

Investing for Today: Should We Flip a Coin or Put it All on Black

Brian P. Baker

2 February 2010

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Biographical Information

Brian P. Baker

Mr. Baker is a managing director in the Hong Kong office and chief executive officer and director of PIMCO Asia Ltd. He oversees servicing of PIMCO's institutional clients as well as business development in the region. Mr. Baker is also co-head of PIMCO's official institution business, overseeing investment services to central banks, sovereign wealth funds and supranational organizations. Prior to joining PIMCO in 1997, he was a vice president at Bank of Montreal, managing North American institutional client relationships. He has 22 years of investment experience and holds an MBA from the University of Chicago Graduate School of Business. He holds an undergraduate degree from George Washington University.

Global Benchmarks: Why Use an Index?

Opportunity Set

- Represents the investment universe
- Evolves over time as market does

Basis for Asset Allocation

- “Beta” for strategic allocation
 - Risk / return
 - Correlation with the rest of the portfolio
- Details risk factor exposure of asset classes

Performance Benchmark

- Informs managers about investment objectives
- Separates alpha from beta

Global Benchmarks: Major Index Providers

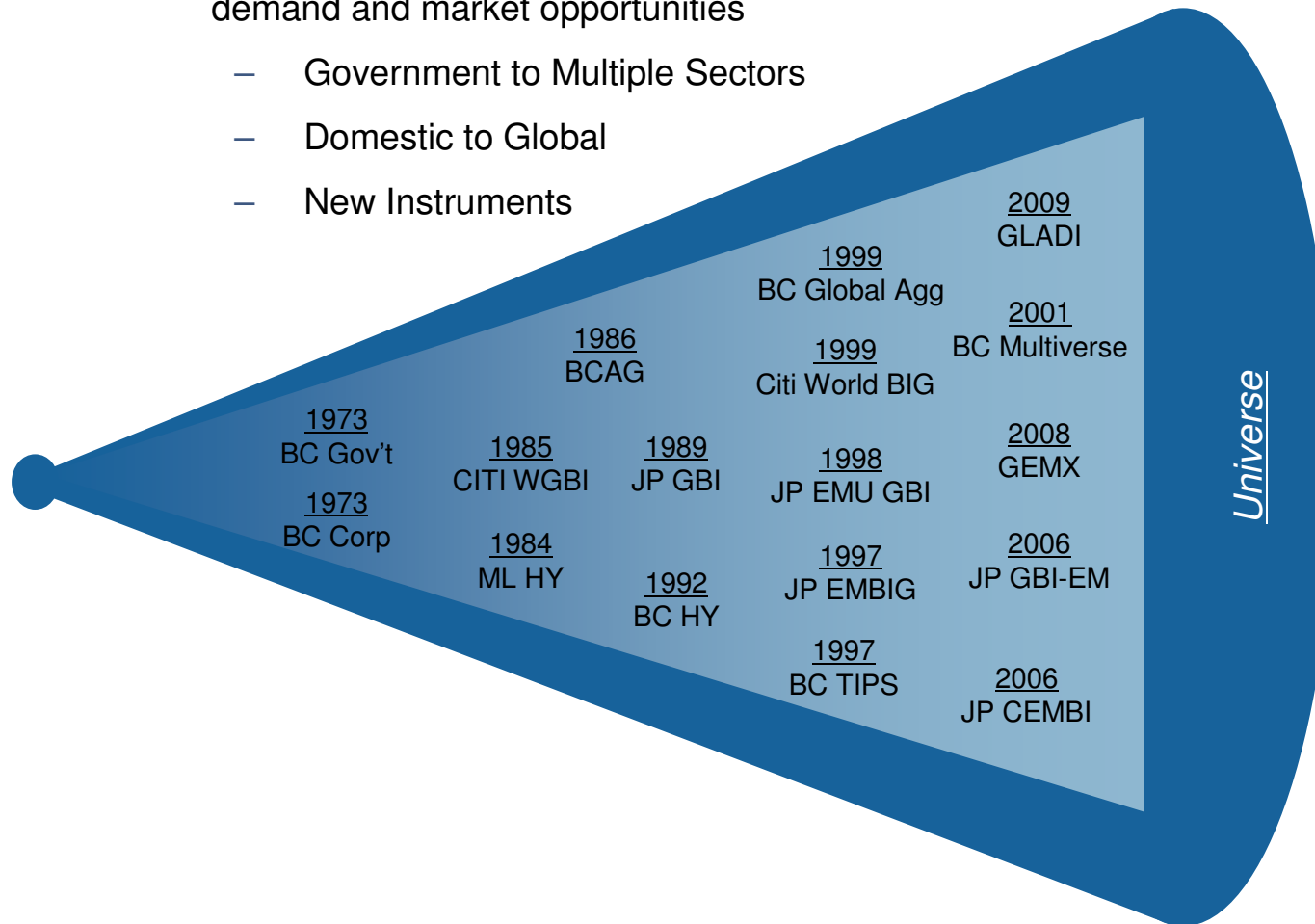
- Barclays Capital
 - Barclays Global Aggregate Bond Index

- Citigroup
 - Citi World Broad Investment-Grade Bond (World BIG)
 - Citi World Government Bond Indices (WGBI)

- JPMorgan
 - JPMorgan Global Government Bond Index (GBI)

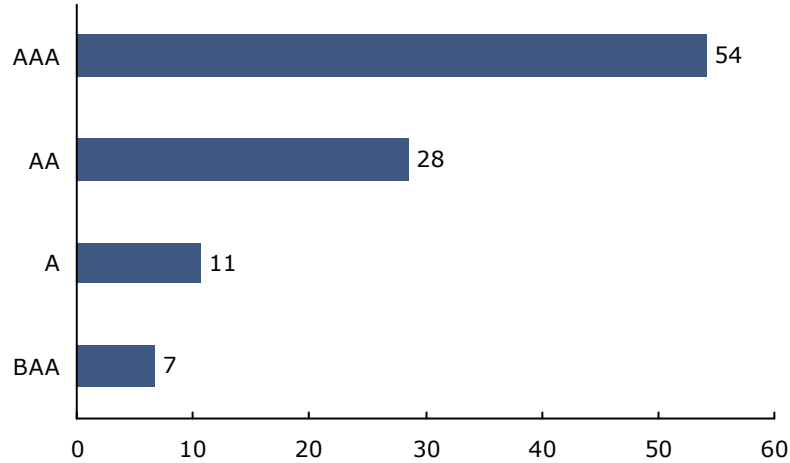
Global Benchmarks: Historical Timeline

- Evolution of fixed income benchmarks that adapt to investor demand and market opportunities
 - Government to Multiple Sectors
 - Domestic to Global
 - New Instruments

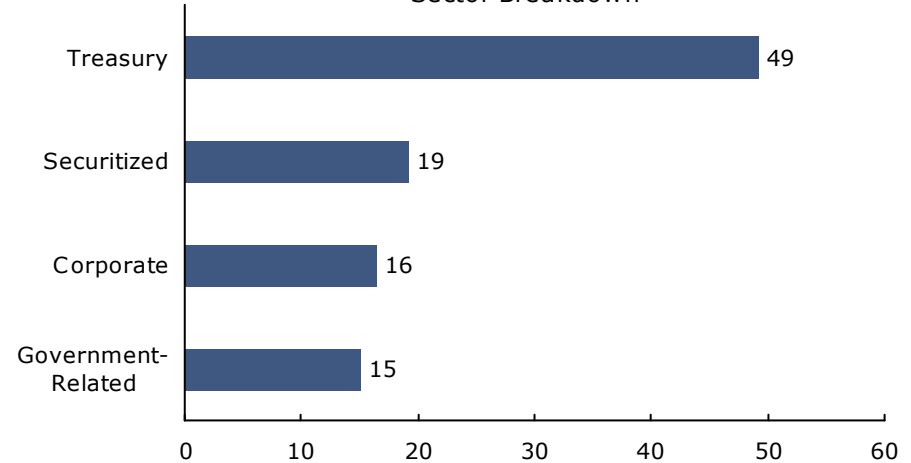


Barclays Capital Global Aggregate – Market Value Weighted (%)

