

Real Returns in All Assets

In a bleak market environment of heavy losses across the board, investors seem to forget that only real returns assure no loss of capital at the end of the day. Using dynamic asset allocation strategies, PIMCO's All Asset Fund and All Asset All Authority Fund focus on long-term growth of purchasing power. Portfolio manager Robert D. Arnott goes beyond mainstream stocks and bonds to provide true diversification and risk optimization

What is your investment philosophy?

Most investors keep the majority of their money in mainstream stocks and bonds, which means they have a return orientation as opposed to a real return orientation. If we have a disinflationary expansion, that is brilliant for mainstream stocks, while a disinflationary contraction is brilliant for bonds. However, if we have a reflationary expansion or contraction, it tends not to be good for either stocks or bonds.

One element that both All Asset Fund and All Asset All Authority Fund share is a focus on real returns. Another common feature of the two funds is their reliance on asset classes outside of the mainstream stocks and bonds, which most investors principally rely on. The products' ultimate focus is on creating a framework that allows true diversification, a toolkit that investors largely lack. We employ a quantitative strategy that looks to add value by measuring which markets are priced to provide us the best forward-looking returns.

The goal of the All Asset Fund is to explore an array of asset classes, in order

“One element that both All Asset Fund and All Asset All Authority Fund share is a desire to focus on real returns.”

to identify those that may represent a good opportunity for long-term real returns and diversification away from conventional stock and bond risk, as well as for tactically investing in attractively priced markets. The All Asset All Authority Fund offers the same, with megavitamins. It allows up to 50% of leverage on the net assets. It allows a little shorting, so we may choose to short 30% of the assets in the fund (or, more specifically, 20% of the net assets of the fund, which we can leverage up to 30%). And it uses a wider range for each market.

The most important component of the process, for both strategies, is something that we refer to as a “building blocks model.” Anything we invest in has three sources of return—yield, growth and changes in valuation levels. We can compare the yield on any market with its historical yields, to get some indication of whether those yields are above or below historic norms. And we can know the historical growth in income on most assets. Only the changes in valuation levels can't be gauged with any accuracy. While this last piece is the most important component of short-term returns, it's the least important for the long-term investor, because it tends to mean-revert over the very long run and be bounded by what is available in other asset classes.

Provided you know the yield and you know the historical normal growth rate in income, the sum gives us a reasonably good gauge



ROBERT ARNOTT served as Editor of the Financial Analysts Journal. He has authored over one hundred articles for journals such as the Financial Analysts Journal, the Journal of Portfolio Management and the Harvard Business Review.

In 2002, Arnott established Research Affiliates, LLC to offer sub-advisory services, software and asset management models. He has joined forces with PIMCO, serving as a sub-advisor, to offer a global asset allocation product to make active use of liquid alternative markets, beyond conventional stocks, bonds and cash.

In the past, Arnott also served as a Visiting Professor of Finance at UCLA, on the editorial board of the Journal of Portfolio Management and two other journals, and on the product advisory board of the Chicago Board Options Exchange and two other exchanges. He previously developed quantitative asset management products and teams as Chairman of First Quadrant, LP, President of TSA Capital Management (now Analytic Investors) and as Vice President at The Boston Company (now PanAgora), and served as global equity strategist at Salomon (now Salomon Smith Barney). He graduated summa cum laude from the University of California in 1977 in economics, applied mathematics and computer science.

of long-term forward-looking returns. The growth component can be positive if linked to inflation—as with stocks and REITs. In the case of stocks growing a little faster than inflation, in the case of REITs growing a little slower because properties age and depreciate. If you compare this very simple yield plus growth formulation for forward-looking returns with historic norms, you can identify which markets are priced today to offer a better forward-looking return than other markets and, in addition, which markets are priced today to offer a better forward-looking rate of return than their own historic norms.

Bearing in mind that stock market earnings and dividends tend to grow with inflation, the average real growth in earnings and dividends—over and above inflation—is between 1% and 1.5%. You are getting an inflation kicker, a real return component, in stocks on the income. But, the inflation impact on stock valuation levels goes the other way: stocks tend to see falling valuation levels when inflation is rising.

What other elements drive your asset allocation process?

