PIMCO

Your Global Investment Authority

Investment Outlook

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They say defense wins Super Bowls, but the Mannings, Bradys and Montanas of gridiron history are testaments to the opposite. Putting points on the board, especially in the last two minutes, has won more games than goal line stands ever have, even if the scoring has been done by the field goal kickers, the names of whom have been confined to the dustbins of football history as opposed to the Hall of Fame in Canton, Ohio. Canton, however, has an approximately equal number of defensive in addition to offensively positioned inductees, so there must be a universally acknowledged role for both sides of the scrimmage line. What fan can forget Mean Joe Greene, Deion Sanders or Mike Ditka? The old, now politically incorrect showtune laments that "you gotta be a football hero, to fall in love with a beautiful girl," but football and any of life's heroes can play on either side of the line, it seems.

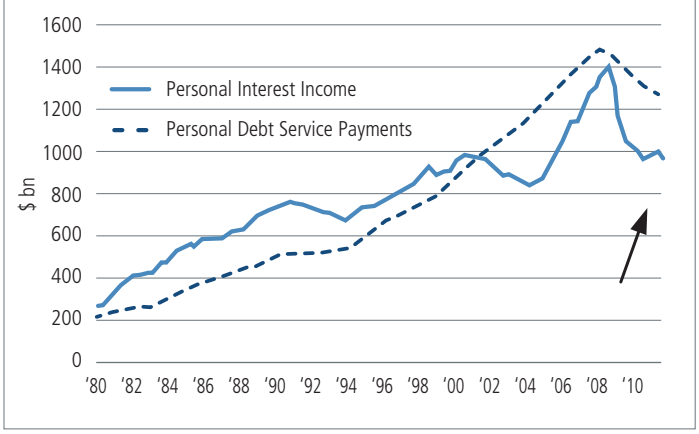
My point about pigskin offense and defense is the perfect metaphor for the world of investing as well. Offensively minded risk takers in the markets have historically been the ones who have dominated the headlines and won the hearts of that beautiful gal (or handsome guy). Aside from the rare examples of Steve Jobs and Bill Gates, however, the secret to getting rich since the early 1980s has been to borrow someone else's money, throw some Hail Mary passes and spike the ball in the end zone as if you had some particular genius that deserved monetary rewards 2^{10} times more than a Doctor, Lawyer or an Indian Chief. Nah, I take that back about the Indian Chief. The Chiefs, at least, have done pretty well with casinos these past few decades.

Still, the primary way to coin money over the past 30 years has been to use money to make money. Although the price of it started in 1981 at a rather exorbitantly high yield of 15% for long-term Treasuries, 20% for the prime, and real interest rates at an almost unbelievable 7-8%, the gradual decline of

yields over the past three decades has allowed P/E ratios, real estate prices and bond fund NAVs to expand on a seemingly endless virtuous timeline. Books such as "Stocks for the Long Run" or articles such as "Dow 36,000" captured the public's imagination much like a Montana to Jerry Rice pass that always seemed to clinch a 49ers victory. Yet an instant replay of these past few decades would have shown that accelerating asset prices weren't due to any particular wisdom on the part of academia or the investment community but an offensively minded Federal Reserve and their global counterparts who were printing money, lowering yields and bringing forward a false sense of monetary wealth that was dependent on perpetual motion. "Rinse, lather, repeat – Rinse, lather, repeat" was in effect the singular mantra of central bankers ever since the departure of Paul Volcker, but there was no sense that the shampoo bottle filled with money would ever run dry. Well, it has. Interest rates have a mathematical bottom and when they get there, the washing of the financial market's hair produces a lot less lather when it's wet, and a lot less body after the blow dry. At the zero bound, not only are yields rendered impotent to elevate P/E ratios and lower real estate cap rates, but they begin to poison the financial well. **Low yields, instead of fostering capital gains for investors via the magic of present value discounting and lower credit spreads, begin to reduce household incomes, lower corporate profit margins and wreak havoc on historical business models connected to banking, money market funds and the pension industry. The offensively oriented investment world that we have grown so used to over the past three decades is being stonewalled by a zero bound goal line stand. Investment defense is coming of age.**

This transition is not commonly observed, although it is relatively easy to prove statistically and even commonsensically. Take for instance the rather quizzical notion that lower yields must produce an equal number of winners and losers since there is a borrower for every lender and the net/net therefore should have no effect on the real economy or its financial markets. Chart 1 shows that since 1981, which marks the beginning of the secular decline of interest rates, personal interest income has rather gradually (and now somewhat suddenly) shrunk relative to household debt service payments.