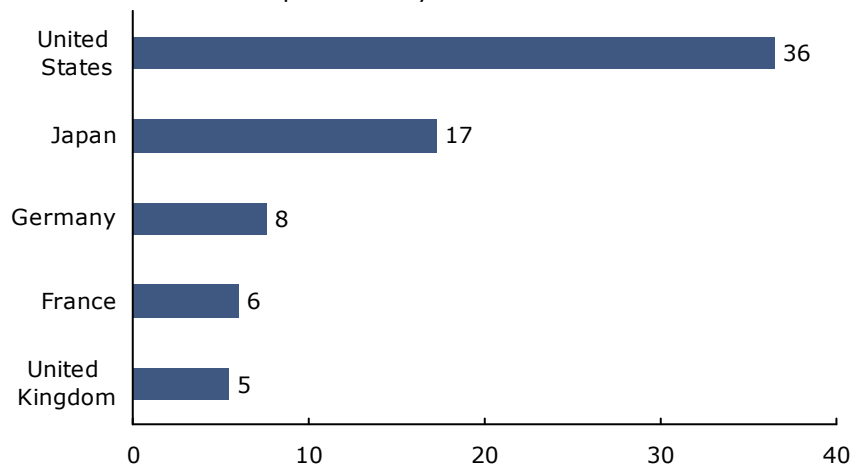
Credit Breakdown



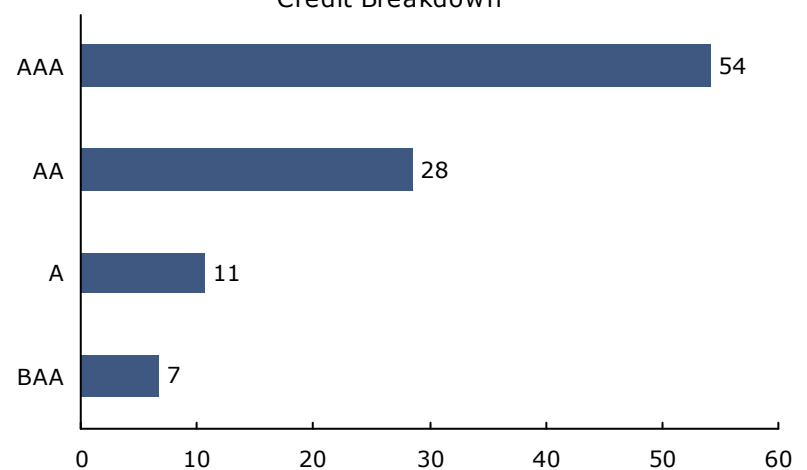
Sector Breakdown



Top 5 Country Breakdown

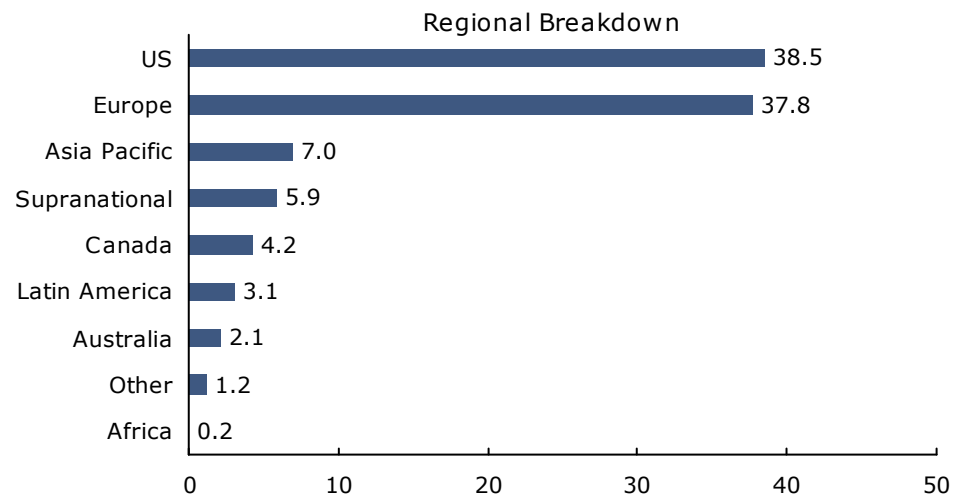
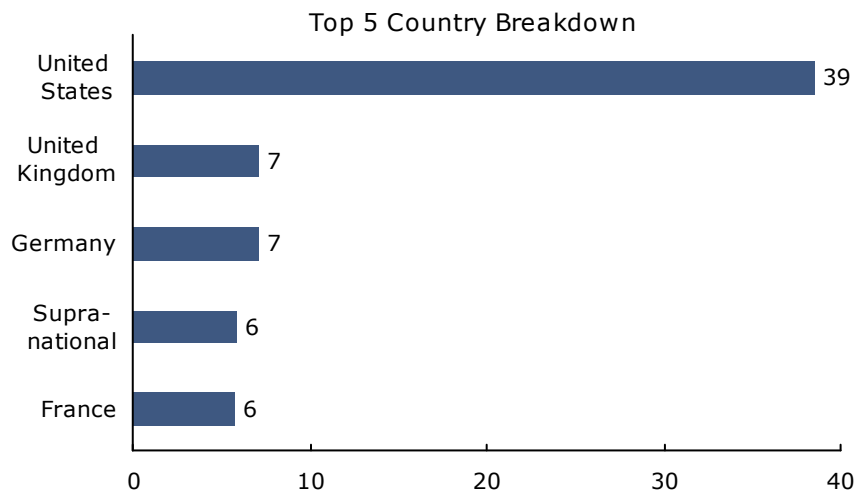
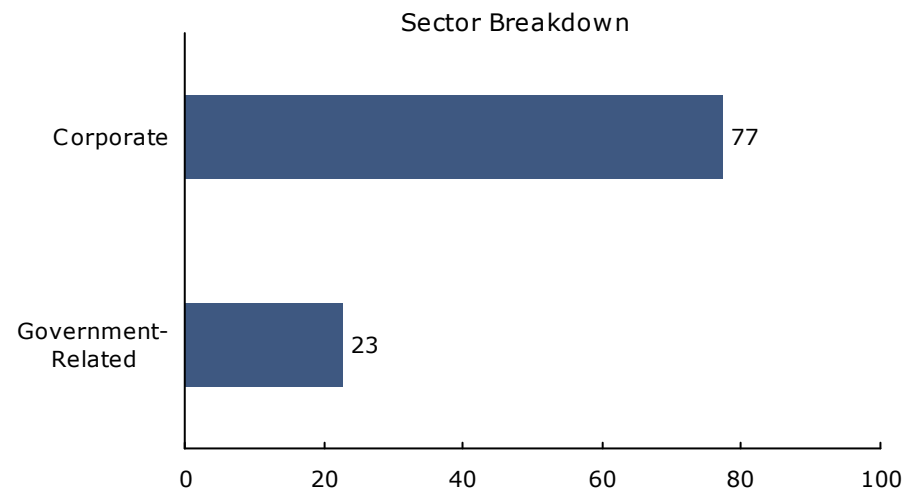
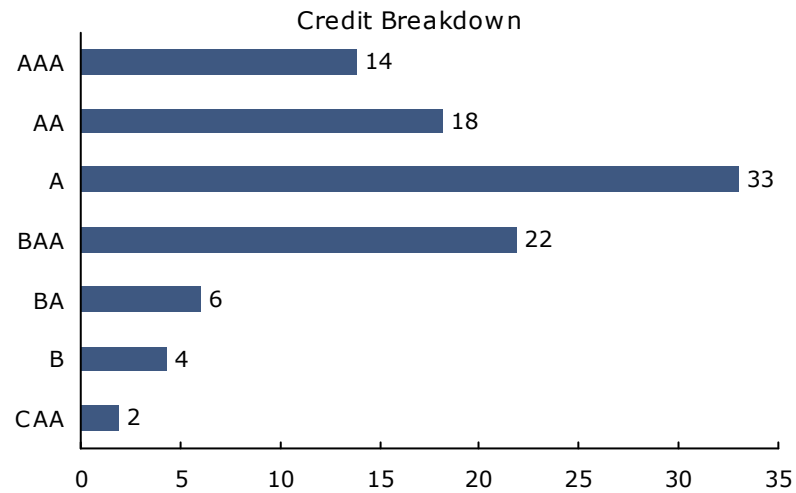