A key component of the asset allocation process is our examination of PIMCO's Alpha. There are some asset classes, enhanced cash for instance, where the opportunity to add value is rather modest. If you add 50 basis points, it's a home run. Still, there are other markets where the opportunity set is much larger and the alpha can be much larger. We look at historic evidence of PIMCO's skill in each of these areas and add an expected alpha that is derived from the historical alpha but truncates it. In doing so, we recognize that past alpha and future alpha are not the same thing; we give credit—but not full credit—for past success.

Then, we look at the quality spreads in the bond market—the slope of the yield curve—and the equity risk premium—earnings yields for stocks relative to bond yields. We gauge, historically, which risk

premium measure is most relevant to any single asset and how predictive it is of forward-looking rates of returns. We can look at risk premium relationships and see that the equity risk premium is important for stock market returns.

We also evaluate statistical momentum and lead-and-lag relationships. There are certain markets that exhibit trending where, if they are on a roll, regardless of how expensive they are, you are better off not selling just yet, and likewise, if they are tumbling, you are better off not buying until they have shown some signs of regaining their footing. Other markets exhibit a reversal effect where, if they move sharply, they tend to reverse. We can always use history as a gauge of that. Furthermore, we can find lead-and-lag relationships; for example, the movement of the treasury market tends to presage movements in the emerging markets debt markets.

Another component of the asset allocation decision is the business cycle. That is a relatively new component. We find that it's relatively easy to gauge where we are in the economic cycle; whether we are in an early recession, late recession, early expansion, or late expansion. There are different asset classes that perform better—or worse—in each of these segments of the cycle.

Do you include commodities and metals in your all asset model?

Commodities are treated as one collective asset class across agricultural, energy, metals, and industrials. For this purpose we use the Dow Jones-AIG Index. In our portfolios, that translates into roughly one third energy and two thirds scattered across industrial, agricultural and metals, with the mix varying slowly over time.

Do you include currencies as well in your All Asset class?

Indirectly: the emerging markets debt and local currency emerging markets debt have a currency component. Not only

does local currency emerging markets debt have direct EM currency exposure, it also has a backdoor currency exposure: if commodity prices are rising, these yields are usually falling, giving us an added dose of inflation protection. Unlike the developed countries, the local currency EM debt has exposure in emerging economy currencies, where the correlations tend to be lower.

Could you describe your portfolio construction process?

Our portfolio construction is organized around mean-variance optimization, which more-or-less linearly links our expected returns to the mix. But, our allocations are not terribly aggressive, averaging around 10% in the markets that we like. Anything north of 20% is a very significant allocation. We've gone beyond 40% only once—in long TIPS around year end 2002.

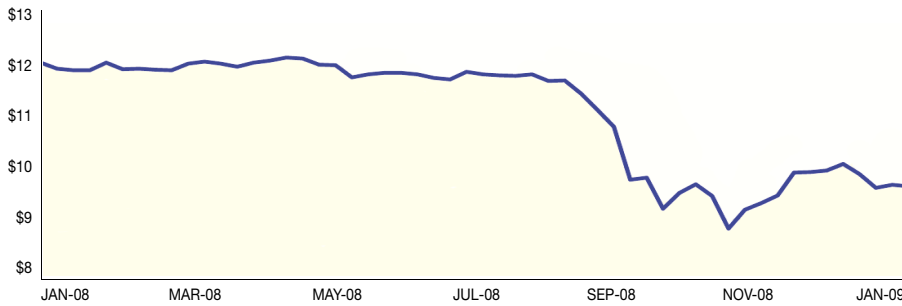
What are your risk control strategies?

Risk control is very straightforward. We have a targeted volatility in all assets of 6% to 8%. We recently exceeded it only because markets have been more volatile than normal and correlations, in turn, have been much higher than normal. Nevertheless, that target volatility is about the same as long governments. All Asset All Authority has a higher target of about 8% to 10%, in line with the typical 60-40 investor. These are not high-risk strategies—by intent.

We also use optimization as a mechanism for controlling risk. By having limitations on our asset class allocations, we cannot put more than half of All Asset or more than three-fourths of All Authority into a single asset class. Nor have we ever come close to even these limits. Also, it's worth noting that the most volatile asset classes we have at our disposal are no riskier than stocks. If we were extremely aggressive and used the asset allocation ranges to their ultimate upper bounds, our volatility would be roughly that of the stock market. It is not plausible for us to get higher than that and, in fact, it is not

Performance - Price History N.A.V.

