (London Interbank Offered Rate) is the rate banks charge each other for short-term Eurodollar loans. Barclays Capital US Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the US investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. 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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