



Rethinking Asset Allocation: PIMCO's Strategy for a Changing World

As challenges continue to beset the global economy, from the sovereign debt crisis in Europe to stubbornly high unemployment in the U.S., investors' asset allocation decisions have become more complex and challenging.

Three years ago, PIMCO launched the Global Multi-Asset Strategy as a means to provide clients with an innovative way to think about a multi-asset global portfolio. In the following interview, Mohamed A. El-Erian, portfolio manager, chief executive officer and co-chief investment officer, along with co-portfolio managers Curtis Mewbourne and Vineer Bhansali, discuss the strategy's investment framework, its positioning consistent with the shifting global economy, and its performance since inception.

Q: Could you discuss the motivation behind the creation of the Global Multi-Asset Strategy, and how the strategy has performed?

El-Erian: To answer this question, it is useful to go back to the run up to the global financial crisis of 2008 and the aftermath.

Many will recall the two terms that dominated the industry in the mid-2000s: "great moderation" and "Goldilocks" (not too hot, not too cold). At PIMCO we used a very different characterization: "stable disequilibrium." The world appeared stable, but the underlying forces made this stability increasingly fragile. So, at that time, we launched a number of initiatives to address the question: How do we help our clients navigate a potentially bumpy journey to



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a new equilibrium, what we call a New Normal? Our conclusions about how best to manage risk and generate returns are reflected in three elements of the Global Multi-Asset Strategy: the design, the analytical underpinnings and the management team.

On design, we felt it important to provide those clients looking for absolute returns the ability to tap the range of liquid global markets in order to find what we view are the most compelling places to generate returns and manage risk. Thus, we included global equities, commodities, currencies and fixed income.

On the analytics, we recognized that correlations across asset classes could change radically and therefore it was critical in our view to focus on risk factors (for example, equity or currency risk) and consider their relationship across seemingly diverse assets. We also came to understand that diversification would be necessary but not sufficient for risk management, and we saw the need to incorporate tail hedging focused on minimizing the impact of severe market downturns.

And we recognized that it was critically important to have both intellectual and framework agility to help clients manage this bumpy journey.

We composed the management team taking these things into account – the concept was to channel PIMCO’s companywide thinking into this strategy using three people who have different insights but would be working as one coherent team.

We chose Curtis for the alpha, or the value generation on top of the portfolio positioning. We chose Vineer for the tail risk hedging, and I became responsible for the overall beta positioning, or asset allocation.

So has it worked? We now have three years of evidence, and I can say that in our opinion, the strategy has done what it was expected to do.

We have helped clients navigate what has been an extremely turbulent time, even more turbulent than what we had expected. By incorporating the three elements I mentioned, we seek to deliver attractive absolute returns over a market cycle while hedging downside risk and providing liquidity by investing in liquid global markets.

Q: Moving to the current environment, what are the broad allocations of the strategy and how are they informed by PIMCO’s worldview?

EI-Erian: At PIMCO, we believe much of what is occurring can be reduced to four basic factors that play an important role in our approach to positioning the strategy.

The first is balance sheets – whether there is balance sheet strength or weakness. If we are on a bumpy journey to a new destination, the strength of personal, corporate and public balance sheets is a very important determinant of how to navigate that journey.

The second factor is growth exposure. I think that many people now recognize that we live in a multi-speed world in which growth in Western economies will be generally sluggish because of structural impediments, while the emerging world continues to benefit from structural tailwinds rather than headwinds. So exposure to the differentiated multi-speed growth dynamics is absolutely critical.

The third element is what we call “policy and politicians.” We believe policies and politicians play a very large role today in determining both absolute and relative market valuation, and we look for opportunities where they are not undermining the realization of value.

And the fourth factor is social movements at play around the world, some of which are headwinds, while others are tailwinds to the policy side. These factors are very much in play in Europe, as well as the U.S., China and other parts of the world.

So how do these factors translate into the strategy? We believe that a central theme for Global Multi-Asset today is to be generally defensive and selectively offensive.

We are generally defensive in terms of how much equity risk we are taking. Also, we are high in the capital structure in terms of our corporate positions and our sovereign positions, and that includes completely avoiding Europe’s peripherals – Portugal, Greece and Ireland.

Importantly, we have shifted the way we think about commodities. A year ago, we believed that commodities across the board had value and our commodity exposure was notably higher, including through generalized commodity exposures. Today it is a highly selective commodity exposure.

