

Commodities, Inflation and Real Return Investing in Today's Market Environment



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01/21/09- PIMCO recently held a call to talk about commodity markets, inflation and real return investing in the current environment. Bob Greer, executive vice president and real return product manager, and Chris Caltagirone, vice president and product manager, discussed the tumultuous events of the past year, the outlook for the future, and the potential benefits of the CommodityRealReturn Strategy, which combines derivative commodities exposure and an actively managed Treasury Inflation Protected Securities (TIPS) portfolio.

Commodities Markets in 2008 and 2009

In the first half of 2008, investors still believed the global economy was growing. In particular, they expected the strength of the Chinese economy would continue to fuel increasing demand and higher prices for commodities. This dynamic was coupled with constrained supplies for some commodities: the expected decrease in Russian crude oil production after 2007's peak and historically low inventories of wheat and corn, for example. Markets searched for equilibrium prices under the assumption that supply and demand were inelastic, spurring a rise in volatility and prices.

In the second half of 2008, the gains in the first half of the year were erased. The Dow Jones AIG Commodity Total Return Index ended the year down just over 35% as the economic outlook deteriorated sharply and the supply and demand dynamics were reversed. For example:

- U.S. drivers clocked fewer miles and switched to more fuel-efficient cars.
- The U.S. Strategic Petroleum Reserve discontinued purchases of West Texas Intermediate light sweet crude oil.
- Nigeria, a large supplier of light sweet crude, had fewer production disruptions.
- Favorable crop conditions led to expectations for a global wheat surplus.
- In the fall, the credit crunch forced investors to exit commodity futures positions, making the market less liquid and exacerbating price movements.

- As the liquidity problems on Wall Street spilled over to Main Street, the expectation for a global recession drove commodity futures prices down further.
- While futures markets were less liquid, they continued to function properly throughout the credit crisis.

Commodities and Diversification: What Happened in Q4 '08?

Diversification does not necessarily mean commodity prices will always rise when prices of stocks or bonds fall. Rather it means that the fundamental factors driving commodity prices are different than the primary factors driving stock or bond prices. In the first half of 2008, commodities and equities moved in opposite directions, driven by completely separate factors. In the second half of 2008, commodities and equities both fell for related, but different, reasons.

- In the fourth quarter of 2008, bond prices were driven lower primarily by the credit crunch and liquidity crisis.
- The liquidity crisis morphed into an economic crisis, driving equity prices down primarily due to expectations for a global recession.
- Commodity prices, on the other hand, were driven lower primarily by expectations for falling demand and fewer supply constraints.

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

Gaining Perspective Market Insights from PIMCO

Allianz Global Investors is among the five largest asset management firms in the world, with a client list that includes more than half of the Fortune 100 companies. Our objective is to provide a broad spectrum of high-quality investment solutions that can help investors work toward their unique financial goals.

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.

Outlook for commodities in 2009

The near-term outlook for commodities is uncertain, since we don't yet know how long or severe this global recession will be. We do know that much of the reduction in commodity demand is due to slower economic growth, and we are beginning to see less correlation between individual commodities across the broader commodities market, as individual commodities are beginning to be affected by individual supply factors, rather than just demand expectations. We believe that the credit crisis and the decline in commodity prices are sowing the seeds of future commodity price appreciation.

- Due to lower commodity prices and tight credit, commodities producers are delaying projects for capacity expansion, which could constrain future supply when global growth resumes.
- For example, as the credit crunch encroaches on the agricultural markets, farmers cut their plantings because of falling prices for their crops and lack of financing to buy fertilizers, reducing supply.

A Volatile Year for TIPS

The decline in TIPS prices in 2008 makes TIPS attractive on an absolute basis and relative to nominal Treasuries. Even though the near-term outlook for inflation remains very low, PIMCO's secular outlook for developed economies paints a supportive picture for TIPS, since inflation is expected to rise over the medium term.

- Break-even inflation rates are priced to reflect expectations for nearly 3% deflation over the next five years. This is not PIMCO's outlook, and suggests that TIPS are significantly undervalued.
- While growth is expected to contract in 2009, government stimulus may reflate the economy in 2010 and beyond.
- PIMCO expects several months or quarters of negative year-over-year consumer price index readings due to excess capacity and production and lower employment levels.
- Over the near term, a lack of inflationary pressures along with the likelihood of below-potential growth should keep inflation subdued. The Federal Reserve and Obama administration are trying to fight the deflationary menace and avoid

a potential liquidity trap – these policies are likely to reflate the economy over the 3–5 year secular horizon.

- PIMCO's outlook for year-over-year headline inflation is low to no-inflation.

TIPS and Commodity Exposure in PIMCO's CommodityRealReturn Strategy Fund

The PIMCO CommodityRealReturn Strategy Fund derives its exposure to commodities from derivatives that track the Dow Jones AIG Commodity Total Return Index, and the derivatives are collateralized with an actively managed TIPS portfolio. This combination pursues a “Double Real” return that captures specific commodity inflation through the index exposure and broad price inflation via the TIPS portfolio.

- Index exposure offers broad exposure to the entire asset class, without the complication of owning individual commodities.
- Commodities offer the benefits of diversification within a portfolio as well as a historical negative correlation with stocks and bonds over longer periods of time.
- The CommodityRealReturn Strategy Fund may add alpha over the long term. It is actively managed to employ the full breadth and depth of PIMCO's investment process, and it seeks to take advantage of structural inefficiencies and risk premiums in the commodity markets.

