

Manager Research

Pacific Investment Management Company LLC (PIMCO)

Emerging Local Bond

Summary

PIMCO is among the top fixed income managers distinguished by their superior operational infrastructure and risk management systems. Through its Global Secular Forum discussion, PIMCO investment professionals debate the economy's underlying risks, and forecast turning points -- often correctly. Using both a top-down macro approach and an in-depth bottom-up security selection process, portfolios are built to express PIMCO's best ideas.

Qualitative Score

3.39

Key Criteria

I. Organization

Score**Wtg.**

2.25

20%

PIMCO rates average. The firm has a solid foundation for successful portfolio management and ability to attract top talent. However, recent high level turnover posts some concerns.

Founded in 1971 as a subsidiary of Pacific Mutual, now Pacific Life, PIMCO has operated as an independent entity since 1982. In 2000, German financial services multinational, Allianz purchased the majority stake of PIMCO Advisors LP, the parent of PIMCO LLC. PIMCO became the global fixed income management leader for Allianz and operates as an autonomous entity.

PIMCO employs a hub and spoke system. The Investment Committee (IC) is considered the "brain" of the organization, consisting of permanent and rotating members. They determine top-down, global macroeconomic directions for all firm's strategies. These members sit on the trading floor, and are also responsible for the day-to-day management of strategies. Sector specialists and research analysts construct specific portfolios according to guidelines, and select individual securities. Bonuses are based on contribution to investment process, client retention, portfolio consistency, relative performance, and peer comparison. This organizational structure has been refined over the years. The IC members have demonstrated cohesiveness, at the same time the ability to provide individual inputs and contrary views in order to avoid group think.

PIMCO has experienced some high level turnover. In 2010, Changhong Zhu, a former IC member, resigned to become the CIO of China's currency regulator, the State Administration of Foreign Exchange (SAFE). In 2011, Paul McCulley, a former IC member, decided to retire to be more involved in writing, public speaking, and non-profit work. On the other hand, PIMCO has recruited some industry talents. In December 2009, former Goldman Sachs's head of high yield, Andrew Jessop, joined PIMCO, and Marc Seider was hired to take over Zhu's and McCulley's responsibilities. While PIMCO has managed the transitions well and has retained a strong investment culture, the recent organizational flux remains a concern.

The Emerging Market team is headed by Michael Gomez and Curtis Mewborne. They lead the EM team with offices in Europe and Asia. Guillermo Osses (a PM) left the firm in early 2011. Kumaran (DK) Damodaran will succeed Guillermo on the EM desk and take over his trading and fund responsibilities.

II. Information

Score	Wtg.
3.25	20%

PIMCO scores above average. The firm's internal analyses, coupled with external inputs, provide breadth and depth to its research. The data warehouse infrastructure ensures efficient communication of research and information. PIMCO's organizational structure where credit analysts are responsible for all credits in their respective industry, including investment grade and high yield, foreign and domestic, poses some concerns

PIMCO devotes significant resources to gather, compile, and process information; thus it has established one of the top proprietary analytic and data distribution systems among its peers. As a large consumer of external data, PIMCO has access to numerous sources. It uses these sources both as a sounding board against their own independent research, as well as to develop and improve internal models. Credit analysts supplement external data with independently acquired information. Sources include qualitative information from industry roadshows and on-site conversations with senior company management. Offices outside the U.S. provide a true global perspective and understanding of local markets. Team members often take trips to different countries. Information gathered from foreign policy makers and local bankers add to the research effort. An extensive warehouse centralizes data from internal and external sources. PIMCO maintains a library of information to support security evaluation, risk monitoring, and research distribution.

Each of the 31 analysts in PIMCO credit research group covers the full spectrum of credits in an industry regardless whether the credits are investment grade or high yield, foreign or domestic. For example, the telecom analysts are responsible for AT&T in the US, Telebras in Brazil, and Sprint, a high yield issuer. This structure allows the analysts to be industry experts; however, their expertise in one particular area (investment grade vs high yield) or country is questionable. Many high yield deals warrant in-depth knowledge and experience with the deal covenants. Understanding country-specific accounting rules and political systems is also needed for thorough analyses of foreign issuers. In addition, the analysts' focus and time allocation are driven by the firm's top-down focus and dollars at risk. This may result in a number of overlooked companies at different stages of the cycle. For these reasons, we have some concerns about the credit research team.