We are focusing on commodities with little supply responsiveness and those that serve an added purpose in addition to being a pure commodity. We continue to have gold exposure, which we manage tactically. And finally, we have significant cash balances right now in the strategy because we believe that the optionality of cash is highly valued in the volatile world that we are navigating.

On the selective offense, we have taken advantage of differential movements in equity markets to shift some of our developed market exposure into emerging markets. We continue to find potential value in emerging markets, including in local emerging market bonds, emerging market corporate bonds and external bonds.

The bottom line is that the strategy is positioned to navigate the bumpy journey to the New Normal – a world of muted growth in the Western economies, significant market volatility, recurring balance sheet issues and continued income and wealth convergence of the emerging world with the developed world.

“We see potential for heightened volatility in markets to continue in the years ahead.”

Q. Vineer, your role within the Global Multi-Asset Strategy is to manage tail hedges – the hedging of possible dramatic market downturns (associated with the left tail of a bell-shaped probability curve). Could you discuss why PIMCO believes tail hedging is an important element of the strategy, and how you approach it?

Bhansali: As part of our New Normal worldview that Mohamed discussed, we see potential for heightened volatility in markets to continue in the years ahead, and that could include more frequent significant downturns, which are tail events. And, unfortunately, one severe market shock can erase many years of gains. It is also important to recognize that while traditional diversification strategies may help investors weather a normal bear market, we believe they generally fail during tail events, when asset class correlations tend to spike. PIMCO believes that explicit tail risk hedging is critical to prepare for these situations, not just to mitigate their effects but to potentially benefit from them.

Our implementation of tail hedging begins with the building blocks of the strategy that Mohamed mentioned, including the analytical framework. That framework is based on what we call risk factors, and can be described in simple terms as the process of scaling, or determining how much of each type of exposure is appropriate.

In our view, a critical market determinant of risk and return across many types of strategies is equity risk, and other important risk factors include liquidity, currency and public policy. We believe focusing on these and other risk factors helps us to estimate how much risk we are willing to incorporate for potential upside performance and downside hedging against severe drawdowns.

Q. Specifically, how does tail hedging function in the strategy and under what circumstances could tail hedges potentially add to returns?

Bhansali: There are two sides of the coin of tail risk hedging: defensive and offensive. The defensive aspect is probably best known, and it is to seek to hedge downside volatility. There are different techniques for this goal; perhaps the most common – and we also use this in Global Multi-Asset – is the process of actively de-risking, which entails trying to discern whether or not markets are going to be more volatile going forward and, if so, reducing exposure to assets deemed risky.

But that first approach has limitations. It is unlikely that everyone can de-risk at the same time and there tend to be costs involved. Also, once an investor sells some risky holdings, they might be difficult to get back in a subsequent rally.

Another hedging technique is to buy negatively correlated securities, or what is typically known as diversification. U.S. Treasuries and other securities seen as good credit risks may be a good mechanism to hedge downside risk, but likely with an opportunity cost today in the form of low yield as well as long-term duration risk (duration refers to a security's sensitivity to a change in interest rates).

The third option, which we have used quite a bit over the last few years, is to incorporate explicit tail hedges, such as options. In Global Multi-Asset, we quantify exposures to see how much equity beta exists. Also, we take a holistic view of the strategy – instead of hedging different exposures or positions, we typically hedge the entire strategy and its equity beta.

Now, explicit hedging is not free. We typically budget between 25 basis points per year to about 100 basis points per year. But we do not see that as deadweight cost.

As I mentioned, we believe tail hedging can be offensive. We believe actively managing tail risk hedges can potentially enhance the overall return in two ways. First, we think having tail hedges allows us to tilt the strategy in directions which we believe are potentially more attractive, and some examples since inception have been getting more aggressive on equities and emerging markets than we would have felt comfortable with in the absence of hedges.

Second, having offensive tail hedges potentially enables us to monetize and “harvest” amid severe market drawdowns. Hedges have the potential to generate cash amid downturns, potentially enabling us to invest when prices are falling.

Ultimately, we view tail hedges as integral to the strategy, and having this integrated approach to asset allocation is critical to maintaining the robustness of the strategy.

Q: Curtis, could you discuss your key focus in co-managing the strategy – the alpha generation?

Mewbourne: By alpha, we mean security selection and related bottom-up investments that our specialty teams around PIMCO identify as part of their everyday effort to add value within each of their respective asset classes above and beyond the passive index for that market.

