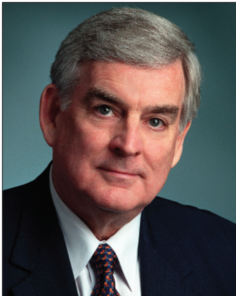
Gaining Perspective
Market Insights from NFJ

Allianz Global Investors

Worst of the Shocks May Be Behind Us



Ben Fischer
Managing Director
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3/20/09—In a recent conference call, NFJ's Ben Fischer discussed possible signs of life in the economy as well as the long-term prospects for dividends.

Fed Actions Raise Hopes

While most investors were caught off-guard by the severity of the stock sell-offs from October 2008 through early March 2009, there is reason to hope that this difficult six-month period has seen the worst of the shocks.

On March 18th, the Federal Reserve announced that it intended to boost its balance sheet by buying some $1 trillion in Treasuries and mortgage-backed securities. Through its purchases, the Fed is effectively supercharging the money supply. This should create liquidity and help rev up the economy. The markets recognized the announcement as a big event, with stock prices surging for several days afterward.

Different from Earlier Recessions

The Fed measures have been unusual, but necessary. One of the distinguishing characteristics of the current crisis is the massive debt weighing down our economy. As a result, typical responses to recessions, such as lowering interest rates and inventory run-offs, are simply insufficient, running the risk of pulling us into a depression.

A probable consequence of the Fed's aggressive actions is a fiscal deficit of over $1 trillion for the next several years. This raises concerns about inflation, as political pressure will make it difficult for the Fed to pull back smoothly from this level of spending. In that scenario, international stocks, which would be less affected by a potentially weaker U.S. dollar, may be a reasonable hedge against inflation. However, investing in non-U.S. securities has its own risks, including political and economic risk and the risk of currency fluctuations, all of which may be enhanced in emerging markets.

A Difficult Winter for Cyclicals

Companies that are sensitive to economic and interest-rate changes are typically hit hardest during recessions. As these stocks are usually cheap as the economy weakens, value portfolios tend to suffer more during downturns than their growth counterparts. We saw this in 2000, at the peak of the Internet bubble, as well as in 1989, when the cyclical downturn did the greatest damage to value stocks. Each time, however, these stocks really shone once we came out of the downturn.

As deep value investors, we were not immune to the decline in cyclicals. On a relative basis, however, our portfolios managed to hold ground. We believe this was due to our bottom-up investment approach, which in 2007 and early 2008 led us to view the financial sector as unacceptably risky. That underexposure provided some relative protection in the last quarter of 2008, although of course on an absolute basis the portfolios were down for the year.

Dividend Opportunities Still Available

As the recession and credit crunch have made evident, there is no guarantee that dividend-paying stocks will continue to pay dividends. Indeed, many businesses have been forced to suspend or dramatically cut their dividends. That said it is still possible to find companies with what we believe are good dividend outlooks and strong fundamentals.

- The financial sector, typically a robust source for dividends, has experienced sharp dividend cuts as institutions deleverage or raise enough capital to get out from under government assistance provided by the TARP. Once that happens, we believe that the stronger financial firms will reinstate or aggressively raise their dividends. In the meantime, their stocks appear attractively valued.

To gain perspective into the current market climate, visit allianzinvestors.com.gp

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To achieve this, Allianz Global Investors draws upon the expertise and experience of our respected investment firms: PIMCO, NFJ Investment Group, RCM, Nicholas-Applegate, Oppenheimer Capital and Cadence Capital Management.* These firms include some of the most established and forward-thinking investment managers in the business. Rather than trying to develop a uniform "house style," we have chosen to nurture the singular investment culture and expertise of each—thus maintaining a breadth of approaches.

- A number of companies have managed not only to maintain, but raise their dividends in this environment. Among industries, dividends from oil and selective pharmaceutical companies do not appear at risk and could be increased as conditions improve.

Avoiding Value Traps

Our goal is to hold what we believe are high-quality companies whose stocks are discounting future good news. In murky markets, however, investors must be especially wary of value traps. These are stocks that appear to be cheap, but which are in fact vulnerable to additional bad news not yet reflected in the price.

NFJ has historically found dividends to be a reliable signaling mechanism for avoiding such value traps. In order for a stock to be considered for potential investment, it must pay a dividend. We also spend considerable time trying to identify companies likely to grow their dividends, which points to overall corporate health and a promising investment "story."

For Long Term Investors, the Benefits of Dollar-Cost Averaging

While no one can call an exact bottom to the downturn, there are signs that a recovery could be in the offing. Some commodity prices (copper, oil) have moved modestly higher and flows into stock mutual funds have improved, suggesting that investors are working through the bulk of the bad news.

Certainly, the intensity of the drop has laid the groundwork for exceptional opportunities. Market values for stock indices have been cut in half since their October 2007 highs, which means that with patience, investors might expect to see very attractive potential rates of return.

These painful declines have provided another silver lining—the opportunity to dollar-cost average. For those who are willing to take a contrarian stance and who can tolerate uncertainty, disciplined investing even during turbulent periods can be an important advantage over the long term.

(Dollar-cost averaging does not assure profit and does not protect against loss in declining markets. Investors should consider their financial ability to continue their purchase through periods of low price levels.)

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*Cadence Capital Management is an independently owned investment firm.

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