portfolio construction

MARKETS SUMMIT

Tuesday 16 February 2010

Theme 1
The big picture

The big picture

Doug Hodge

Chief Operating Officer, PIMCO

Robert Swift

Head of Multi Strategies, BT Investment Management

Tim Farrelly

Principal, farrelly's

Stephen van Eyk

Founder, van Eyk Research

The big picture

Doug Hodge
Chief Operating Officer, PIMCO

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PortfolioConstruction Markets Summit 2010

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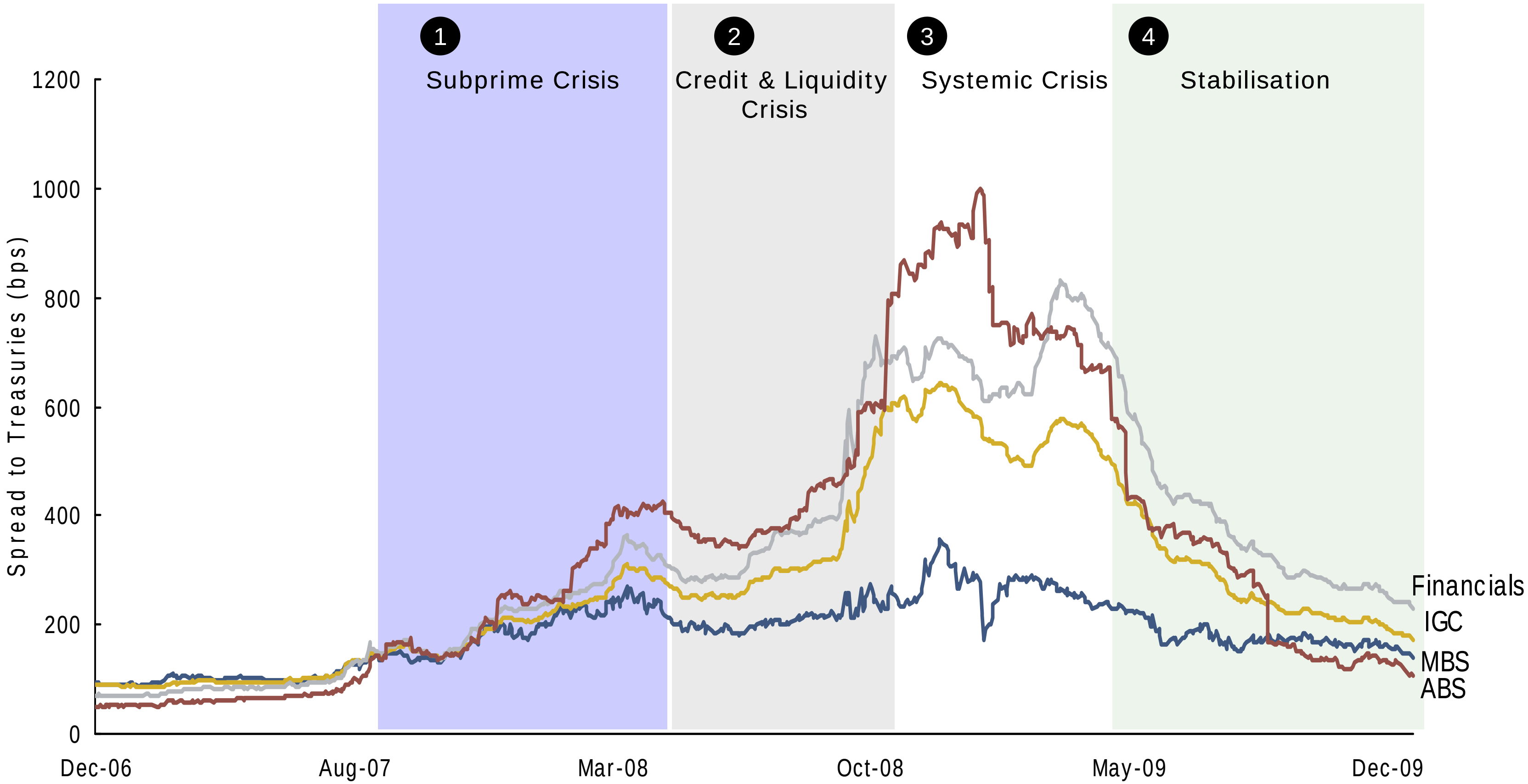
Re-Living the Past



