



PIMCO Total Return Fund: A Brief Summary Report of the World's Largest Bond Fund

The PIMCO Total Return Fund inceptioned on May 11, 1987. The fund's assets totaled over \$241 billion for all share classes, as of January 9, 2012. PIMCO has not set specific limits on assets under management for the fund.

As a total return fund, the portfolio's goal is to maximize shareholder return via a combination of interest income and capital gains. The fund invests primarily in intermediate-term, investment grade fixed income securities.

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Fund and Organization

PIMCO is a top notch organization, owned by German financial concern Allianz SE. PIMCO operates separately from its parent company. Further, PIMCO has a sterling reputation within the fixed income world, a strength that allows them to recruit the best and brightest professionals. This contributes to a deeply talented organization. PIMCO has discussed with PEI on several occasions the role of Bill Gross. Mr. Gross, age 67, is undoubtedly the public persona of the Total Return Fund. Nonetheless, PIMCO has stressed on a number of occasions that the portfolio management team is a talented GROUP, and that the portfolio is managed with input from a large group of analysts, macro-strategists, and sector specialists. The fund has shown its adaptability and reflected the tenacity of management over the course of time, as it has evolved into the world's largest bond fund. PIMCO employs nearly 500 investment professionals at last count, and has a trove of portfolio management resources available to them.

Permissible Investments

The fund has a broad investment mandate. The fund's main focus is investment grade securities. However, as this is a core plus portfolio, the manager is permitted to invest in certain securities which fall outside this realm. For instance, the manager is permitted to allocate up to 10% of the fund to high yield securities. Company representatives have stated that it is unlikely that the 10% limit on junk bonds would ever be reached due to illiquidity in those markets. In addition, the fund is permitted by its prospectus to invest in securities issued in foreign currencies (30%), as well as certain issues related to emerging markets (15%). Typically the limit on foreign currency exposure in the fund will be twenty percent of the total portfolio. The fund may invest all of its assets in derivative instruments across a broad spectrum. Short-selling is also permitted in the fund.

Investment Process Highlights

PIMCO has a vast array of tools and resources at its disposal for use in portfolio management. They conduct a large amount of proprietary research using a set of complex quantitative and qualitative tools. In addition, they have access to sell-side research, credit rating agencies, and a bevy of economic experts. Management never relies on a single information source, instead employing many inputs in order to construct an optimal portfolio.

The fund's investment tenets are built around a number of prongs which incorporate their macro views on the economy and interest rates, as well as fundamental, bottom-up security selection and analysis. PIMCO estimates that they use top-down analysis to shape roughly 80% of the portfolio on average. This process is then coupled with bottom-up fundamental analysis.

Diversification is one of the key tenets of portfolio management. There are a number of components which can and do affect this portfolio at any given time. The first important step in the process begins with secular analysis. PIMCO holds a meeting once per year called the "Secular Forum." The purpose of this gathering is to formulate a market outlook for bond markets around the world for approximately the succeeding three to five years. These positions are the culmination of the work of global secular researchers who present their findings to the Forum on various topics, including economic policy, inflation, productivity, global trade, and other pertinent subjects. Finally, various experts on economics and finance are invited to address the Forum on relevant topics in the aforementioned areas.

The Forum sets the stage for policy setting within PIMCO. The company's investment staff also convenes quarterly to examine business cycle trends and shorter term economic outlooks, spanning roughly the next two to three quarters. The company's Investment Committee then incorporates this information into a consensus that becomes a building block for portfolio management. The Committee consists of Mr. Gross as well as several senior portfolio managers. Using the macro-strategies developed at the Forum, as well as bottom-up fundamental research produced by sector specialists, the Committee arrives at

targets for the attributes that shape their fixed income portfolios. These attributes can include duration, convexity and credit quality, as well as sector and yield curve exposures. The portfolio manager then assimilates this information in the construction of the portfolio. The manager is expected to keep the portfolio within a reasonable range surrounding the target characteristics, yet he may differentiate it from the model through the use of timing, issue selection, and other factors.