Credit Breakdown



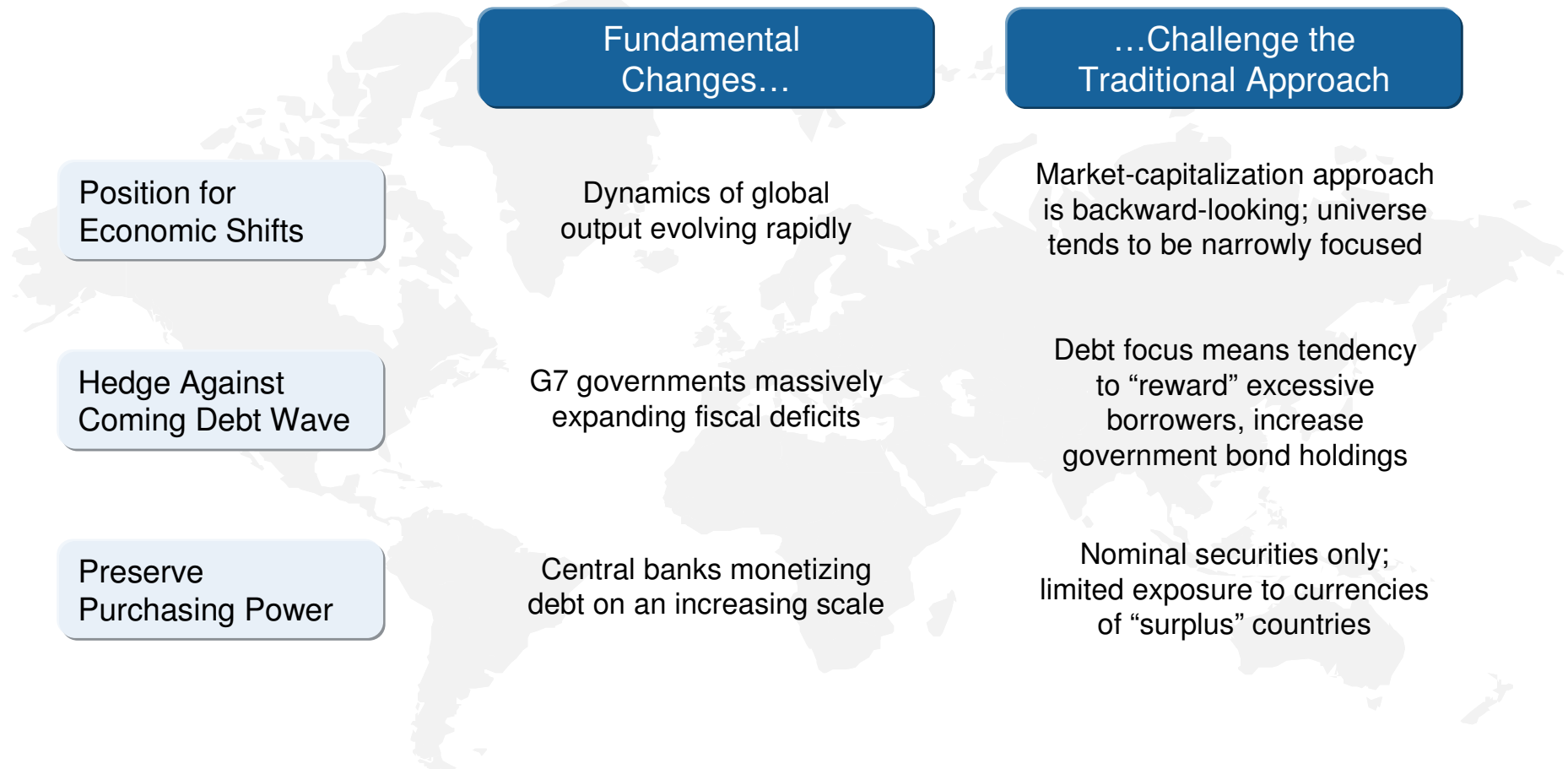
SOURCE: Barclays Capital, as of 31 December 2009

Barclays Capital Credit – Market Value Weighted (%)



SOURCE: Barclays Capital, as of 31 December 2009

Time For A New Approach?



Your Index Should Reflect the Sources of Future Investment Opportunities

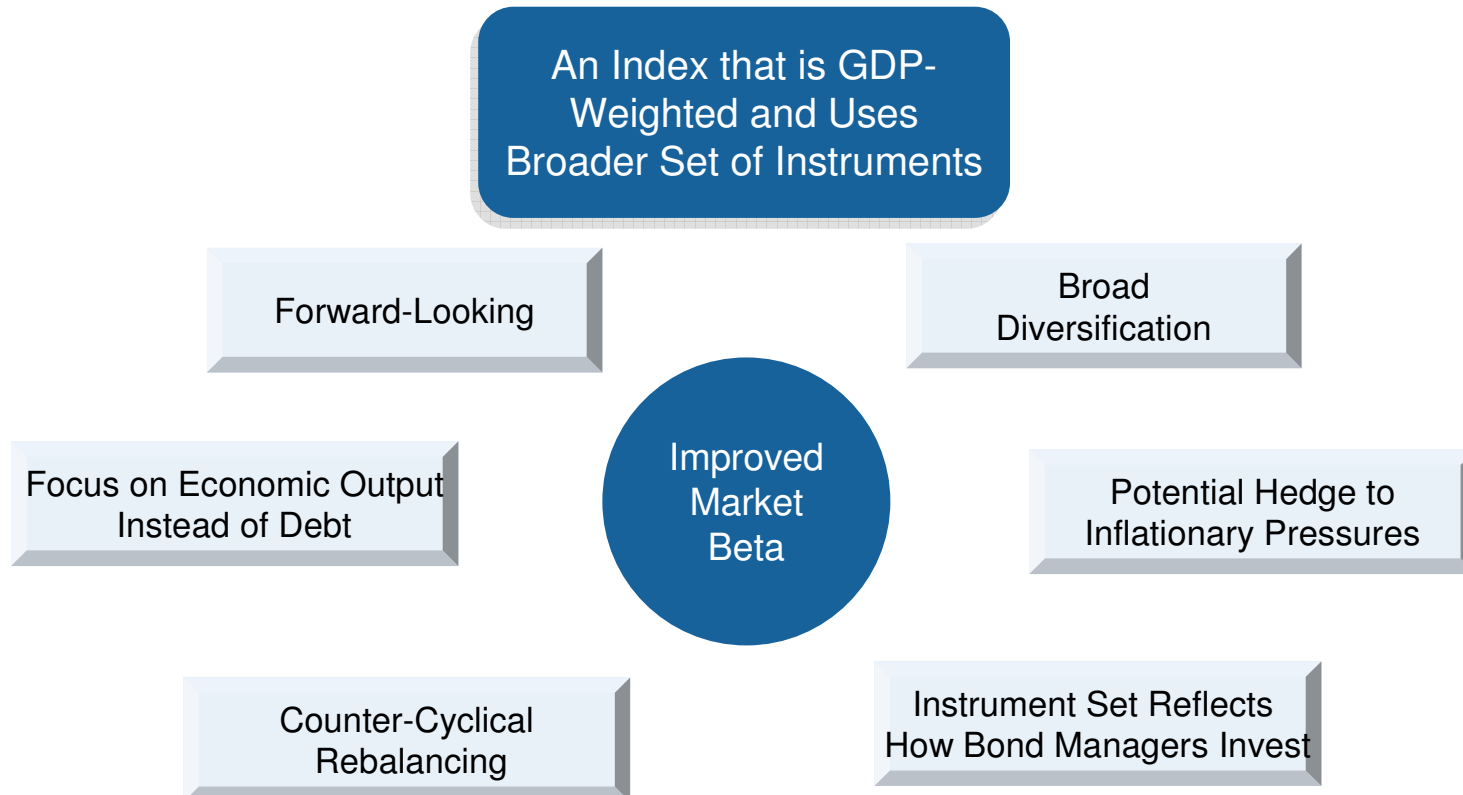
P I M C O

*Wayne Gretzky said the key to success in hockey is to “skate to where the puck **is going to be**, not where it **has been**”*







An Index should be designed to help position investors where potential investment opportunities are likely to be, as opposed to where they have been in the past