SOURCE: Barclays Capital
Spreads for MBS, Investment Grade Corporate, ABS, and Financials are nominal spreads over Treasuries. MBS spreads are represented by the Barclays Capital Agency Fixed Rate MBS Index; Investment Grade Corporate spreads are represented by Barclays Capital U.S. Corporate Investment Grade Index; ABS spreads are represented by the Barclays Capital Asset-Backed Securities Index; Financials spreads are represented by the Barclays Capital Investment Grade: Financial Institutions Index.

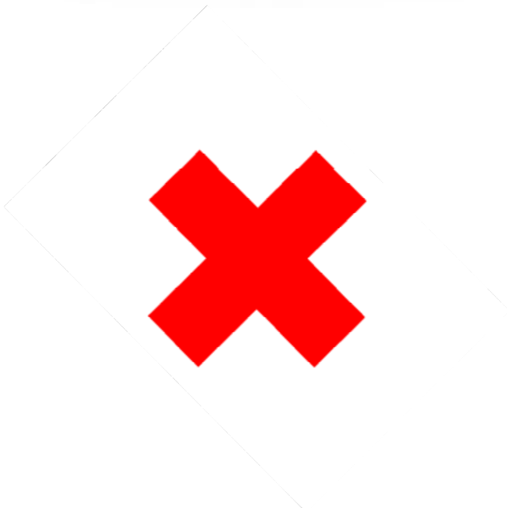
[1] Bear Stearns hedge funds implode [2] Bear Stearns takeover

[3] Lehman Brothers bankruptcy [4] Federal reserve conducts stress tests of 19 largest financial institutions

PIMCO positioning in 2009

- Overweight Duration in US, Europe, UK and Australia
- Overweight Agency MBS
- Overweight Investment Grade Credit, particularly financials

- Underweight lower quality credits



What will be the key investment theme for 2010?

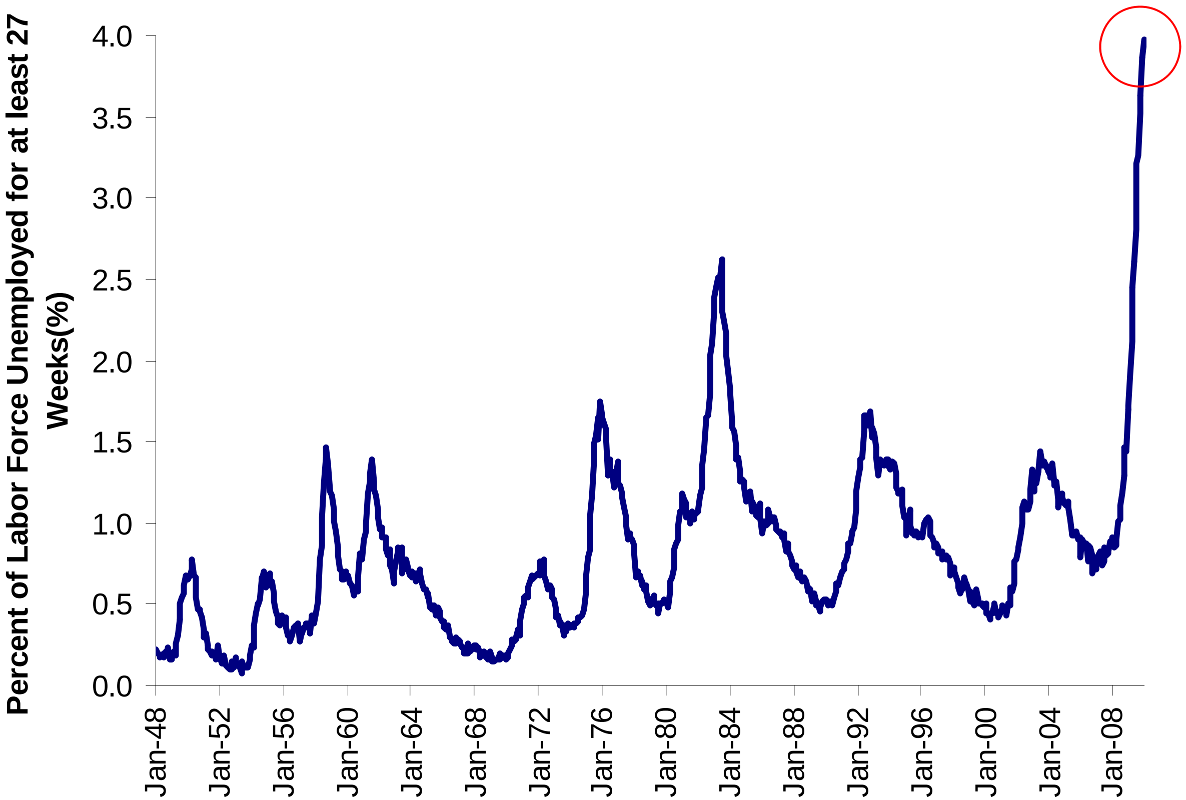
2008: Year of **the financial collapse**

