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Investment Outlook

August 2013

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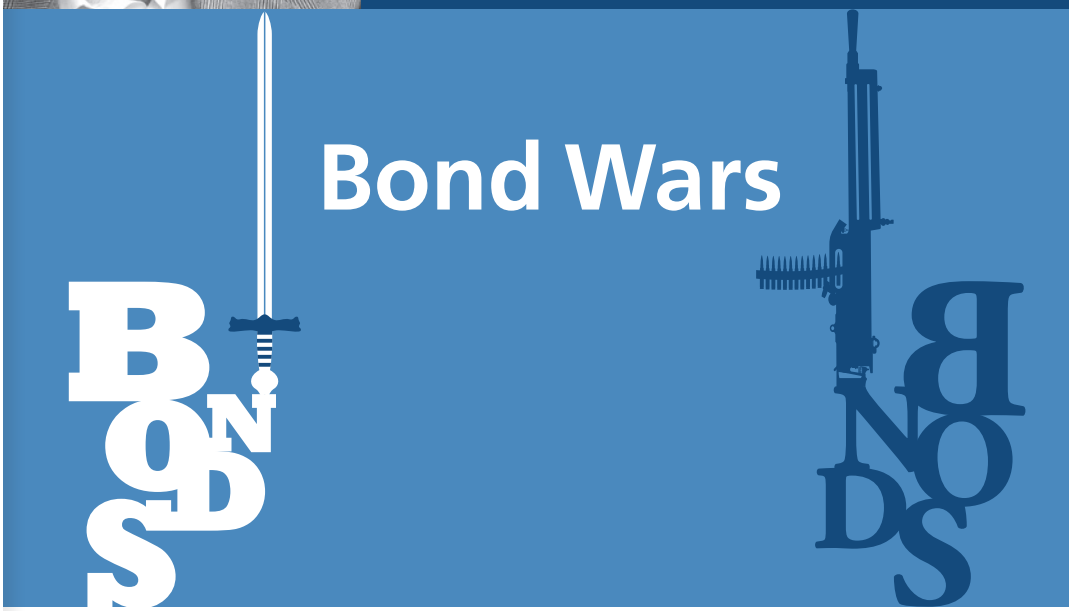
Bond Wars



Adaptation is tantamount to survival in the physical world. So argued Darwin, at least, and I am not one to argue with most science and its interpretation of natural laws. Adaptation has been critical as well for the survival of countries during wartime, incidents of which I am drawn to like a bear to honey, especially when they concern WWI. Stick with me for a few paragraphs on this – the following is not likely to be boring and almost certainly should be instructive.

In the first decade of the 20th century, British war colleges and their generals were philosophically trapped by the successful strategies of a prior era – an era before the invention of a functional machine gun. They felt that machine guns might dampen the spirit of their fighting forces. What counted was the horse and the sword. Britain's cavalry training manual of 1907 in fact stated that "the rifle or machine gun, effective as it is, cannot replace the devastation produced by the speed of the horse, the magnetism of the charge, and the terror of cold steel."

The British were to experience the horror of their inability to adapt at the Battle of the Somme in 1916. German and British lines were separated by only 300–400 yards and millions of pounds of barbed wire. After several weeks of intense mortar barrage, which the British felt would leave German trenches in shambles, the Brits were ordered to advance on the German lines – each three feet apart, at a deliberate pace, wearing 65 pounds of gear. The soldiers heard their generals' whistle at the break of an early July dawn, climbed over the top and advanced slowly. They were accompanied by officers on horseback flashing steel sabers, confident that the charge would psychologically and then physically overwhelm the mortar-battered Germans in a matter of minutes.

Instead, they were met by 1,000 German machine guns. The Germans, it seems, had burrowed themselves for weeks, 50–100 feet underground, surviving the mortars relatively intact. And their generals were well-versed in British tactics – always charging at the break of dawn, always blowing loud shrieking whistles, always advancing three feet apart with horses and bayonets of a bygone era. But the Germans believed in machine guns, not horses. Within the first few minutes there were 30,000 dead and wounded. By the end of the day there was not a single British soldier alive that had penetrated German barbed wire. Machine guns cut them down like scythes harvesting wheat. The few that reached German trenches were incinerated by German flamethrowers, another 20th century technological invention. The Somme was the biggest disaster in the history of British arms, and perhaps history's bloodiest single slaughter. During the extended battle, one million British and German soldiers were killed or wounded, yet it was Britain's not Germany's temporary Waterloo, based on their failure to adapt to a new age.

