Allianz Global Investors

Creating a Tiered Cash Portfolio

Paul McCulley
Managing Director
PIMCO

Paul Reisz
Senior Vice President
PIMCO

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03/24/09—In a recent conference call, PIMCO's Paul McCulley and Paul Reisz shared their expertise on the current state of the cash markets and offered what they believe are prudent strategies for enhancing cash potential. The following is a summary of the call.

Too much cash

The money market fund universe has expanded tremendously since the summer of 2007, growing by $1.2 trillion to almost $4 trillion today. This past fall, Treasury funds experienced particularly large inflows, as investors began a "flight to quality" following the collapse of Lehman Brothers and the "breaking of the buck" by a large money market fund. A money market fund is said to "break the buck" when its share price varies from $1 per share.

While anxiety is understandable in volatile markets, it is PIMCO's belief that many investors may be holding too much cash, stemming largely from two sources:

- On a relative basis, cash—which unlike most other asset classes, trades at par—has risen as a percentage of an aggregate portfolio as other portions have declined.
- On an absolute basis, many investors have been sitting on the sidelines, taking their bond coupons and dividends in cash while waiting for a signal to return to the marketplace.

At the same time, pure "cash" is yielding close to zero, a level the Federal Reserve recently indicated it will maintain for "an extended period." That will likely make cash painful to hold for the next few years.

Fed works to improve near-cash markets

The "near-cash" markets—primarily high-quality ultra-short and low-duration bonds—suffered declines during the worst of the credit crisis. This was not because they were in danger of default, but because the marketplace had become exceedingly illiquid. In that environment, high-quality credits—the only securities with interested buyers—experienced massive sell-offs.

Since then, the Fed has gone out of its way to try to improve the workings of the near-cash markets.

- It kicked off its efforts in October 2008, with the Commercial Paper Funding Facility (CPFF). The program, designed to stimulate liquidity in the commercial markets, appears to be succeeding; Fed participation has shrunk from $350 billion to $250 billion as markets have regained some health. It should be noted that PIMCO manages the CPFF program for the New York Federal Reserve.
- More recently, in March, the Fed introduced the Term Asset-Backed Securities Lending Facility (TALF), which is designed to inject as much as $1 trillion into the asset-backed securitization markets. This is effectively printing money to increase liquidity.

These measures are the right ones, in PIMCO's view. Going forward, they should keep spreads from not only going wider, but actually bring them in. That would provide an opportunity to earn capital gains—as the value of bond holdings increase with demand—in addition to relative income.

A case for enhanced cash

Given these developments, we see encouraging risk/return prospects for taking a small step from "always-trades-at-par" money market accounts towards an enhanced cash structure.

In our view, the market dislocations and economic slowdown have created unprecedented opportunities among short-term and low-duration funds that are concentrated in high-quality issues.

Gaining Perspective
Market Insights from PIMCO

Allianz Global Investors

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.

These would include high-quality agency mortgages, asset-backed paper, as well as short-dated corporates, notably the senior debt of the "too-big-to-fail" financial institutions; these are unlikely to undergo restructuring even as the government moves forward with its stress-test plans for the banking system.

We believe the risk landscape for such spread products has improved markedly. Investors should be less anxious about "trying to catch a falling knife," because the Fed has in effect said, "Our hands will get bloody before yours." At the same time, in its ability to create liquidity, the Fed has a printing press and gets its ink for free, as it were.

Managing a cash strategy

Investors looking to put their excess "reserves" to work must first determine how much cash is too much. A useful way to create a cash strategy is to break down cash needs into distinct buckets. The key considerations for each bucket are cash flows (liquidity) and risk tolerance (principal preservation).

Cash can typically be allocated using a three-tiered process:

1. Cash for immediate needs, such as groceries and monthly bills. As these cash flows must be liquid, and have the highest degree of principal preservation, minimal risk should be taken. A money market strategy would be most appropriate here. Although, as noted earlier, *money market funds are not insured or guaranteed by the FDIC or any other government agency, and although these funds seek to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in money market funds.*
2. Cash for three to six months out; "emergency" funds. This is a semi-permanent cash reserve, in that it will not be used immediately. For this bucket, it could make sense to move slightly out beyond money markets to high-quality, short-term or low-duration strategies, which have some price variability but better yield potential.
3. Cash above and beyond; "excess" reserves. This is a permanent allocation, part of a larger strategy for meeting long-term goals such as college tuition or purchasing a car or a house. In this case, a high-quality, intermediate-term bond strategy, which has less liquidity but higher growth potential, could be an attractive choice.

Management experience is key

As the last 18 to 24 months have made apparent, negotiating the "plain vanilla" cash marketplace is not easy. Investors face the dilemma of balancing liquidity and yield under unprecedented conditions, making experience and risk management essential.

That is why PIMCO devotes considerable resources to managing its cash investments. Its money market and short-term funds are managed by some of the firm's most seasoned investment professionals, and are supported by the same deep credit research and analytical tools underlying all of PIMCO's portfolios. Diligent risk management, which lies at the heart of our investment philosophy, has helped us steer past the worst of the landmines during this challenging period for cash and short-term credit markets.

*Cadence Capital Management is an independently owned investment firm.