An Index for the “New Normal” World



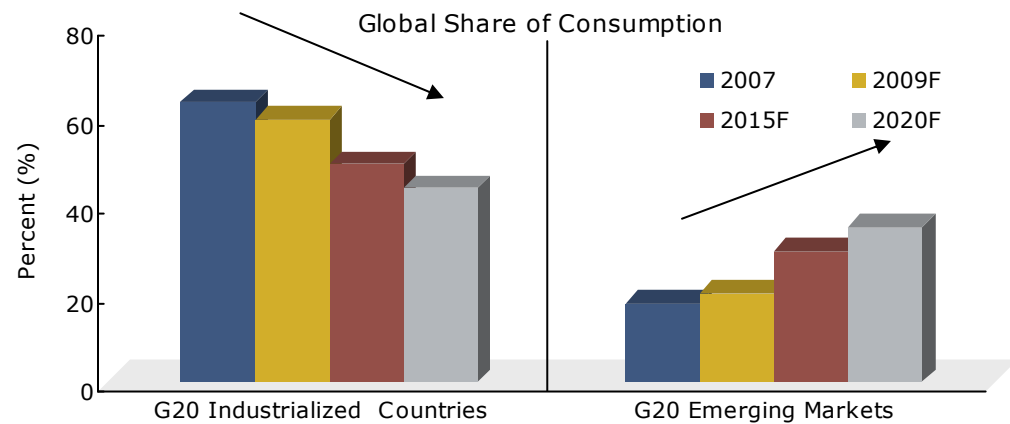
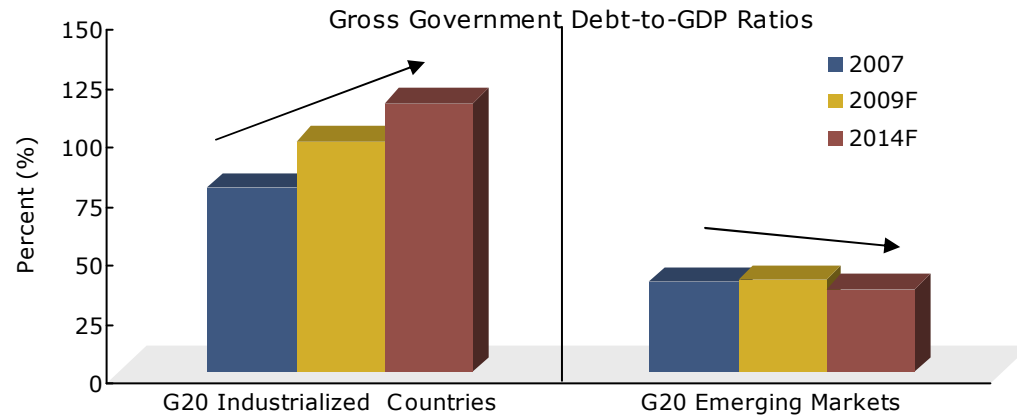
Income vs. Debt: Maximize the Former and Minimize the Latter

		<u>Indebtedness</u>	
		Low	High
<u>National Income</u>	High		
	Low		

By focusing on GDP rather than outstanding debt, a new index would emphasize countries with low debt-to-GDP ratios and underweight those that borrow excessively

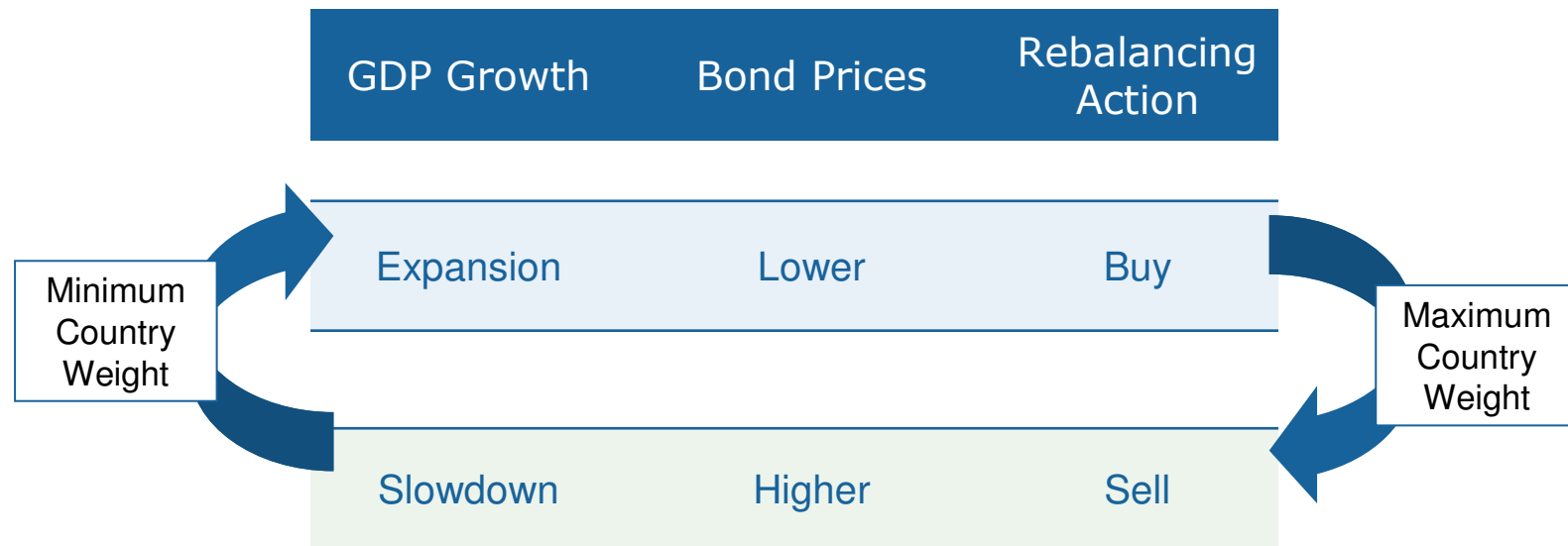
Income vs. Debt

As of August 31, 2009



SOURCE: IMF, PIMCO, Credit Suisse

Counter - Cyclical Rebalancing: Reduce that Which Increases in Supply

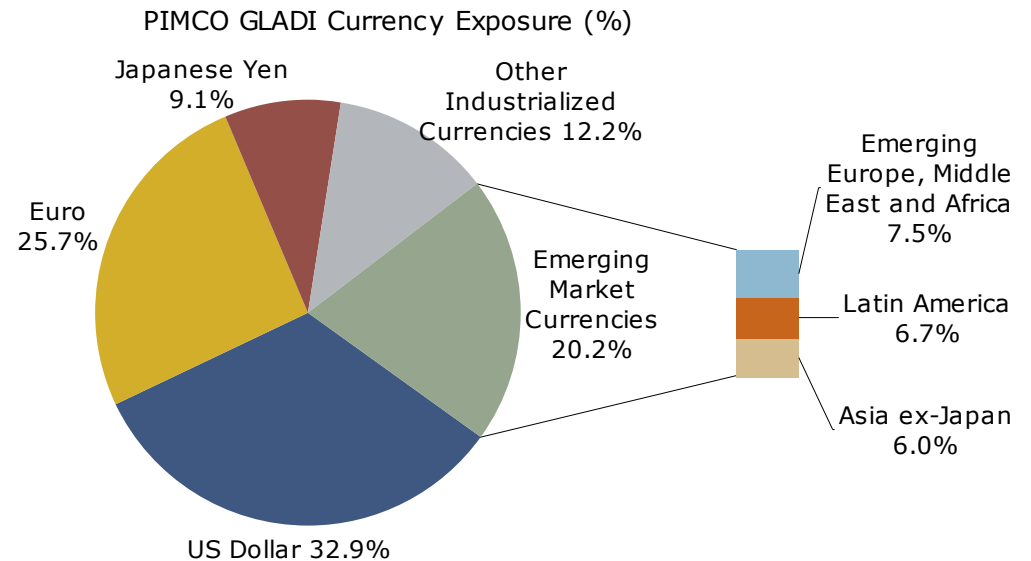
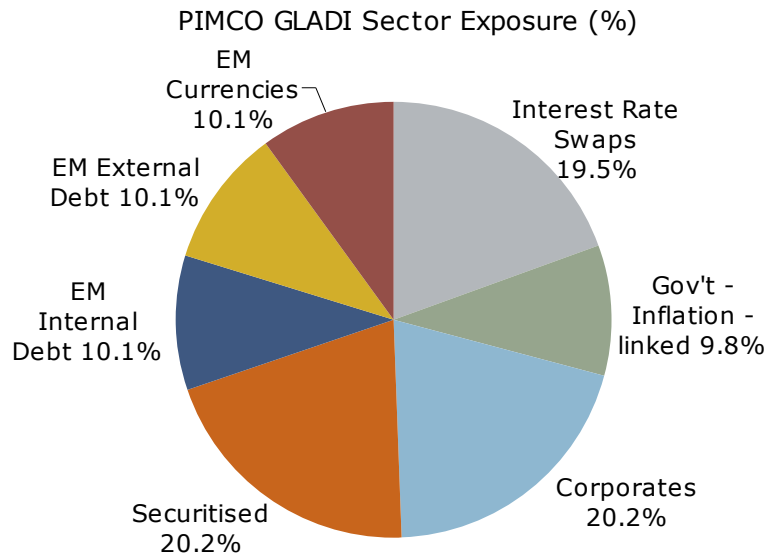


In contrast to the pro-cyclical rebalancing of traditional indices, a new index should rebalance counter-cyclically, increasing allocations when bond prices are low and decreasing them when prices are high

GLADI: Broad Diversification

As of October 31, 2009

- Geography
- Currency
- Sectors
- Instruments



A more effective index would have broader geographical, sector, instrument and currency representation than existing benchmarks

SOURCE: Markit

The data shown above for the PIMCO GLADI index is based on the target-weights consistent with the GDP weights of each region shown. The index rebalances to these target-weights on a quarterly basis (January, April, July, October) and the intra-quarter weights may vary slightly from the targets shown. The target GDP weightings are updated annually based on each region's average GDP contribution over the past five years.