The idea that seems quite pervasive in the management of the portfolio is that the long-run focus should dominate short run considerations in order to achieve maximum value for shareholders. PIMCO believes that one of its core strengths is its ability to evaluate opportunities in order to realize long-term value in the portfolio as opposed to timing market movements which are often reactionary and short-lived.

In addition to secular determinations, there are quite a few other important factors in the management of this complex portfolio. One of the tenets of portfolio construction for this fund is to be somewhat neutral to duration. Management tries to keep the portfolio within +/- 2 years of benchmark duration in an attempt to mitigate the impact of dramatic swings in interest rates. This duration decision is deeply influenced by PIMCO's outlook on both domestic and international interest rates.

Relative value determinations also shape the face of the Total Return Fund. At any given time, management may shift among the various sectors of the bond market, depending on where they find attractive valuations. This is achieved through bottom-up resources. Fundamentally focused bottom-up sector specialists scour their areas of coverage in an attempt to find good relative value among issues, as well as between sectors, while incorporating all the other moving parts that impact this portfolio. The sector specialists are aided by analysts who conduct further credit research. They seek value on a global basis, scanning fixed income sectors ranging from corporates, mortgages, emerging markets, governments, convertibles and inflation protected. Sector specialists may have some discretion over the execution of their ideas, as directed by the portfolio manager. Ultimately, the portfolio is managed using all the resources of a large team.

In addition, volatility analysis and yield curve positioning are two other factors that may affect bond prices and fund performance. Consequently, management also attempts to forecast volatility and yield curve positioning into the portfolio management process. The yield curve decision is a reflection of PIMCO's views on inflation as well as its beliefs about future Central Bank actions.

Summary of the Use of Leverage and Derivatives

One of the highlights from the fund's prospectus is that it is possible that the entire portfolio can be invested in derivative securities. This may sound extreme, however Gross has never invested the entire portfolio in such instruments. Although PIMCO has actively utilized most types of financial derivative securities at one point or another, it is important to keep in mind that this is done with all of the aforementioned economic and risk targets as a backdrop. Derivatives can have a negative connotation within the financial markets, implying greater leverage and inherent risk. PIMCO does make use of derivatives with a leverage component. However, PIMCO uses derivatives in order to gain certain exposures that are consistent with the fund's desired risk profile. In addition, when leveraged securities are employed, PIMCO will separate a piece of the portfolio to cover these obligations, as permitted by law. Derivatives, on average, have added between 20 and 35 basis points to overall performance of the fund on an annual basis according to PIMCO.

Types of Derivatives Typically Employed: In the past several years, derivative use has been limited to futures, options, swaps and mortgage derivatives such as collateralized mortgage obligations, or CMOs, which are all fairly common. Interest-only and principal-only strips (IOs and POs) have also been utilized from time to time. The usage of other derivatives such as structured notes has been much less common.

Rationale for The Use of Derivatives: A very common use of derivatives for the Total Return portfolio has been to gain an exposure for the portfolio in a market where a physical security is not publicly available. For example, there are no bonds available for an interest rate index. In

this case, options may be used as a substitute for the securities. In general, this technique allows management to better hedge the portfolio against various risk factors. Options have also been used to facilitate exposure to the price activity, or volatility, of an underlying physical security or index. Recently, derivatives have been used in order to add or subtract duration (interest rate sensitivity) from the portfolio. This is a means of gaining exposure to specific areas along the yield curve in a very low-cost fashion. The logic behind this is that if the manager feels that bond rates may move up or down, they may want to alter the portfolio's duration. The value of a portfolio will move inversely with a change in interest rates. Therefore, the manager may want to try to limit just how susceptible those values are to interest rates moves by using a futures contract or other derivative instrument in order to try to negate the impact. In June 2010, Treasury Futures were the most-often used derivative in the portfolio. In 2011, the fund made use of Eurodollar futures in order to offset the ever-changing situation with the European debt crisis.