2009: Year of **the <u>power</u> of government policy**

2010: Year of **the <u>limits</u> of government policy?**

Government policy brought us back from the brink…but we are far from Old Normal

Long-Term Unemployment Rate in the United States



Elevated long-term unemployment points to persistent structural, not just cyclical, problems

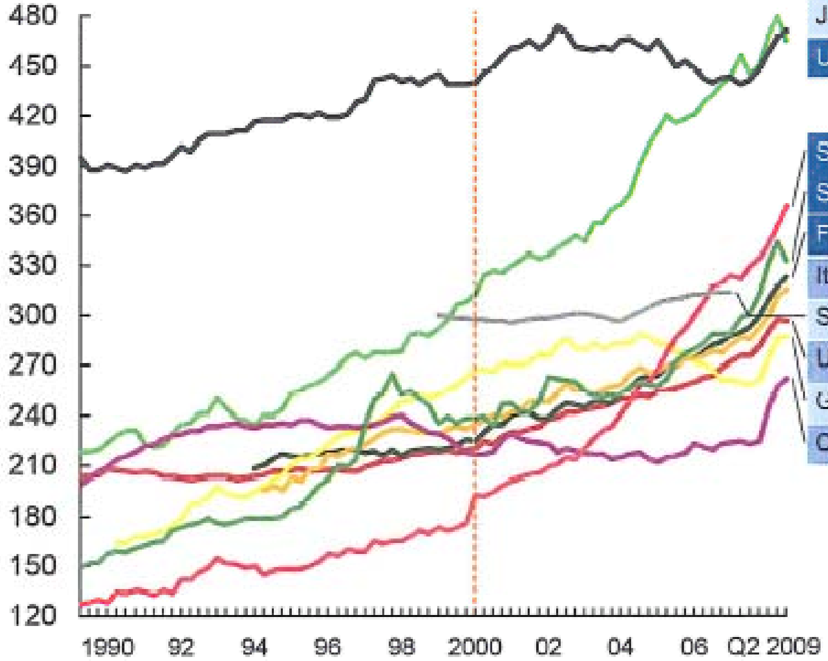
SOURCE: Bureau of Labor and Statistics

Economic activity in recent years fuelled by extraordinary debt growth

Debt grew in most mature economies

Rapid growth
Moderate growth
Slow/negative growth

Domestic private and public sector debt[1] by country