Chart 1 **Losing End**



Source: Bureau of Economic Analysis, Federal Reserve, Credit Suisse

It is Main Street that has failed to keep up with Wall Street and corporate America in the race to see who can benefit more from lower yields. As the interest component of personal income gradually weakens, the ability of the consumer to keep up its frenetic spending is reduced. Metaphorically, it's akin to a 4th quarter two minute Super Bowl drill, but one where the receivers haven't been properly hydrated. They're a half step slow, their legs are cramping, and it shows. Lower interest rates are having a

negative impact on households because their water bottles are filled with 50 basis point CDs instead of Gatorade.

While Wall Street and levered investors have fared better than their Main Street counterparts, it's not as if they're in "primetime Deion Sanders" shape either. Conceptualize the historical business model of any financially-oriented firm for the past 30 years and you will see what I mean. **Insurance companies, for instance, whether they be life insurance with their long-term liabilities, or property/casualty insurance with more immediate potential payouts, have modeled their long-term profitability on the assumption of standard long-term real returns on investment. AFLAC, GEICO, Prudential or the Met – take your pick – have hired, staffed, advertised, priced and expensed based upon the assumption of using their cash flows to earn a positive real return on their investment. When those returns fall from 7% positive to an approximate 1% negative, then assumptions – and practical realities – begin to change.** If these firms can't cover inflation with historical real returns from their float, then they begin to downsize in order to stay profitable. The downsizing is just another way of describing a transition from offense to defense in a zero bound nominal interest rate world where any almost level of inflation produces negative real yields on investment.

Not only insurance companies but banks suffer from this inability to maintain margins at the zero bound. In the process, they close retail branches that once were assumed to be the golden key to successful banking. Defense! And here's one of the more interesting anecdotal observations on our current zero-based environment, one to which my investment paragon – Warren Buffett – would probably immediately admit. His business model – and that of Berkshire Hathaway – has long benefitted from what he has described as "free float." Those annual policy payments, whether for hurricane, life or automobile insurance, have long given him a competitive funding advantage over other business models that couldn't borrow for "free." Today, however, almost any large business or wealthy individual can borrow or lever up with minimal interest expense. Buffett's "Omaha/West Coast" offense is being duplicated around the world thanks to central bank monetary policies, placing an increasing emphasis on stock and investment selection as opposed to business model liability funding. Buffett will succeed based upon his continued strong offensive play calling, but the rules of the game are changing.

The plight of Buffett of course is in some respects the plight of PIMCO or any investment/financially-oriented firm in this new age of the zero bound. And it seems to us at PIMCO that successful investing in a deleveraging, low interest rate environment will require defensive in addition to offensive skills. What does that mean? Well, let's briefly describe PIMCO's own historical investment offense for the past 30 years in order to provide a defensive contrast:

PIMCO Offensive Strategy 1981 – 2011

Ready, Set, Hut 1, Hut 2 –

1. Recognize downward trend in interest rates and scale duration accordingly.

   A. Emphasize income and capital gains.
      PIMCO Total Return Strategy.

   B. Utilize prudent derivative structures that benefit from systemic leveraging – financial futures, swaps (but no subprimes!)

   C. Combine A and B along with careful bottom-up security selection to seek consistent alpha.

PIMCO Defensive Strategy 2012 – ?

Ready, Set, Hut, Hut, Hut –

1. **Recognize zero bound limits and systemic debt risk in global financial markets. Accept financial repression but avoid its impact when and where possible.**

   A. **Emphasize income we believe to be relatively reliable/safe.**

   B. **De-emphasize derivative structures that are fully valued and potentially volatile.**

   C. **Combine A and B along with security selection to seek consistent alpha with admittedly lower nominal returns than historical industry examples.**

So there you have it – the PIMCO playbook. I suppose if I had any common sense I would hold up that clipboard to the front of my mouth like sideline coaches do during big games. Don't want to chance any of the competition reading our lips to get a heads up on PIMCO's next offensive play call. But then that's never been my or Mohamed's style, given the importance of informing you, our clients, of what we are thinking when it comes to investing your hard-earned capital. Go ahead competitors and read our lips, we'll just pound that pigskin down the field anyway. Besides, as I've pointed out, the emphasis these days should be on the defensive coach. Leveraging has turned into deleveraging. 15% yields have turned into 0% money. The Super Bowls of the future will have their Mannings and Bradys, but the defensive line may record more sacks and make more headlines than ever before.

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