Refer to Appendix for additional index and risk information.

An Inflation Hedge

- A combination of inflation-linked bonds and foreign currency exposure would hedge and enhance purchasing power
- Inflation-linked exposure would directly hedge inflation
- Diversified foreign currency exposure would potentially help offset the inflationary impact of debt monetization



Sample for illustrative purposes only.
Refer to Appendix for additional index and risk information.

GLADI vs. Barclays Capital Global Aggregate Bond Index Sector and Currency Exposure

Sector Exposure	PIMCO Global Advantage Bond Index* (%)	BC Global Aggregate Bond Index (As of Sep 09) (%)
Developed Countries		
Government - Nominal		46.5
Government Related		15.2
Interest Rate Swap	19.5	
Government - Inflation-linked	9.8	
Corporate	20.2	16.4
Securitized	20.2	19.3
Emerging Markets		
EM External Bonds	10.1	
EM Internal Bonds	10.1	2.7
EM Currencies	10.1	
Currency Exposure	PIMCO Global Advantage Bond Index* (%)	BC Global Aggregate Bond Index (As of Sep 09) (%)
U.S. Dollar	32.9	39.6
Euro	25.7	30.4
Japanese Yen	9.1	18.0
Other Industrialized Currencies	12.2	9.5
Emerging Markets		
Asia ex-Japan	7.5	1.7
Europe, Middle East and Africa	6.7	0.7
Latin America	6.0	0.3

SOURCE: Markit, Barclays
 * Data values as of 10/31/09

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GLADI vs. Barclays Capital Global Aggregate Bond Index Sector Exposure

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SOURCE: Markit, Barclays

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Refer to Appendix for additional index information.

The Financial Crisis and the Resulting “New Normal” World

Requires Not Only New Benchmarks But

A More Robust Means of Asset Allocation

Traditional Asset Allocation Approaches Were not Designed for the New Normal

Traditional Approaches

New Approach

Tend to be model driven

Qualitative and driven by an investment process

Assume asset class diversification equals risk diversification

Focus on risk diversification

Allocate based on long-term asset class forecasts

Allocate based on an outlook on economic activity and financial risk and return

Rely on mean-reversion in returns

Don't assume mean-reversion. Focus on forward-looking views on risk factors

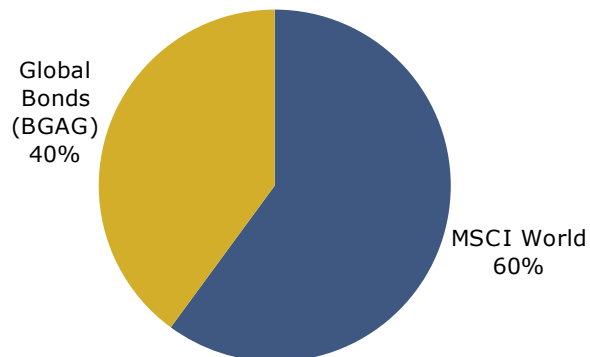
Assume markets remain liquid and ignore "Fat Tail" events

Anticipate periodic illiquidity and seeks to hedge "Fat Tail" events

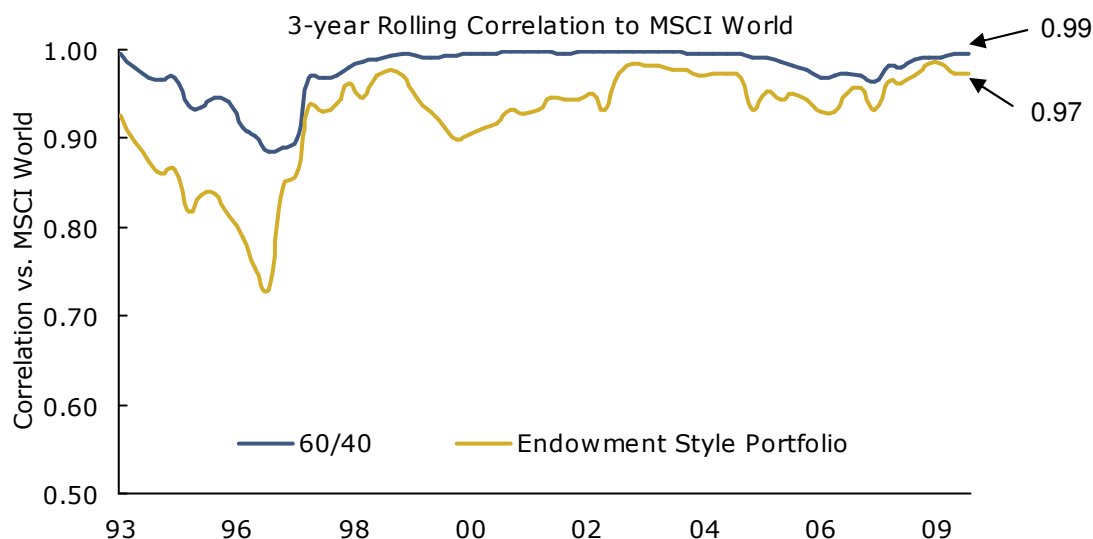
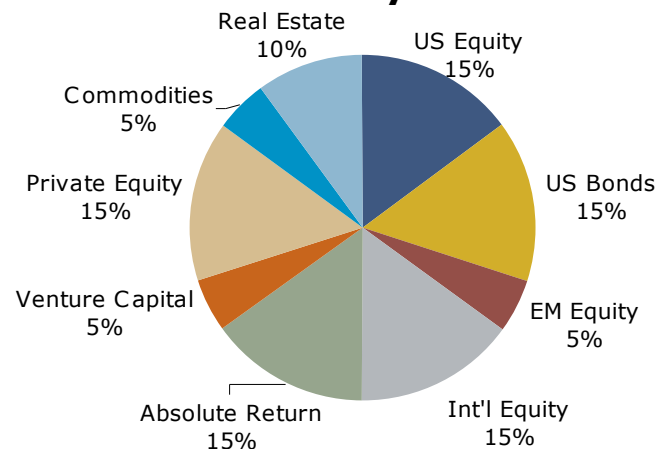
Asset Class Diversification Does Not Necessarily Result In Risk Diversification

As of June 30, 2009

60/40



Endowment Style Portfolio



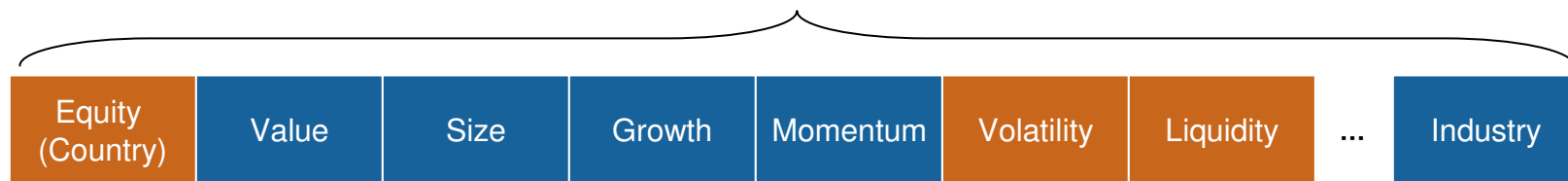
- A 60/40 stock/bond portfolio is highly correlated to equities
- Even the “endowment style” portfolio has become highly correlated to equities and has a beta to the MSCI World Index in the range of 0.6 – 0.7

SOURCE: Morgan Stanley, Bloomberg, Cambridge Associates, and Hedge Fund Research. Private Equity and Venture Capital quarterly returns are released approximately 12-15 weeks following the close of each quarter. Refer to Appendix for additional endowment style portfolio index sources, correlation, and index information.