PIMCO All Asset Fund (PASAX)



	2006	2007	2008
S&P 500 Index	15.79%	5.49%	-37.00%
PIMCO All Asset Fund	4.70%	7.90%	-15.90%

plausible for us to get even close to that volatility.

Could you give some historical examples that illustrate your investment strategy? For example, how have the funds fared in the recent turbulence of the markets?

We view the risk dial as a very important part of our toolkit; our normal risk target tends to be between 6% and 8%. We went into the 2004 election with the highest risk exposure that we'd ever had. Investors were frightened, with most investors worried about a resumption of the 2000/2002 bear market. Consequently, our models prompted us to take on more risk because of those fears. As investors became complacent in 2005, we took our target risk down from about 9% to about 6%. By the end of 2006 we had taken it down to 5%, and by the end of 2007 we had taken it down to 4.5%. Coming into 2008, we had a 4.5% risk target. Coming into the market crash, we had barely nibbled away into incremental risk, taking it up to barely 5%. We came into the market crash with—we thought—a risk profile below the low end of our range. While risk soared during the global crash, we're grateful to have taken such a cautious stance.

Of course, in September/October both volatility and correlations sharply increased. Our volatility spiked up, even

though we were broadly diversified in a wide array of asset classes and we had very little in the highest volatility asset classes. Our equity allocation coming into last summer was 7%; our allocation across stocks, REITs and commodities, the three most volatile asset classes, was around 12%. We had 88% in relatively low volatility asset classes, so we came into this with a very cautious stance, expecting to weather any storm well.

No U.S. investor practicing today had ever experienced such a storm. You do have to go back to the 1930s to find similar volatility. But even back then, the damage wasn't as broadly dispersed across multiple asset classes as it was in 2008. As volatility and correlations spiked, our investors were not especially protected in September and October—not nearly as well as we'd have liked. They recovered a lot of the damage in November/December, as the market began sorting through the opportunities and allowing sharp recovery in the asset classes that had been hit too hard, while continuing to punish those that still had some credit risk or economic exposure.

Coming into the current year, stocks are at the cheapest valuation levels since 1990-91, on the eve of the recession that swung the 1992 election. On the surface, this might suggest that stocks are now

PIMCO All Asset Fund

Symbol **PASAX**
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 Address PIMCO
 840 Newport Center Drive
 Suite 300 Newport Beach
 CA 92660
 Telephone 800-426-0107
 Inception 07/31/2002

PORTFOLIO

Total Net Assets* \$1,198
 Avg Mkt Cap (\$ Weighted) * \$281.5
 Average Price/Earnings Ratio 0.51x
 Average Price/Book Ratio 0.04x
 Turnover Ratio 96%

INVESTMENT INFORMATION

New Investment Open
 Min Initial Investment \$1,000
 Min Subsequent Investment \$50
 Min Initial IRA Investment N/A

RISK (AGAINST S&P 500 DAILY REINV IX - 3 YEARS)

Alpha 0.30
 Beta 0.54
 R-Squared 0.58
 Ann Std Deviation 11.26
 Sharpe Ratio -0.52

RETURNS VS. S&P 500 DAILY REINV INDEX

	PASAX	Index
1 Year (Cum.)	-19.59%	-38.63%
3 Year (Ann.)	-3.12%	-11.78%
5 Year (Ann.)	1.25%	-4.24%

FEES AND EXPENSES

Max Sales Charge - Front** 3.75%
 Max Sales Charge - Deferred 0.00%
 Max Redemption Fee*** 2.00%
 Total Expense Ratio 0.81%