These relative value opportunities can arise from short-term dislocations, where we believe securities are priced above or below fair value, as well as from longer-term structural inefficiencies that may persist. Collectively, these alpha strategies offer attractive risk-adjusted return potential that supplements our top-down asset allocation decisions. My role is to ensure the strategy incorporates as many of those good ideas as possible and that they are scaled properly.

“The strategy’s positioning reflects PIMCO’s investment framework, which is built around our secular and cyclical views.”

Q: Why make alpha formation a distinct step in Global Multi-Asset? And how do you identify opportunities?

Mewbourne: We made alpha a distinct step in our management of the strategy because it is critical in our view to focus on reviewing global opportunities to add to returns, given the shifting challenges investors face, including a low-rate environment and the potential for continued volatility in markets and slowing global growth. We add alpha onto the core beta construction and the incorporation of tail risk hedging for the formation of a comprehensive strategy.

We believe we have a distinct advantage when it comes to adding active management alpha within multi-asset portfolios. While we have demonstrated our bond market expertise over the past four decades, we have also expanded that expertise to incorporate a broad range of other asset classes. Currency selection has been a core competency and a key focus for alpha generation, which perhaps is not too surprising since currency management is a requisite for managing global or emerging market bond portfolios. We have also been actively managing diversified commodities portfolios since 2005 and most recently, we have launched a range of active equity strategies managed by veteran equity portfolio managers.

We use a team-based approach to identify opportunities across those asset classes. We seek to leverage all PIMCO portfolio management resources in our 11 global offices – every day our portfolio managers are monitoring markets for investment opportunities and to help manage risks within their areas. So whether the teams are commodity teams or emerging market equity teams or mortgage security specialists, they are constantly monitoring the markets. As they identify opportunities, we want to ensure we are taking advantage of the ones that make sense within the Global Multi-Asset Strategy.

Q: In addition to the tail hedging that Vineer discussed and the comments from Mohamed, is there anything you want to add on how the Global Multi-Asset Strategy is positioned for today’s fluid, very volatile environment?

Mewbourne: The strategy’s positioning reflects PIMCO’s investment framework, which is built around our secular and cyclical views. Our three to five year secular outlook speaks to a multi-speed world in which emerging market (EM) growth is expected to outpace developed market growth. As a result, we will generally look to emphasize allocations to EM equity, debt and currencies, as we view these as tending to be supported by stronger growth prospects and better balance sheets, while offering the potential for higher yields.

Looking over the next few quarters, our nearer-term cyclical outlook calls for slowing global growth and heightened volatility owing to debt imbalances in Europe, and to a less urgent degree, in the U.S. That means that around our secular biases, we are also looking to trim overall risk, carefully manage country exposures and keep some dry powder in order to potentially benefit from volatility via a focus on opportunistically finding some bargains across global asset classes.

Our secular and cyclical frameworks pair with structural elements of our overall multi-asset portfolio management effort to complete the strategy. These structural elements involve selected alpha trades and tail risk hedging, which is particularly important since the current volatile environment with the potential for binary outcomes is likely to persist given the increased role of policymakers in financial markets.

Q. Mohamed, finally, where does the Global Multi-Asset Strategy fit within an overall asset allocation framework?

El-Erian: Whether investors are using a typical asset allocation of 60% equities and 40% fixed income or a more diversified approach, we view the Global Multi-Asset Strategy as complementing their overall asset allocation exposure, rather than just adding specifically to one asset class.

Global Multi-Asset can be viewed as not only an opportunity to generate returns and manage risk, but also as a way for clients to compare and contrast with what they are doing in their own customized asset allocations. We hope to both supplement what clients are doing and to ensure information transfers in terms of how we think about different asset classes in what will likely remain for a number of years, unfortunately, quite a volatile and fluid market environment.

Past performance is not a guarantee or a reliable indicator of future results. The Global Multi-Asset Strategy invests in other products and performance is subject to underlying investment weightings which will vary. The cost of investing in the strategy will generally be higher than the cost of investing in a strategy that invests directly in individual stocks and bonds. 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. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Currency rates may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. Commodities contain heightened risk including market, political, regulatory, and natural conditions, and may not be suitable for all investors. Tail risk hedging may involve entering into financial derivatives that are expected to increase in value during the occurrence of tail events. Investing in a tail event instrument could lose all or a portion of its value even in a period of severe market stress. A tail event is unpredictable; therefore, investments in instruments tied to the occurrence of a tail event are speculative. 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. The asset allocation of the strategy is subject to change without notice and may not be representative of current or future allocations. Diversification does not ensure against loss.

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