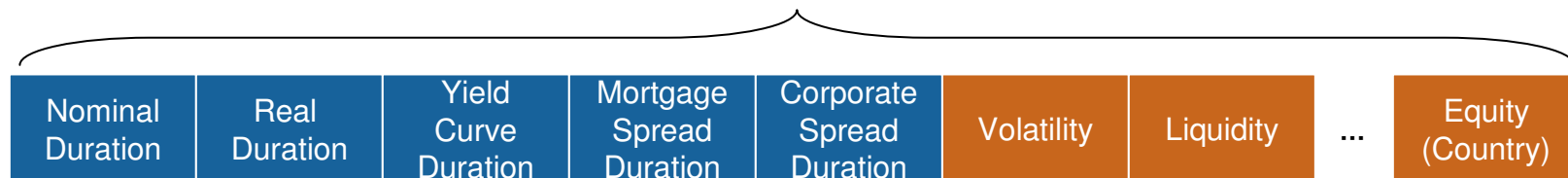
Asset Classes can have Common Underlying Risks

- Risk: The building blocks that drive asset class returns
- Asset classes are simply carriers of various risk factors

Stocks



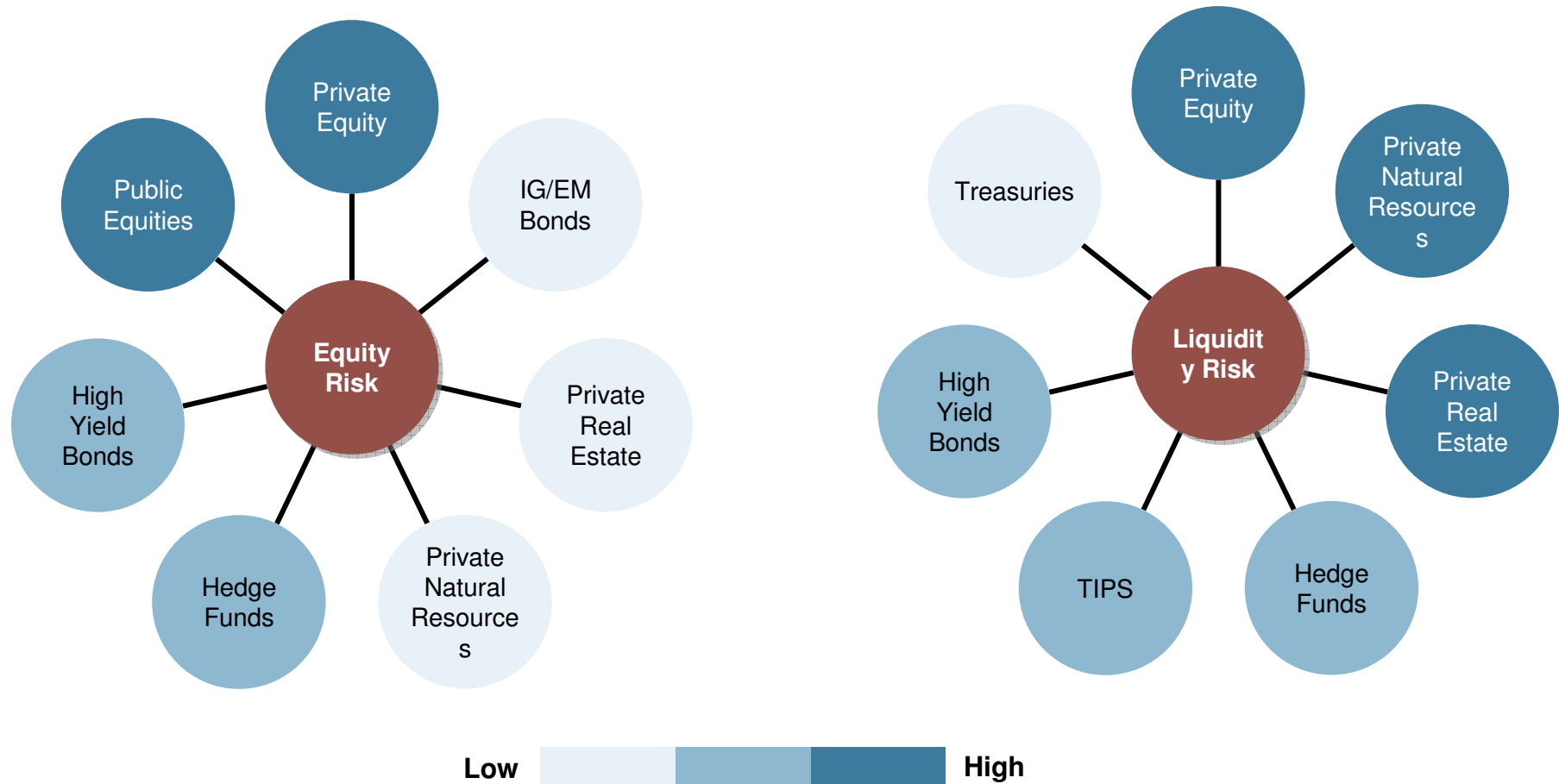
Bonds



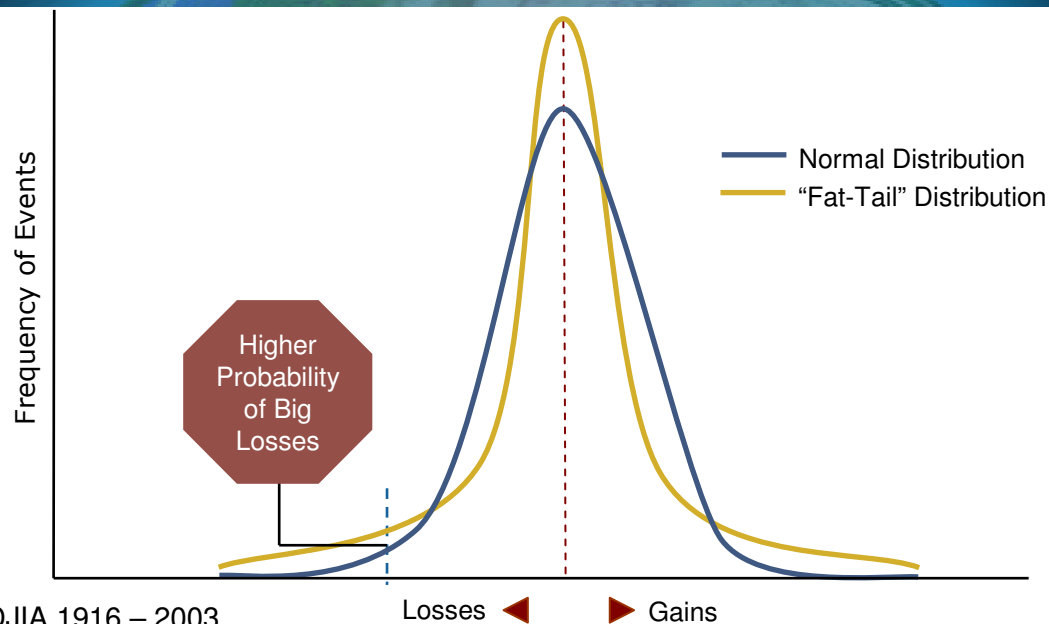
Use a risk factor based approach to investing

Risk Factors Across Asset Classes

- Different asset classes can carry exposure to the same underlying risk, although the level of exposure may vary



Traditional Asset Allocation Approaches Ignore Tail Risk Events



Daily Change in DJIA 1916 – 2003
(21924 Trading Days)

Daily Change (+/-)	Normal Approximation	Actual	Factor
> 3.4%	58 days	1001 days	17
> 4.5%	6 days	366 days	61
> 7%	1 in 300,000 years*	48 days	Large

Major Financial Crises since 1980

- 1982 Mexico defaults on bonds leading to international debt crisis
- 1987 Black Monday, Dow drops 22.6% in one day
- 1989-91 United States S&L and Latin American debt crises
- 1992-3 European Monetary System crisis
- 1994-5 Mexican peso crisis, requiring \$50 bn US guarantee
- 1997-8 Asian financial crisis, requiring \$40 bn IMF bailout
- 1998 Russian default and LTCM
- 2001-2 Argentine default, dot-com bust, Sept 11 terrorist attacks
- 2007-9 Financial market meltdown

SOURCE: PIMCO, Benoit Mandelbrôt: The (Mis)behavior of Markets

Sample for illustrative purposes only.