% of GDP



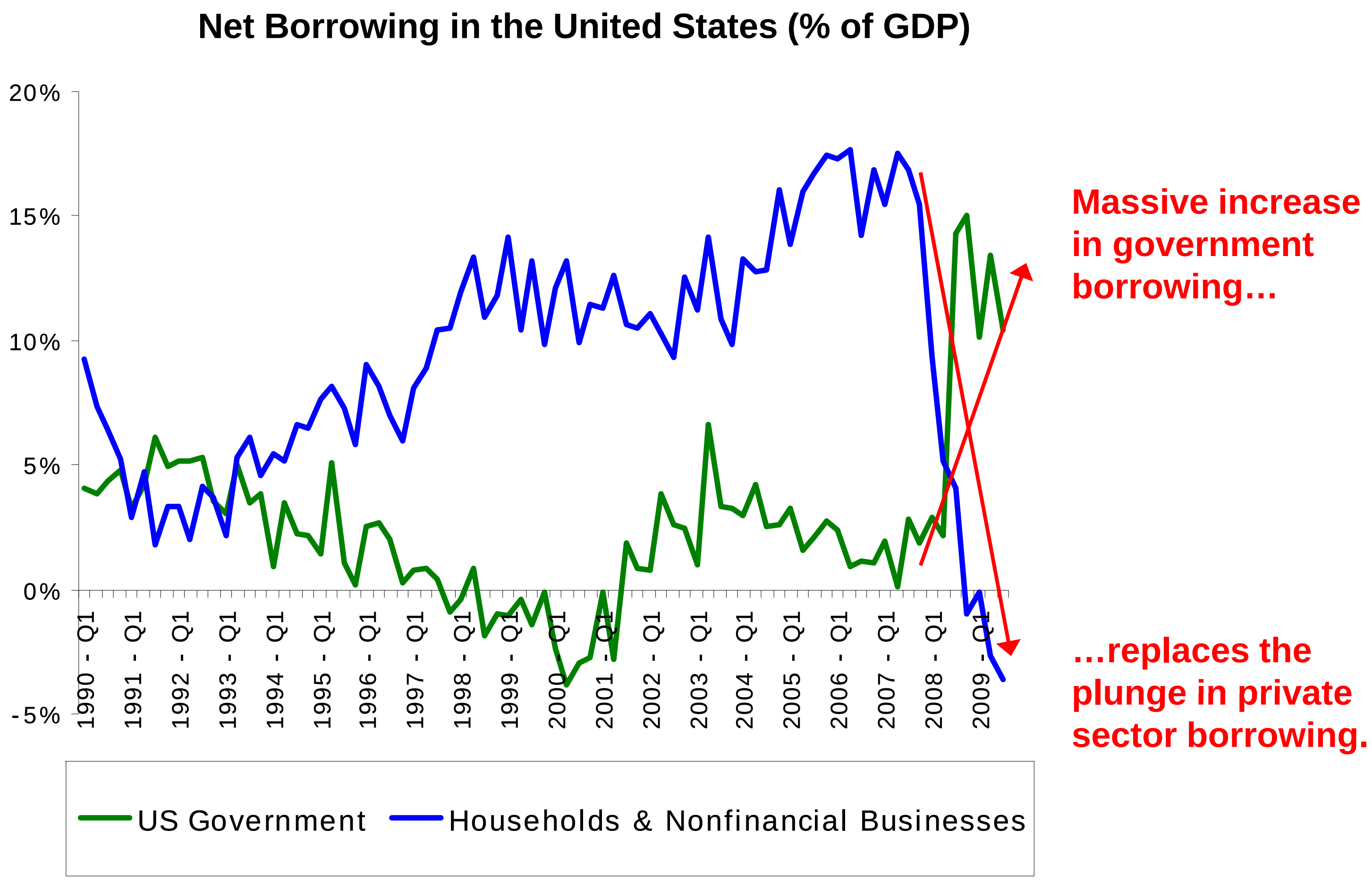
	CAGR[2], % 1990-00	CAGR[2], % 2000-08	Change, p.p. 2000-08
Japan	1.2	0.5	19
UK[3]	3.3	5.2	157
Spain	4.1	7.4	150
S. Korea	4.3	4.2	93
France	1.2	3.9	83
Italy	2.9	3.1	64
Switzerland	N/A	0.8	17
US	0.6	3.5	70
Germany	5.6	0.3	7
Canada	0.3	1.5	28

1 "Debt" is defined as all credit market borrowing including loans and fixed-income securities.
2 Compound annual growth rate. Where data are unavailable, the longest possible period is used.
3 Even after removing foreign lending by UK banks, UK debt/GDP remains higher than every country except Japan.