Commodities within Broader Asset Allocations

There is no definitive level of exposure to commodities that is universally appropriate for all portfolios. One of the most important aspects of assessing the appropriate commodity allocation is to understand one's risk tolerances and how commodities fit into overall risk factor allocations.

- An Ibbotson Associates study recommends an allocation of as little as 5% and as much as 20% in commodities in a moderate risk portfolio.
- It can be prudent to phase commodities into a portfolio over time – for example, by committing to half of a proposed exposure for the first 6-9 months in order to become accustomed to how commodities perform from month to month.

Gaining Perspective Market Insights from PIMCO

Conclusion: Benefits and Purpose of Commodities Investing

- Increased portfolio diversification
- Negative historical correlation to stocks and bonds
- Historical returns that are comparable to equities

PIMCO believes that a future increase in global demand for commodities along with a reduction in supply offers potential for price appreciation in this asset class. But again, PIMCO thinks the primary benefits of investing in commodities are diversification and inflation hedging. Don't buy commodities because they are going up; buy them because you want to expect the unexpected.

Investors should consider the investment objectives, risks, charges and expenses of this Fund carefully before investing. This and other information is contained in the Fund's prospectus, which may be obtained by contacting your financial advisor, by visiting www.allianzinvestors.com or by calling 1-888-877-4626. Please read this prospectus carefully before you invest or send money.

Past performance is no guarantee of future results. This material is presented only to provide information on investment strategies and opportunities. It contains the current opinions of PIMCO, which are subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market. Some products/services may not be offered at certain broker/dealer firms.

Diversification does not assure a profit or protect against loss. Inflation-indexed bonds issued by the U.S. Government, known as TIPS, are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation, which will affect the interest payable on them. Repayment upon maturity of the adjusted principal value is guaranteed by the U.S. Government. Neither the current market value of inflation-indexed bonds nor the share value of a fund that invests in them is guaranteed, and either or both may fluctuate. The Consumer Price Index (CPI) is an unmanaged index representing the rate of inflation in U.S. consumer prices as determined by the U.S. Department of Labor Statistics. Alpha measures a portfolio's risk-adjusted performance, which is the difference between a portfolio's actual and expected returns, given the level of market risk as measured by beta. The Dow Jones AIG Commodity Total Return Index is composed of futures contracts on 19 physical commodities. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. It is not possible to invest directly in an index.

Please speak to your financial advisor to discuss whether an allocation to commodities is right for you. Commodities are assets that have tangible properties, such as oil, metals, and agricultural products. This Fund will typically seek to gain exposure to the commodity markets by investing in commodity-linked derivative instruments backed by a portfolio of inflation-indexed securities and other Fixed Income Instruments. The Fund invests in commodity-linked derivative instruments, including commodity index-linked notes, swap agreements, commodity options, futures and options on futures. These instruments and commodities in general may subject the Fund to greater volatility than investments in traditional securities.

Commodities and commodity-index-linked securities may be affected by overall market movements and other factors that affect the value of a particular industry or commodity, such as weather, disease, embargoes, or political and regulatory developments. The value of a commodity-linked derivative is generally based on: price movements of a commodity, a commodity futures contract, a commodity index, or other economic variables based on changes in the commodities markets. Use of derivative instruments may involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk and the risk that a fund could not close out a position when it would be most advantageous to do so. Portfolios investing in derivatives could lose more than the principal amount invested in those instruments.

The Fund will seek to gain exposure to the commodity markets primarily through investments in leveraged or unleveraged commodity index-linked notes and through investments in the PIMCO Cayman Commodity Fund I Ltd., a wholly-owned subsidiary of the Fund organized under the laws of the Cayman Islands (the "Subsidiary"). The Subsidiary is advised by PIMCO, and has the same investment objective as the Fund. As discussed in greater detail in the prospectus, the Subsidiary (unlike the Fund) may invest without limitation in commodity-linked swap agreements and other commodity-linked derivative instruments. However, the Subsidiary is otherwise subject to the same fundamental, non-fundamental and certain other investment restrictions as the Fund. Additionally, the Fund or the Subsidiary may invest in derivative instruments linked to the value of a particular commodity or commodity futures contract, or a subset of commodities or commodity futures contracts. The Fund's or the Subsidiary's investments in commodity-linked derivative instruments may specify exposure to commodity futures with different roll dates, reset dates or contract months than those specified by a particular commodity index. As a result, the commodity-linked derivatives component of the Fund's portfolio may deviate from the returns of any particular commodity index.

The Fund's commodity exposure is backed by a portfolio of inflation-indexed securities and other fixed income instruments. Inflation-indexed bonds issued by the U.S. Government, known as TIPS, are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation, which will affect the interest payable on them. Repayment upon maturity of the adjusted principal value is guaranteed by the U.S. Government. Neither the current market value of inflation-indexed bonds nor the share value of a fund that invests in them is guaranteed, and either or both may fluctuate. The value of some mortgage-related or asset-backed securities may be particularly sensitive to interest rate changes, and there is no assurance that private insurers of the underlying mortgages or assets will meet their obligations. This Fund may invest in non-U.S. securities, and in non-U.S. currency denominated securities, which may entail greater risk due to foreign economic and political developments, a small percentage in high yield securities, and may invest in mortgage-related securities. High-yield bonds typically have a lower credit rating than other bonds. Lower rated bonds generally involve a greater risk to principal than higher rated bonds. This Fund is non-diversified, which means it may incur greater risk by concentrating its assets in a smaller number of issuers than a diversified fund. The Fund may also invest in common and preferred stocks as well as convertible securities of issuers in commodity-related industries.

*Cadence Capital Management is an independently owned investment firm.