* Assumes 252 trading days per year.

Updating the Paradigm on (Tail) Risk Management

Old Paradigm

- Portfolio risk defined by likely outcomes
 - Focus on the “ordinary”: large probabilities with small consequences
- Systemic risk is ignored
 - Stable correlations
 - Distribution of returns is normal
 - Liquid, stable markets
- Leaves investors exposed to systemic risk (events in which “correlations tend to one”)

New Paradigm

- Portfolio risk defined by extreme outcomes
- Focus on the “tail”: small probabilities with immense consequences
- Systemic risk is explicitly assessed
- Changing correlations during market stress
- Distribution of returns is “fat tailed”
- Deleveraging drives illiquidity in undesirable ...
- Aligns portfolio holdings with desired exposures to idiosyncratic *and* systemic risks
- **But requires an investment process that assesses global macro risk factors**

Hedging the “Tails”

- What are “tail risks”?
 - Seemingly infrequent events with severe consequences (the “tails” of outcome distributions)
 - Largely macro events (systemic risk) that are accompanied by monetary policy easing
 - Occur more frequently than is typically priced into markets (every 5-7 years)
- How are tail risks hedged?
 - Hold options or “option like” securities (e.g., puts, calls, swaptions, CDX, ITRAXX indices)
 - Hold positions with negative correlation to tail risk (e.g., VIX)
 - Buy Treasuries or Eurodollars (rally during flight to quality and Fed easing)
 - Simply reduce exposure to risk/spread products (move off the efficient frontier)
- How to value tail risk hedges?
 - Stress test the portfolio (comparison of portfolio value with and without hedges)
 - Look for structural and cyclical entry points (cheapness may be driven by structural volatility selling strategies, mispricing of long dated risk)
 - Budget an annual cost of 50-75 bps, which may be more than validated over a cycle when a risk emerges

Understanding Tail Risk

- Tail risk at the portfolio level is almost always a systemic risk
- Episodes of systemic crisis coincide with significant financing/liquidity risks (macro risks)
- Macro risks, including deleveraging risk, are highly correlated with monetary policy risk
- Therefore, systemic risk is hedgable via macro instruments

Build the “Beta”

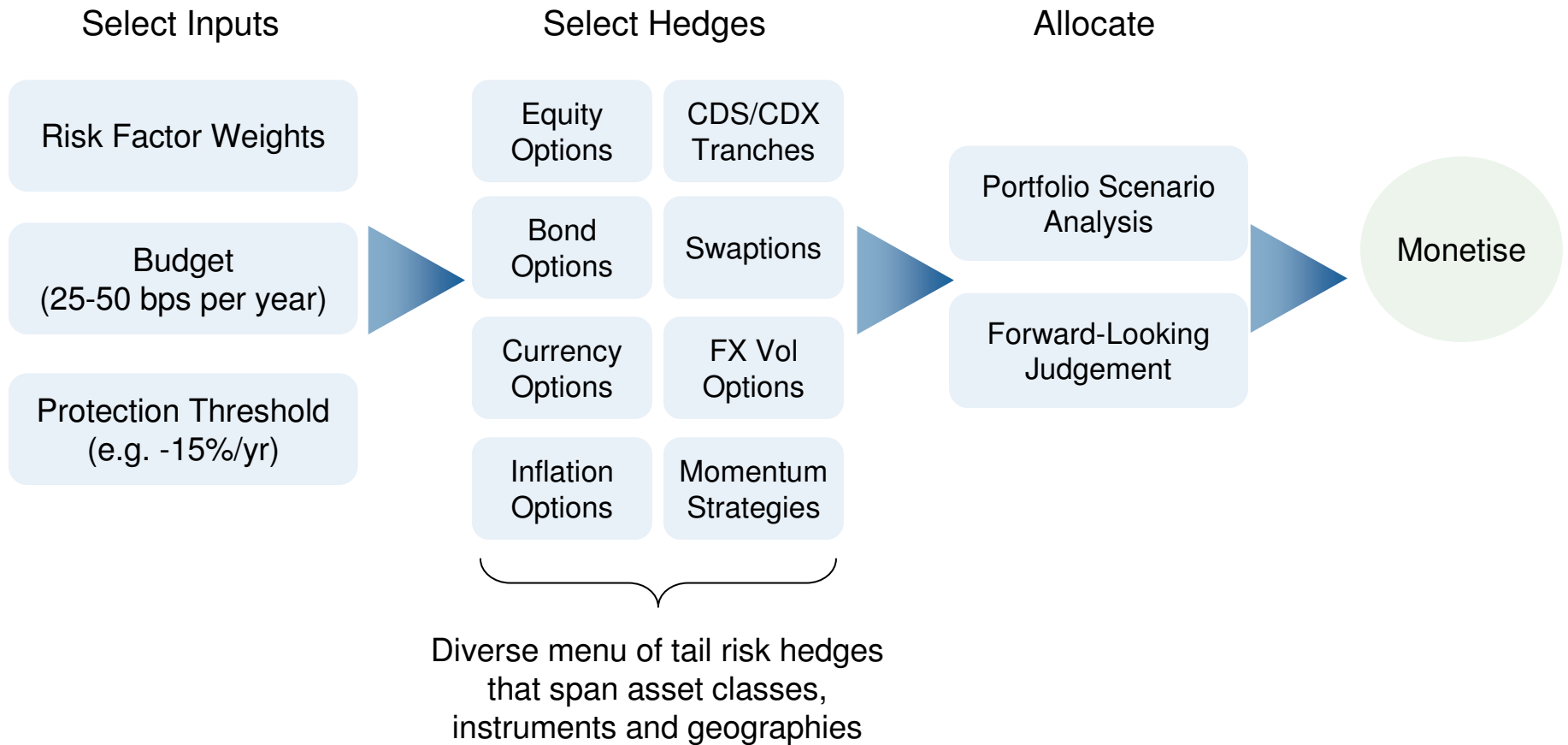
As of June 30, 2009

Portfolio Implementation*

GMA Risk Factor Exposures		Asset Class	MV%	Instrument	Total
Equity Risk	0.30	Developed Markets Equities	15%	PIMCO Funds, Equity Market Futures, ETFs, and Total Return Swaps	18%
Interest Rate Risk	1.91	Developing Markets Equities	3%		
Yield Curve Risk	0.46	Developed Markets Fixed Income	65%	PIMCO Funds, Overlays, and Individual Securities	69%
Mortgage Spread Risk	0.43	Developing Markets Fixed Income	4%		
Corporate Spread Risk	0.46	Real Assets	13%	PIMCO Funds and ETFs	13%
Swap Spread Risk	0.73				

* Representative account
Refer to Appendix for additional representative account, risk factors and risk information.

Hedge the “Tails”



Appendix

Past performance is not a guarantee or a reliable indicator of future results.

Risk Factors

Fund's price sensitivity to a change in the equity markets as proxied by the S&P 500 Index. For every 1% increase (decrease) in the total return of the S&P 500 Index, a portfolio with an Equity Risk factor of 1.0 can be expected to rise (fall) in price by 1% under normal market conditions.

Fund's price sensitivity to changes in the 10yr U.S. Government bond rates. For every 1 basis point fall (rise) in interest rates, a portfolio with duration of 1 year will rise (fall) in price by 1 bp.

Fund's price sensitivity to changes in the slope of the yield curve as measured by the difference between 30yr U.S. Government bond yield and 2yr U.S. Government bond yield, holding the 10 year yield constant. For every 1 bp of steepening (flattening), a portfolio with curve duration of 1 year will rise (fall) in price by 1 bp.

Fund's price sensitivity to changes in spreads, or yield premiums, that affect the value of bonds that trade at a spread to government bonds. For every 1 bp of spread tightening (widening), a portfolio with spread duration of 1 year will rise (fall) in price by 1 bp.

Correlation

The correlation of various indices or securities against one another or against inflation is based upon data over a certain time period. These correlations may vary substantially in the future or over different time periods that can result in greater volatility.

Diversification

Diversification does not ensure against losses.