SOURCE: Central banks; Haver Analytics; McKinsey Global Institute

SOURCE: McKinsey Global Institute

Now, private sector de-leveraging cushioned by massive public re-leveraging



SOURCE: US Federal Reserve Flow of Funds

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Rising public debt levels have put sovereign creditworthiness "in play"

Greece spreads imply 25% probability of default within five years.

5yr Sovereign CDS Spreads

SOURCE: Bloomberg

Where are we now? Bond investors must think beyond traditional “interest rate risk”

Large budget deficit…

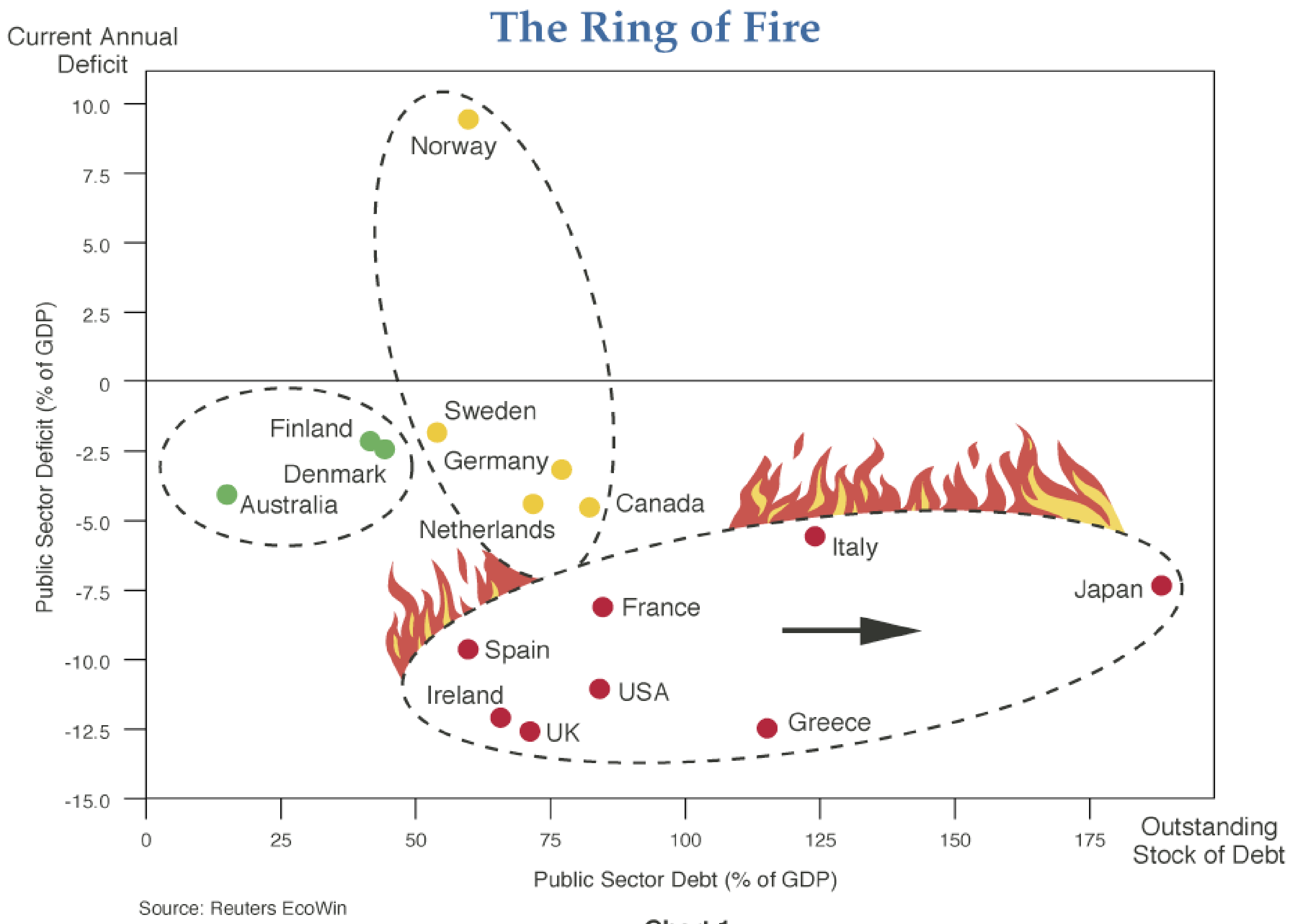

Chart 1

…combined with…

…Large debt stock

= Trouble

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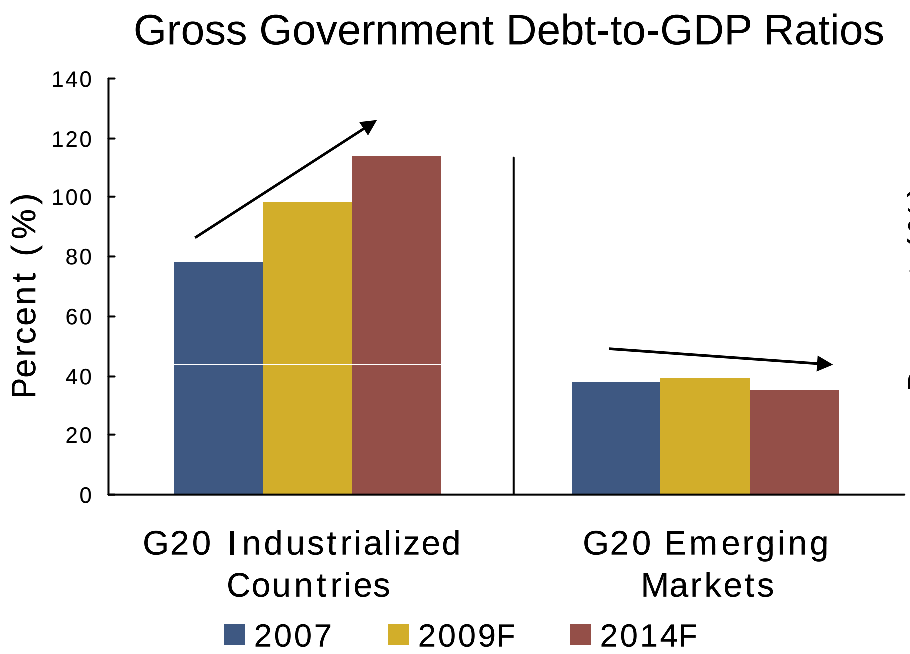
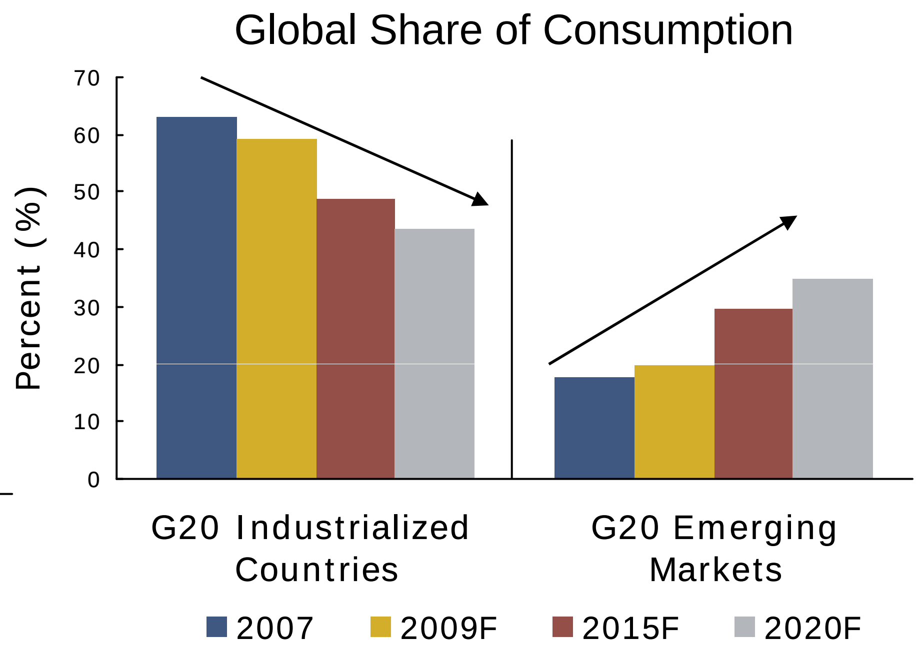
Traditional patterns of global indebtedness are being turned around





