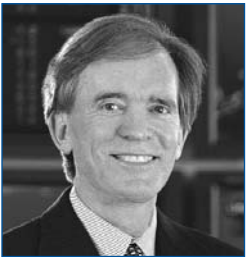


Investment Outlook

by PIMCO's Bill Gross

So CQish



Bill Gross
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I think of myself as a pretty smart guy, but not that smart, if you know what I mean; no Mensa candidate, but intelligent enough to earn a few paper degrees that helped get me a job where the real education began. My mother used to tell me that I had the highest IQ of all the first graders in Butler County, Ohio, which sounded impressive until I figured out that there were just a handful of kids that had taken the test. You're smart, but not a genius, if you graduated "non" cum laude from both Duke and UCLA graduate school. That's me. Still, I'll take it because I've come to the conclusion that success—at least in a career—requires more than an IQ. It requires a CQ.

A CQ is what I think of as a "Common Sense Quotient." It refers to an ability to not just absorb information and recycle it upon demand, but to analyze it and apply it within a uniquely different environment or context. A CQ Mensa candidate is able to view the world in a state of apparent equilibrium and wonder—"does this make sense?" And if not, "what might change it, and when?" The problem with measuring CQ, however, is that you never can be quite sure that you or anyone else has it. It's elusive and perhaps even ephemeral. It's also uniquely personal: the world always makes sense when viewed from your own eyes—it's those other people who can't seem to understand. Still—in the business and investment worlds—time has a habit of unmasking one-dimensional pretenders who have the obvious IQ, but score below 100 with an experience-tested CQ. Warren Buffett, a bona fide Mensa in both categories, said it best many years ago in his usual folksy way: "You don't know who's swimming naked until the tide goes out."

CQs, then, in Buffett's metaphor, know that protective cover-ups—call them swimming-suit insurance policies—should be worn even when the water's high and the whole world seems to be enjoying an endless summer at the beach. That is an apt description of the global investment environment up until Bear Stearns 2008. The world seemed so caught up in the long-term unfolding of the "Great Moderation" that almost everyone assumed that nothing could go wrong. I heard a brilliant, high-IQ portfolio manager describe himself on the radio a few days ago as a "child of the 25-year secular bull market—trained to buy on dips." In fact, we all are bull market children. But those that define it by "dip buying," or a secular time frame encompassing only the past quarter century, are certainly self-limiting and perhaps lacking in common sense. **The era now coming to an end is not a one-generational bull market that was born out of the ashes of double-digit inflation, and the end of governmental strangulation of private initiative in the early 1980s. It was much more, and much longer in duration.**

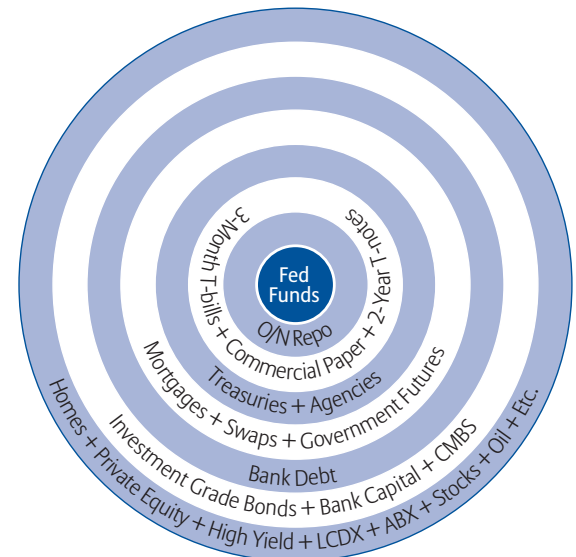
The past era can best be described as a more than half-century buildup in credit extension and levered finance. While home mortgages or buying a washing machine on "time" began in the early decades of the 20th century, the use and innovative application of credit really began when—well, when I was born.

1944 is as good a year as any to chronicle the beginning of our levered economy. I was a child of war, but also a child of a new global leadership confirmed at Bretton Woods and founded on faith in the U.S. dollar and the healing power that its printing could bring to the global community. That Richard Nixon amended the bargain in the early 1970s did no immediate damage save for the inflationary decade that followed. Credit continued to be the mighty lubricant of capitalism's engine, allowing its pistons to accelerate at an increasing pace as financial innovation mixed with our own animal spirits produced more and more profits, more and more jobs, more and more everything. Mortgage-backed GNMs in the 1970s, financial futures a bit later, swaps, then credit default swaps (CDS)—the litany is too long to list.

What is important, though, is that at some point early in the 21st century, things began to go terribly wrong with this miracle of modern finance. It was spreading substantial benefits via diversification and indeed the productive powers of lending upon which capitalism depends. But it had assumed an arrogance—if a secular phenomenon can be personified—that nothing could go wrong. It was promoting not just smooth sailing—a moderation—but a “great moderation.” Unstoppable. Except, of course, for that homeowner in Modesto, California, who bought a marked-up home for \$500,000 with no money down and a 2% teaser interest rate. Even the pinnacle of levered finance could not support that fantasy and so, as yields inevitably rose and the defaults began in 2006, our great moderation was exposed for what it was—a naked swimmer at high tide.