Money market futures are another way to gain yield curve exposure. Another common device is credit default swaps, which are an effective way to gain exposure to corporate bonds which may not be readily available for purchase in the markets. Furthermore, credit default swaps can be used as a type of insurance policy for the bonds a portfolio already owns.

Finally, there are various instances when the portfolio manager wishes to gain certain exposures, such as to a particular bond issuer, and it is simply a case that there is better relative value to be achieved via ownership of the derivative.

Risks: While some derivative securities can have relatively higher degrees of risk, it is important to keep in mind that these same risks also exist among traditional bonds. Among those risks are interest rate risk, illiquidity and counterparty credit risk. PIMCO takes care to manage these risks in the entire portfolio on a constant basis with respect to the risk boundaries set in the decision-making process for the overall portfolio. PIMCO, with its vast resources, employs a broad variety of proprietary models which allow management to model a wide variety of bond market conditions.

Derivatives employing leverage are subject to further controls. First, the portfolio will only be leveraged within the appropriate duration range. For those derivatives with counterparty risk, those transactions are marked to market daily, and collateral is posted for values over \$250,000 per account per counterparty. A committee meets at least four times per year to review the approved counterparty list.

Sources of Performance

Sector shifts, or rotations, are made depending upon changes in relative valuations among different classes of bonds. Excess performance can be attributed to several factors. Over time, roughly one-third comes from out-of-benchmark investments, such as emerging markets, high yield and non-dollar denominated strategies; one-third of excess returns are derived from in-benchmark investments such as corporate, mortgages and Treasuries; the final third comes from interest rate strategies such as duration and yield curve positioning.

PIMCO integrates their views on the macro environments as well as fundamental analysis as previously described. Given this mix of so many individual elements, it is a challenge to isolate the impact of individual variables on overall performance. However, over time, the approximate weightings, according to PIMCO, are as follows:

Duration	25%
Yield Curve	25%
Sector	30%
Issue Selection	20%

Summary

The fund's emphasis on diversification, evaluation of exposure to certain risk factors, and relative value all help to limit the overall risk exposures. Management is often willing to bet on various sectors in accordance with their long-term outlook in order to derive excess returns. The fund's immense size is often-criticized, although it is actually an advantage in navigating the bond market. The portfolio manager is able to gain access to high-ranking

officials as well as corporate managements with regard to fixed income transactions. The fund's size also helps PIMCO to obtain best execution when conducting trades, especially in holdings that might be less liquid. PIMCO's sheer size allows it to foster its own liquidity without the aid of the capital markets.

The fund has been a strong performer over long stretches of time. In recent years, there have been a couple periods of relative underperformance, such as in 2006 and again in 2011. In 2006, PIMCO was early with their concern about the housing market, choosing to underweight related issues earlier than many investors. While this early call detracted from relative results in 2006, it proved beneficial in the subsequent years as their outlook proved correct. In 2011, Gross and his team simply bet incorrectly against U.S. Treasuries. They significantly cut their exposure to U.S. Treasuries due to their outlook on the nation's looming debt crisis. However, as the crisis in Europe escalated, investors sought out the continued perceived safety of Treasuries. The important distinguishing factor is whether or not these certain periods of underperformance are short-lived aberrations or are indicative of a longer-term trend. In this instance, we can see that while Bill Gross and his team are not infallible, they have, over a long time frame, shown the ability to produce outstanding results. Overall, based on the depth of the PIMCO organization, the sound and well researched investment process and the skill and experience of the lead manager Bill Gross, the PIMCO Total Return Fund remains a strong option for investors within the fixed income space.

This report was created using information made publicly available by PIMCO, such as the fund's prospectus and due diligence questionnaire, in addition to ongoing calls and meetings with various members of their organization.

Underpinning our success has been our core philosophy:
do everything in the best interest of the client.

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