PORTFOLIO MANAGER

Robert D. Arnott 07/31/2002

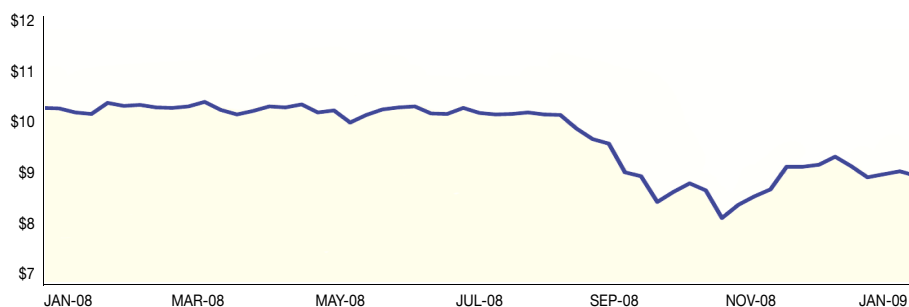
*millions **for amount invested less than \$100,000

***0 months after purchase

01/31/2009; Source: Company Documents; Lipper

Performance - Price History N.A.V.

PIMCO All Asset All Authority Fund (PAUAX)



	2006	2007	2008
S&P 500 Index	15.79%	5.49%	-37.00%
PIMCO All Asset All Authority Fund	2.40%	9.40%	-7.50%

cheap. But, there are broad swaths in the bond market that are priced for a Great Depression or even worse. Investment grade corporate bonds at year-end yield roughly 8% or roughly 6% above treasuries. If you have a 6% yield spread over treasuries, for investment grade bonds that are not expected to have any material risk of default, that yield spread suggests something over 10% expected default rate—per annum—over the life of the bond. That is worse than what we experienced in the Great Depression and that creates a relative returns opportunity.

The stock market, particularly the growth side of the market, is priced for a moderate-to-serious recession. That's mild compared to what the bond markets are priced for. If stocks are correctly priced, the bonds are cheap; if bonds are correctly priced, the stocks are still overvalued. High-yield bonds came into the new year yielding 20%, 18% spread above the treasuries. With these levels of yield you have to have 30% to 40% annualized default rate to lose that entire spread and earn only a treasury return. The Great Depression did not deliver that level of damage. Today, I believe we are looking at categories of bonds, convertibles and high yield that are all priced for a scenario considerably worse

than the Great Depression. A year ago, I was described in a business magazine as a "permabear." I was amused, because I've been bullish—and bearish—on pretty much every market at different times in the past. But, this is one "permabear" who is not nearly as pessimistic about our economy as the bond market seems to be. The opportunities appear to be marvelous in the wide dispersion of economic expectations, reflected in the various asset classes. Growth stocks are currently priced at 1995 multiples, which are quite high by long-term historical standards but too low by more recent standards. The deep value side of the stock market is priced for a grim outlook; this divergence suggests to me that the opportunity set is wide.

Today, we are seeing a very opportunity-rich environment with a whole spectrum of asset classes that are priced to give us double-digit real returns at a time when near-term inflation is at minimum. Treasury bonds and growth stocks are expensive. High yield bonds and convertibles are very cheap. And, for the risk averse, TIPS, investment grade corporate bonds, and emerging markets debt are all priced to give us the best long-term returns that they've offered in quite some time. **T**

PIMCO All Asset All Authority Fund

Symbol **PAUAX**
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 Suite 300 Newport Beach
 CA 92660
 Telephone 800-426-0107
 Inception 7/29/2005

PORTFOLIO

Total Net Assets*	\$536.2
Avg Mkt Cap (\$ Weighted) *	\$123.4
Average Price/Earnings Ratio	0.21x
Average Price/Book Ratio	0.02x
Turnover Ratio	116%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$50
Min Initial IRA Investment	N/A

RISK (AGAINST S&P 500 DAILY REINV IX - 3 YEARS)

Alpha	0.39
Beta	0.37
R-Squared	0.34
Ann Std Deviation	10.42
Sharpe Ratio	-0.26

RETURNS VS. S&P 500 DAILY REINV INDEX

	PAUAX	Index
1 Year (Cum.)	-12.72%	-38.63%
3 Year (Ann.)	0.02%	-11.78%
5 Year (Ann.)	N/A	-4.24%

FEES AND EXPENSES

Max Sales Charge - Front**	3.75%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee***	2.00%
Total Expense Ratio	0.85%

PORTFOLIO MANAGER

Robert D. Arnott 10/31/2003

*millions **for amount invested less than \$100,000

***0 months after purchase

01/31/2009; Source: Company Documents; Lipper

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