



## Mea Culpa

What's happened over the last few months to the world's greatest bond fund? (Well at least arguably the world's largest bond fund). Giants Hall of Famer, Willie Mays, was once asked to name his most outstanding catch. "I don't rate 'em," he said, "I just catch 'em." Likewise at PIMCO. We leave the ratings to you the client, or to Morningstar for which we are always grateful. We just try to catch "alpha" wherever and whenever we can with as little risk as possible and let the performance make our headlines. But this year the headlines have spoken to some dropped fly balls. What's happened to the "Say Hey Kid" and PIMCO's Total Return Fund?

Well, introspective mea culpas are perhaps cleansing but somewhat suspicious in nature. The purpose and even the author's subjective assessment can always be legitimately questioned. But suspicions aside, let me begin by stating this: There is no "quit" in me or anyone else on the PIMCO premises. The early morning and even midnight hours have gone up, not down, to match the increasing complexity of the global financial markets. The competitive fire burns even hotter. I/ we respect our competition but we want to squash them each and every day. You the client have 100% of our attention as always, as do your portfolios. I'm just having a bad year. My fabulous rock of a wife, Sue, always tells me that by December 31st, the alpha is always green, not red, but this year will be a long shot. This year is a stinker. PIMCO's centerfielder has lost a few fly balls in the sun.

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### Special Edition

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The simplest explanation involves the global flight to quality triggered by the European debt crisis and the politically-induced deterioration in this country's growth outlook. As a result, "consensus" expectations did much more than converge to PIMCO's "New Normal" scenario; they went right through it. Let me explain.

The Total Return Fund was doing typically well through the first quarter and then – like the stock market – it began to lose ground, especially in August and September. The anti-stock equivalents in the bond market are good old-fashioned Treasuries. Not much yield – even back in July when the 10-year was at 3%. Lots of "safety"\* though and when investors became more concerned about the return of their money than on their money – then Treasuries went down in yield and up in price. My well-advertised aversion to Treasuries was a little overblown in the press – the fund had positions in German Bonds and Canadian Treasuries to counter the U.S. underweight, but not enough. As Europe's crisis and the U.S. debt ceiling debacle turned developed economies towards a potential recession, the Total Return Fund had too little risk off and too much risk on. Minor percentages of emerging market corporate and sovereign debt, effectively denominated in their local non-dollar currencies went south as opposed to following Treasuries north. And too, many of the Treasuries we did have were inflation protected

TIPS – securities that tend to shine during periods of even moderate growth and potentially higher inflation – but tend to lag during quarters when recession – and lower inflation become more likely. In a quarter in which the long Treasury bond returned close to 30% these portfolio differences were greatly amplified.

I could go on but I would probably lose your interest. The simple fact is that the portfolio at midyear was positioned for what we call a "New Normal" developed world economy – 2% real growth and 2% inflation. When growth estimates quickly changed it was obvious that I had misjudged the fly ball: E-CF or for non-baseball aficionados – error centerfield.

So where do we go from here? Our internal growth forecast for developed economies is now 0% over the coming several quarters and the portfolio more accurately reflects this posture. Yet even so, can the golden glove regain its magic? Well, as I've indicated, we're showing up early every day at the ballpark – in this case for a little fielding practice. And perhaps importantly, we recognize the majesty of the stadium we're playing in. This is big league ball, where your ticketholders come to the park expecting not a circus Willie Mays catch but more wins than losses and a yearend performance that places your bond assets near the top of the standings.

Baseball metaphors aside, we know why PIMCO Total Return is arguably the largest and hopefully the greatest bond fund in the world. You want consistency, no surprises, but at the same time you want to get back through outperformance more than you pay for in fees. PIMCO, Mohamed El-Erian, and yours truly are working hard to make that happen. Despite the approaching World Series, for us it's the beginning of a new season. Play ball!

William H. Gross  
Managing Director

*Investors should consider the investment objectives, risks, charges and expenses of the funds carefully before investing. This and other information are contained in the fund's prospectus and summary prospectus, if available, which may be obtained by contacting your financial advisor or PIMCO representative or by visiting [www.pimco.com/investments](http://www.pimco.com/investments). Please read them carefully before you invest or send money.*

\* "Safety" refers to U.S. Treasuries which are generally perceived as the lowest risk investment option. All investments contain risk and may lose value.

**A word about risk: Past performance is not a guarantee or a reliable indicator of future results.** 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. Certain U.S. Government securities are backed by the full faith of the government, obligations of U.S. Government agencies and authorities are supported by varying degrees but are generally not backed by the full faith of the U.S. Government; portfolios that invest in such securities are not guaranteed and will fluctuate in value. Inflation-linked bonds (ILBs) issued by a government are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. Treasury Inflation-Protected Securities (TIPS) are ILBs issued by the U.S. Government. 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.

The value of most bond funds and fixed income securities are impacted by changes in interest rates. Bonds and bond funds with longer durations tend to be more sensitive and more volatile than securities with shorter durations; bond prices generally fall as interest rates rise.

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