And so—“bravo, brava,” a metaphorical history of the human comedy as experienced by Bill Gross since 1944. How prescient, how personal, how CQish, how self-serving. I suppose. But PIMCO's still standing, and that in this month of October 2008 is as strong a testament to a collective CQ as any I know. We've got some Mensans to be sure, but a bunch of high CQs as well, including my partner on the investment desk, Mohamed El-Erian, who like Buffett, is probably a dual Mensa but would be the last to admit it.

CHART 1
Going Nuclear



For illustrative purposes only. This chart is not indicative of the past or future performance of any Allianz Global Investors product.

For those of you who are reading these *Outlooks* for more than just a history lesson and a commercial, however, let me point you to our latest commonsensical thought piece, one that can be explained with a simple diagram that resembles an atom of uranium—one of nature's more unstable elements.

Uranium-238 has something like 92 electrons circling its nucleus, sort of like the diagram you see in Figure 1. And, importantly, uranium-238 is metaphorically quite similar to the global financial system of the past half century. At its nucleus was the overnight Fed Funds rate which, when priced low enough, led to an ever-increasing circle of productive financial electrons. The overnight policy rate led to cheap commercial paper borrowing and then leapfrogged outward and across the oceans to become LIBOR. In turn, government notes and bonds as well as markets for corporate obligations were created, leading to their use as collateral (repos), which fostered additional credit and additional growth. The electrons morphed into productive financial futures and derivatives of all kinds benefitting all of the asset classes at the outer edge of the #238 atom—stocks, high yield bonds, private equity, even homes and commodities despite their being tangible as opposed to financial assets.

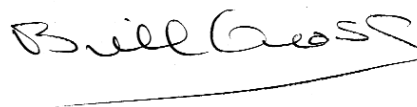
This was how the scientists, the financial wizards with Mensa IQs, visualized the financial system a few years ago: leverageable assets held together by a central bank policy rate at its nucleus with institutional participants playing by the rules of conservative self interest and moderate government regulation. Out of it came exceptionally high returns on assets with minimal risk—the highest returns occurring with the most levered electrons farthest from the nucleus.

Over the past year, however, the process has reversed course and your 401(k) is probably a 201(k) now. Levering has turned into deleveraging; uranium-238 has morphed into uranium-239 and we've had a nuclear implosion—destructive fusion not controllable fission. What's an investor to do? The simplest way to explain this is that during the past 60 years or so, an investor wanted to follow the energy **outward** from the nucleus. A financial system in the process of levering leads to excessive returns for electrons on the perimeter. When the process reverses, however, when fusion takes over, an investor wants to be at the center—in Treasury bills or bank CDs. In fact, over the past 12 months, those government-guaranteed, low-durational assets have been virtually the only ones to show positive returns.

There will come a time, however, perhaps over the next few weeks or months, when **deleveraging of the private sector is met by the leveraging up of the government sectors: the TARP, CPFF, and MMIFF will inject over a trillion dollars of liquidity into the system over a short period of time. At that point, our nuclear atom will begin to stabilize and it should be safer to move a little distance back out toward the perimeter where yields and potential returns are very attractive. PIMCO would focus on the following:**

- 1) A continued above-average allocation to agency mortgage-backed securities—now yielding close to 6%.
- 2) An overweight position in bank capital—bonds and preferred stock in companies where the Treasury has an equity stake. With Uncle Sam as your partner, default seems remote.
- 3) A focus on the frontend of the yield curve. The Fed will stay low for an extended period of time while the inevitable inflationary pressures of government bailouts lay further out on the yield curve.

Can these and a host of other investment ideas come from a commonsensical understanding of the uranium atom, the difference between fission and fusion, and its metaphorical connection to levering and delevering? We at PIMCO think so. Our CQs are engaged, our bathing suits are on; the tide goes out, but inevitably comes back in.



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About the Author

Bill Gross is Co-Founder and Managing Director of PIMCO, one of the country's foremost fixed income managers with a client list that includes many of the largest U.S. corporations. Regarded by many as America's most influential authority on the bond market, Mr. Gross makes frequent appearances on TV and in the business press.

As a reminder, an audio file of this *Investment Outlook* will be available on www.allianzinvestors.com.

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"Mortgage-based securities—now yielding close to 6%"—as of 10/27/08, source: Bloomberg.

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. U.S. government securities are backed by the full faith of the government; portfolios that invest in them are not guaranteed and will fluctuate in value. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. Derivatives and commodity-linked derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Commodity-linked derivative instruments may involve additional costs and risks such as changes in commodity index volatility or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. Investing in derivatives could lose more than the amount invested. Swaps are a type of privately negotiated derivative; there is no central exchange or market for swap transactions and therefore they are less liquid than exchange-traded instruments. Credit default swap (CDS) is an over-the-counter (OTC) agreement between two parties to transfer the credit exposure of fixed income securities; CDS is the most widely used credit derivative instrument. High-yield, lower-rated, securities involve greater risk than higher-rated securities. Equities may decline in value due to both real and perceived general market, economic, and industry conditions.

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"LIBOR" stands for London Inter-Bank Offer Rate.

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