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III. Forecasting

Score	Wtg.
4.25	20%

PIMCO ranks high due to its track record predicting economic turning points and capturing value in the process.

Every May, PIMCO conducts a week-long Secular Forum to construct a three-to-five year outlook on fiscal and monetary policies, inflation, demographics, trades, and other factors that impact the global economy. Investment professionals together with external speakers present secular topics. The Forum serves as a backdrop for information exchange and debate, providing PIMCO's investment professionals with insights to form their economic outlooks. The firm also conducts quarterly Economic Outlooks that forecast economic growth and inflation over six-to-nine month periods. Regional teams from North America, Europe, Japan, and Emerging Markets discuss their research and compare which regions will exceed or fall short of market expectations.

PIMCO's financial engineering team has internally developed over 30 models to identify relative values. But the firm does not employ a black box approach. Rather than relying purely on derived values, the portfolio managers are also expected to use their own experience and judgment, evaluating the data to choose worthy trading opportunities.

IV. Portfolio Construction

Score	Wtg.
3.50	20%

The portfolio construction process earns an above-average score. The model-portfolio approach provides consistency across all accounts and explicitly expresses the firm's strategies. It should be noted that the usage of derivatives may lead to larger variance versus the benchmark.

Portfolio construction begins with a model portfolio. Macro themes are drawn from the Global Secular Forum and the Quarterly Economic Outlook. With a team approach, the Shadow Investment Committee, regional teams, and specialty desks set targets on duration, yield curve, convexity, sector concentration, and credit quality for the specific strategies. The model portfolio is built with all these inputs. Generalist portfolio managers, however, have some leeway to tilt their respective portfolios toward or away from the model portfolio based on their own insight and research. Emerging Market Portfolio Managers will overweight or avoid specific countries or currencies based on the firm's macro view. At times, large country and currency variances from the benchmarks can be observed. Generalist and Specialist Portfolio Managers then perform security selection and implement the strategies.

Because of PIMCO's large asset base, it is difficult to invest in less liquid securities and markets; thus derivatives are widely employed to gain duration, sector, and security exposures. CDS, currency futures, interest-rate futures, and total return swaps are the common instruments used in building portfolios. Since these instruments don't always track their respective underlying securities; hence creating tracking error.

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V. Implementation

Score	Wtg.
3.00	10%

The firm receives a slightly above-average score due to concerns about capacity and portfolio dispersions.

PIMCO's internal systems helped the firm effectively implement and control its strategies despite substantial growth. Capacity and liquidity risks are a concern as the firm is one of the largest fixed income managers in the world with over \$900 billion of assets under management (2009). Derivatives are used to improve liquidity and obtain exposures. Depending on the experience level, Generalist or Specialist Portfolio Managers execute trades. Turnover ranges depending on market opportunities. All block trades are allocated on a pro-rata basis. The firm analyzes trade allocation three times a year to determine whether it helped or hurt a portfolio. Internal systems allow transparency necessary for the entire investment team to monitor portfolios. The Chief Risk Officer sits on the trading floor allowing quick and easy interaction with portfolio managers to ensure portfolios remain within the direction of the model portfolio. Dispersion issues warrant attention given the vast size variance between small separate accounts (minimum \$75 million) and large commingled products (in the Billions).

VI. Attribution

Score	Wtg.
4.35	10%

The system results in a substantially above-average score since risk management and attribution tools are state-of-the-art and continuously evolving.

PIMCO constantly develops extensive tools and analytic software for security modeling and risk management. These tools enable the investment team to effectively monitor portfolios and decompose performance across multiple dimensions. Internal systems consistently revalue securities versus potential investments for relative attractiveness. PIMCO can quickly identify risks as well as seek opportunities due to its ability to both analyze a portfolio as a whole and drill down to the individual security level.

Score Legend	
5 Excellent	2 Below Average
4 Good	1 Unacceptable
3 Above Average	

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