Now that bonds have suffered a near Somme-like defeat in the past few months, fixed income investors are concerned about their prior conceptions of bonds as an asset class – an asset that has historically provided reliable income and stable to higher prices. This concept has been more than validated over the past 30 years as the total return of long-term bonds equaled and even exceeded the performance of stocks for much of the time period. But now – with yields so low, and with a negative 3–4% two-month return for bond indices – investors wonder if the bond "horse and saber" has given way to the alternative asset "machine gun" of a new era.

Well, future performance on the battlefield is one thing – and I will attempt to analyze that in the next few pages. But there will always be a place for the bond market "army." A significant portion of an institutional or individual's portfolio will always require bonds.

Insurance companies, pension funds – all institutions with liability structures that require matched asset hedging require fixed income assets on the other side of their balance sheet. The recent several months' experience of higher yields was, in fact, a blessing for them, as their future liabilities went down faster than the price of their bond assets did! Individuals with 401(k)s invested in bond mutual funds didn't see it that way, although similar logic applies if they present-value their home mortgage liabilities. But I write not to praise higher interest rates, but to bury antiquated portfolio management strategies that would lose money because of them. I write to alert you to evolving thinking that might win this new war without causing you – the investor – to desert an historical and futurely valid asset class that we believe can still provide reliable income and hopefully steady returns even in the face of higher interest rates.

While PIMCO has been rather prescient at warning of New Normals and then predicting the inevitable turn of near zero percent yields, it is an open question whether we are still marching three feet apace with 65-pound backpacks into the face of 1,000 machine guns, or safely burrowed in fox holes with revised strategies adaptive to a new era. Trust me, no investment firm has given this transition more thought. While our strategic execution in May/June of 2013 can and has been publically faulted, we are confident that we know how to win this evolving bond war. We have spent months – indeed years – preparing for this new dawn. We intend for you – our clients – to be surviving veterans of this battle, not casualties. PIMCO will not go down at the Somme.

Here's why, and here's the logic behind our evolving future strategy. **All investments, bonds included, have a number of modern-day weapons at their disposal which can be used to defend against higher interest rates, weapons that don't necessarily go down in price as yields rise. These weapons can collectively be categorized as "carry."** Carry is really another word for yield, but it often comes in forms less obvious than a fixed semi-annual interest payment. Some carry does come in the form of maturity extension – the characteristic that most investors associate with bonds, and the one that can be easily cut down in an antiquated cavalry charge at near zero bound interest rates. When interest rates go up as fast as they did in early May, prices go down for long and intermediate maturity bonds, and the carry associated with maturity extension becomes akin to a horse charging a machine gun.

But bonds have other forms of "carry" that are not necessarily yield or interest rate dependent. Bonds issued by less than Aaa sovereign countries and all corporations have a credit spread that can provide a significant or even higher risk-adjusted carry than does maturity extension. These spreads might widen as interest rates rise, but historically they have not, acting as a diversifier rather than a bear market enhancer. Bonds also have a volatility premium that produces carry, a premium more susceptible to negative consequences if yields rise suddenly like May/June but not during a more gradual increase like one that PIMCO forecasts over the next few years. In addition, bonds have a carry component inherent in the yield curve itself, one which refers to choices between a bullet or a barbell strategy – the bullet

providing historically more carry than the barbell under most market conditions. And a bond can be denominated in non-dollar currencies, all of which provide the potential at some point to enhance carry.

To briefly summarize: All bonds have carry in the following form:

1) Maturity risk
2) Credit risk
3) Volatility risk
4) Curve risk
5) Currency risk

It is, however, maturity risk that most investors fear most in their bond portfolios. It is the reason why bonds were such a successful competitor to stocks since 1981 as yields came down from 15¼% to 2½% in June of 2012. It is also the reason why returns have had a negative cast since then. What to do now?