Industrialized countries are expanding their indebtedness at an unprecedented pace …

…even as their share of global economic activity declines precipitously.

SOURCE: IMF, PIMCO, Credit Suisse As of August 31, 2009

* Brazil, China, India, Mexico, Russia, and South Korea

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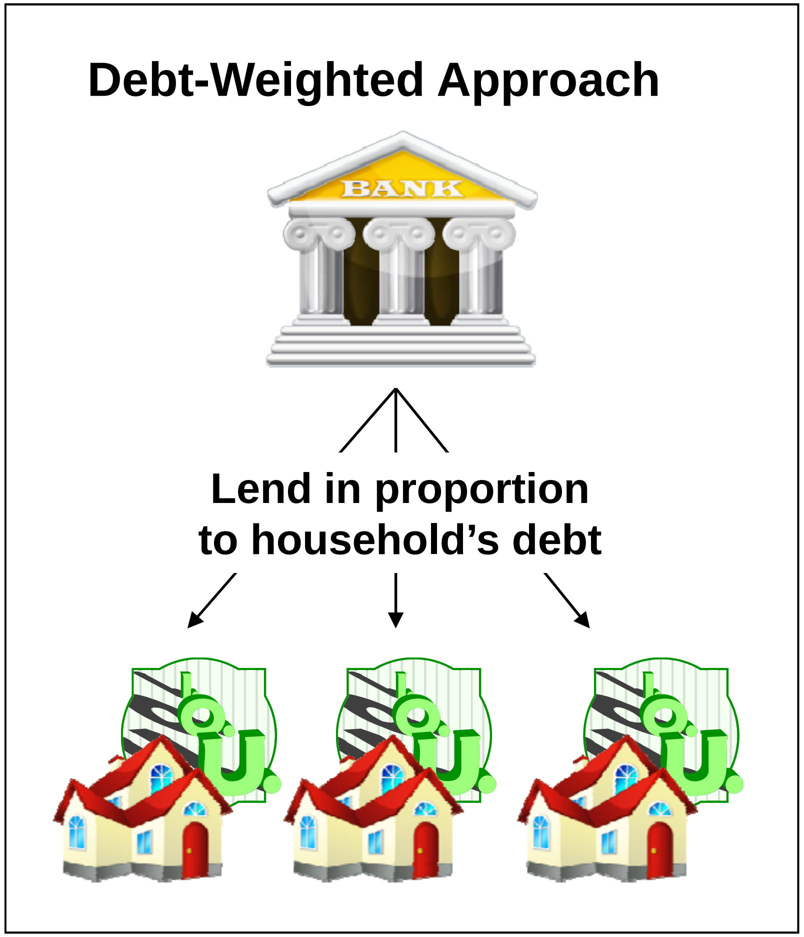
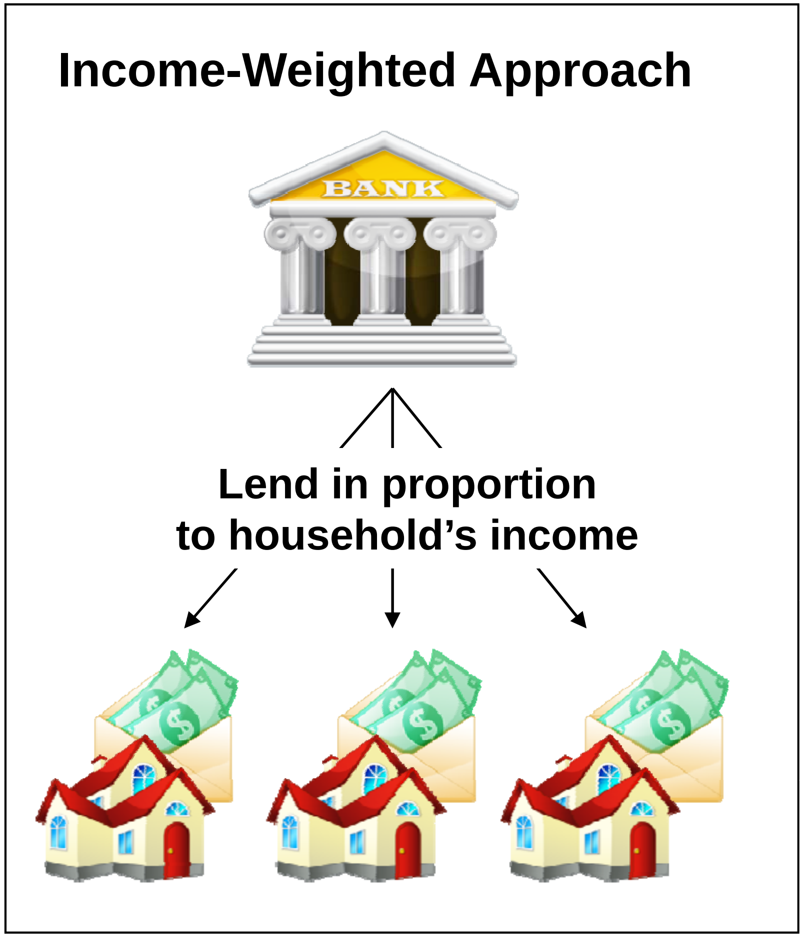
Such transformations call for a new approach to bond indexing