Endowment Style Portfolio Index Sources

US Equities are represented by the S&P 500, International Equities are represented by the MSCI EAFE Net Dividend Index in USD, EM Equities is represented by the MSCI Emerging Markets Index, US Bonds are represented by the Barclays Capital US Aggregate Index, Global Bonds are represented by the JPMorgan Global Unhedged Index, Commodities are represented by the Dow Jones AIG Commodity TR Index, REITs are represented by NCREIF Property Index, Absolute Return is represented by the HFRI Fund Weighted Composite Index, Private Equity is represented by the Cambridge Associates LLC U.S. Private Equity Index®, Venture Capital is represented by the Cambridge Associates LLC U.S. Venture Capital Index®

Investment Strategy

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.

Portfolio Structure

Portfolio structure is subject to change without notice and may not be representative of current or future allocations.

Appendix

Risk

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. 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 while generally supported by a government, government-agency or private guarantor there is no assurance that the guarantor will meet its obligations. Commodities contain heightened risk including market, political, regulatory, and natural conditions, and may not be suitable for all investors. The value of real estate and portfolios that invest in real estate may fluctuate due to: losses from casualty or condemnation, changes in local and general economic conditions, supply and demand, interest rates, property tax rates, regulatory limitations on rents, zoning laws, and operating expenses. Real Assets are Inflation-linked bonds (ILBs) issued by a government are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. 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. Swaps are a type of privately negotiated derivative; there is no central exchange or market for swap transactions and therefore they are less liquid than exchange-traded instruments. Diversification does not ensure against loss.

The All Asset Fund invests in other PIMCO funds and performance is subject to underlying investment weightings which will vary. The cost of investing in the Fund will generally be higher than the cost of investing in a fund that invests directly in individual stocks and bonds. The Fund is non-diversified, which means that it may concentrate its assets in a smaller number of issuers than a diversified fund.

The value of most bond funds and fixed income securities are impacted by changes in interest rates; bonds and bond funds with longer durations tend to be more sensitive and more volatile than securities with shorter durations.

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Appendix

Index Description

Barclays Capital U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. 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.

The Barclays Capital Global Aggregate Credit Index is the credit component of the Barclays Capital Aggregate Index. The Barclays Capital Aggregate Index is a subset of the Global Aggregate Index, and contains investment grade credit securities from the U.S. Aggregate, Pan-European Aggregate, Asian-Pacific Aggregate, Eurodollar, 144A and Euro-Yen indices. The Barclays Capital Global Aggregate Index covers the most liquid portion of the global investment grade fixed-rate bond-market, including government, credit and collateralized securities. The liquidity constraint for all securities in the index is \$300 million. The index is denominated in U.S. dollars. Prior to November 1, 2008, this index was published by Lehman Brothers.

The Citigroup World BIG (Broad Investment-Grade) Bond ex-U.S. Index is a market capitalization weighted index that tracks the performance of international fixed rate bonds that have remaining maturities of one year or longer and that are rated BBB-/Baa3, or better, by S&P or Moody's, respectively. This index excludes the U.S. and is unhedged USD.

The Citigroup World Government Bond Index (WGBI) is a market capitalization weighted index consisting of the government bond markets of the following countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Switzerland, United Kingdom, and United States. Country eligibility is determined based upon market capitalization and investability criteria. The index includes all fixed-rate bonds with a remaining maturity of one year or longer and with amounts outstanding of at least the equivalent of US\$25 million. Government securities typically exclude floating or variable rate bonds, US/Canadian savings bonds and private placements.

The PIMCO Global Advantage Bond Index (GLADI) is a diversified global index that covers a wide spectrum of global fixed income opportunities and sectors, from developed to emerging markets, nominal to real assets, and cash to derivative instruments. Unlike traditional indices, which are frequently comprised of bonds weighted according to their market capitalisation, GLADI uses GDP-weighting which puts an emphasis on faster-growing areas of the world and thus makes the index forward-looking in nature.

The Barclays Capital Intermediate Government/Credit Index is an unmanaged index of U.S. Government or investment grade credit securities having a maturity of at least one year and less than 10 years. Prior to November 1, 2008, this index was published by Lehman Brothers.

Barclays Capital U.S. TIPS Index is an unmanaged market index comprised of all U.S. Treasury Inflation Protected Securities rated investment grade (Baa3 or better), have at least one year to final maturity, and at least \$250 million par amount outstanding. Performance data for this index prior to 10/97 represents returns of the Barclays Capital Inflation Notes Index. Prior to November 1, 2008, this index was published by Lehman Brothers.

The Cambridge Associates U.S. Private Equity Index is based on returns data representing nearly two-thirds of leveraged buyout, subordinated debt, and special-situations partnerships since 1986.

The Cambridge Associates LLC U.S. Venture Capital Index is based on returns data compiled on funds representing over 80% of the total dollars raised by U.S. venture capital managers between 1981 and 2001. Cambridge Associates LLC calculates the pooled net time-weighted return by quarter from March 31, 1981 through the most recent quarter. The pooled means represent the time-weighted rates of return calculated on the aggregate of all cash flows and market values as reported by the General Partners to Cambridge Associates LLC in their quarterly and annual audited financial reports. Net returns exclude all management fees, expenses and performance fees that take the form of a carried interest.

Dow Jones Wilshire Real Estate Investment Trust Index, a subset of the Wilshire Real Estate Securities Index (WRESI), is an unmanaged index comprised of U.S. publicly traded Real Estate Investment Trusts.

Appendix

The Dow Jones AIG Commodity Total Return Index is an unmanaged index composed of futures contracts on 19 physical commodities. The index is designed to be a highly liquid and diversified benchmark for commodities as an asset class.

The HFRI Fund Weighted Composite Index is comprised of over 2000 domestic and offshore constituent funds. All funds report assets in USD and report net of fees returns on a monthly basis. There is no Fund of Funds included in the index and each has at least \$50 million under management or have been actively trading for at least twelve months.

JPMorgan GBI Global (Unhedged) is an unmanaged market index representative of the total return performance in U.S. dollars on an unhedged basis of major world bond markets.

The Merrill Lynch Treasury Index is an unmanaged index that tracks the performance of the direct sovereign debt of the U.S. Government.

The Merrill Lynch High Yield Index is an unmanaged index consisting of bonds that are issued in U.S. Domestic markets with at least one year remaining until maturity. All bonds must have a credit rating below investment grade but not in default.

Merrill Lynch U.S. High Yield, BB-B Rated, Constrained Index tracks the performance of BB-B Rated US Dollar-denominated corporate bonds publicly issued in the US domestic market. Qualifying bonds are capitalization-weighted provided the total allocation to an individual issuer (defined by Bloomberg tickers) does not exceed 2%. Issuers that exceed the limit are reduced to 2% and the face value of each of their bonds is adjusted on a pro-rata basis. Similarly, the face value of bonds of all other issuers that fall below the 2% cap are increased on a pro-rata basis.

The MSCI EAFE (Morgan Stanley Capital International Europe, Australasia, Far East Index) is an unmanaged index of over 900 companies, and is a generally accepted benchmark for major overseas markets. Index weightings represent the relative capitalizations of the major overseas markets included in the index on a U.S. dollar adjusted basis.

The Morgan Stanley Capital International Emerging Markets Index is an unmanaged index that measures equity market performance in the global emerging markets. As of May 2005, the Emerging Markets Index (float-adjusted market capitalization index) consisted of indices in 26 emerging countries: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey, and Venezuela.

The Morgan Stanley Capital International World Index is an unmanaged market-weighted index that consists of over 1,200 securities traded in 22 of the world's most developed countries. Securities are listed on exchanges in the US, Europe, Canada, Australia, New Zealand, and the Far East. The index is calculated separately; without dividends, with gross dividends reinvested and estimated tax withheld, and with gross dividends reinvested, in both U.S. Dollars and local currency.

The MSCI World Net Dividend Index refers to the total return on the MSCI World Index with dividends taxed at the highest European tax rate. The methodology is MSCI's.

The Russell 2000 Index is an unmanaged index generally representative of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index.

The Standard & Poor's 500 Stock Price Index is an unmanaged market index generally considered representative of the stock market as a whole. The index focuses on the Large-Cap segment of the U.S. equities market.

The S&P/Case-Shiller Home Price Indices measures the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan region across the United States. In addition, the S&P/Case-Shiller® U.S. National Home Price Index is a broader composite of single-family home price indices for the nine U.S. Census divisions and is calculated quarterly.

It is not possible to invest directly in an unmanaged index.