Well as I argued in the opening paragraphs, there will always be a need for fixed income and therefore maturity extension in investors' portfolios. Fixed liability institutions demand it and aging boomers worldwide require it. So let's not compare a 5–10 year Treasury note to a British horse. Still, in a rising interest rate environment over time, a portfolio manager might rely less on maturity "horses" and depend more on the "machine guns and flamethrowers" associated with credit, volatility, curve and currency.

Now at first, second or third blush this might seem rather obvious. Gross may have taken many of you through a WWI moment only to confirm what many of you have already figured out. Your reallocations to unconstrained strategies, alternative asset, and even lower duration portfolios are ongoing, and it is those products that predominantly contain non-maturity extension carry. If you are leaning in that direction, then we are in sync even for classic bond strategies such as the PIMCO Total Return Strategy. Less carry from duration, more carry from credit, volatility, curve and currency in the future years ahead.

But can it be that simple? No, because adaptation is required not just philosophically at war colleges in anticipation of evolving weaponry, but on the battlefield itself during the heat of the battle. There will be times when duration is advantaged at the expense of credit, a time when volatility and curve perform less well than a 30-year Bund denominated in euros. What is commonsensical and relevant to disclose in an *Investment Outlook* meant primarily for clients, is that we are aware of the choices, that we know maturity/duration extension is becoming a tired horse, but that it may still have a place on the battlefield under certain conditions. **Will PIMCO charge the machine-gun-laden front lines with consistently overweighted durational bond strategies? No, but we might try to outflank them if yields rise too much like today.** Will we be aware that credit, curve, volatility and currency have their risks as well and could be outdated just as easily? Yes. In fact, the total carry of a portfolio is perhaps the risk most critical in today's bond/unconstrained/alternative asset or even equity wars. The total carry or the total "yield" of a portfolio is PIMCO's dominant focus, not duration reduction. In a highly levered economy/financial marketplace, all forms of carry can go up or down at the same time. They did for successive weeks in May and June. They may do so again. The diversifying aspects of one form of carry vs. another may hold form in most future time periods, but when they don't, almost all investors will regret not focusing on total carry as opposed to discriminating exclusively against maturity extension.

How much carry should a portfolio manager/PIMCO hold for its clients today relative to their desired indices? Here's a helpful guide: Capitalism depends on the successful offering and capture of carry in its multiple forms. If capitalism is faltering (recession) in developed/developing economies and yields are close to the zero bound, then portfolios should have less carry than before. If prospects are mediocre, portfolios should be overweight carry. If prospects are very bright, they should again be underweight bond carry. If we can be mindful of this, and accurately forecast it, we will be successful. This may be the most important conceptual change I have ever written about in an *Investment Outlook*. Readers who have stuck with this *Outlook* at least to this point have a scoop, if not a magic feather.

So, fellow generals in this bond war, today's war college lesson is to be mindful of evolution and the necessity to adapt. Know that maturity extension worked well for 30 years and will work less well with yields close to zero. Know that there are other weapons at your disposal, but they too contain risk and their combined carry is itself probably the most critical variable in future asset return wars. And know that bonds – while containing a certain amount of maturity risk by very definition – will never be antiquated. The secret to using them will be to strategically position their component and combined carry to maintain positive absolute returns. Unconstrained strategies, alternative assets and stocks will be flexible choices in a dynamic

future environment. We want to continue managing them for you. But don't give up on bonds. Flexible bond managers can adapt as well. PIMCO will not go down at the Somme.

Bond Wars Speed Read

1) Bond managers must adapt to a new world of near zero bound interest rates and the likelihood of lower total returns.
2) Reducing maturity is not the only potential strategy to win this new war; in fact because of near 0% money market yields, at times it may be counterproductive.
3) By focusing on "carry" and its diversifying characteristic components, a bond manager can help protect downside risks.
4) Carry consists of maturity extension, credit spreads, yield curve differences, volatility, and currency components.
5) Stick with PIMCO, we're going to win this new war!

William H. Gross
Managing Director

***Included as an attachment is an earlier 1986 version of my first "Bond Wars" which in retrospect seems pretty insightful.**
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