<u>Which makes more sense?</u>

And renewed focus on tail events

- What are Tail Events?
  - Improbable events that cause significant portfolio effects

Statistically: Multi-standard deviation events

Colloquially: Hundred year floods

Examples: Major Financial Crises since 1980			
1982	Mexican default	1994-5	Mexican peso crisis
1987	Black Monday, Dow drops 22.6%	1997-8	Asian financial crisis
1989-91	United States S&L crisis	1998	Russian default and LTCM
1989-91	Latin American debt crises	2001-2	Argentine default, dot-com bust, Enron
1992-3	European Monetary System crisis	2007-9	Financial market meltdown

December PIMCO Cyclical Economic Outlook

Macroeconomic Forecast

- Economic recovery is underway, but growth unlikely to return to "Old Normal" levels
- Growth rates de-synchronised, differentiated by initial conditions and policy responses
- Inflation to remain low due to output gap (commodity/asset inflation possible)
- Potential for "fat tail" outcomes not insignificant

Risks & Opportunities: The Known Unknowns

Uncertainties
▪ Successful exit strategies: the hand off from temporary to sustainable growth drivers
▪ Balanced redistribution of wealth that does not undermine future growth
▪ Credible fiscal policies that limit public debt levels
▪ Key institutions can and will function outside short term political pressures

Concluding Thoughts

- Limits of government policy in the New Normal
  - 2009 was year of recovery, 2010 revealing limits to fiscal/monetary tools
- Changing pattern of indebtedness is critical variable for bond investors
  - Fundamental challenge to traditional concepts of bond indexing & alpha generation
- Reliance on history cannot replace disciplined investment process
  - Models largely based on economic and market rationality, linearity and normal bell curves will fail
- Success will be achieved by those who are prepared, open and alert
  - Forward-looking
  - Focus on risk factors
  - Trim the tails

The New Normal will call for increased adaptability and flexibility from each of us.

So What Should Investors Do?

- Ensure real diversity within portfolio
- Closely examine risks of traditional indexing
- Choose managers with proven forward looking skills

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