BEACON POINTE MANAGER RESEARCH

PIMCO – HOW TO PROSPER IN A LOW RETURN ENVIRONMENT
STRATEGIC MARKETS VISITING SEMINARS
LOS ANGELES & NEWPORT BEACH (MARCH 31-APRIL 1, 2004)
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Introduction

Pacific Income Management Company ("PIMCO") held a seminar at the Four Seasons Hotel located in Newport Beach on March 31, 2004 and one at the Four Seasons Hotel in Los Angeles on April 1, 2004. The purpose of the seminar was to introduce potential and possible strategies that may maximize portfolio returns in a low return environment.

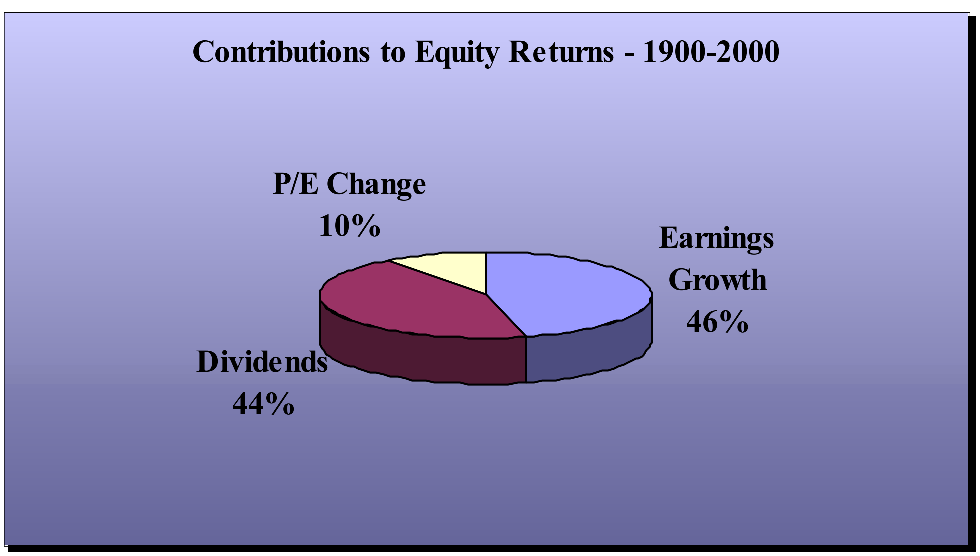
Although, from an asset allocation framework, PIMCO believes that an investor would need both bonds and stocks, the two asset classes in and of themselves, in a possible low return environment, are inadequate to meet investors' investment objectives. PIMCO believes that the past 20 years of decent returns from these two classes are unlikely to be seen going forward and one would have to consider other alternatives in order to ensure that their investment objectives are met.

The presentation was split into four segments:

- Asset Allocation in the Current Environment
- The Importance of Reliable Equity Market Alpha
- Maximizing Portfolio Return Potential – Benefiting from Reflation
- Maximizing Portfolio Return Potential – Utilizing Higher Yielding Asset

Asset Allocation in the Current Environment

PIMCO observed that stocks and bond returns over the last 20 years have been much higher than historical averages and believes that the benefits from low inflation/disinflation are probably behind us. In the equity world, one of the biggest contributors to the stock returns has been the change in P/E level in the 1980s-1990s. However, historically, changes in P/E levels have not been a large contributor to equity returns. In addition, P/Es have never been additive over a cycle starting from high levels. In the long run, dividends and earnings growth drive stock returns, not changes in P/E multiples.



Source: Adapted from PIMCO Presentation. Original Source: Shiller, Bloomberg, Federal Reserve, Research Affiliate

Historically, when the starting P/Es have been higher than 15, the P/E contribution to equity returns have been negative ranging from –1.3% for the period 1900-1919 to –4.3% for the 1960-1979. At current P/E levels (high teens), it is expected that P/E contribution to equity returns will most probably be negative. Thus, with current market dividend yields of 1.5% and real dividend growth of 1.2% (excludes economic growth from new enterprises)[1] and with an almost zero P/E contribution, we can expect long-term real returns from stocks to be about 2.7% and tacking on the inflation rates of 2%-4%, we get nominal equity returns in the range of 4.7%-6.7%, according to PIMCO. These low expected returns going forward may have severe implications for investors that have liabilities on their balance sheets and looking to equity markets to meet their cash flow needs.

According to PIMCO, based on study by Ibbotson, equities and pension fund liabilities have had unstable relationship. In addition, the correlation of equity returns to liabilities has been low and rather insignificant.

Now, the expected low returns from the equity market and its low correlation to liabilities in conjunction with poor returns from bonds can significantly impact asset-liability matching. The best estimates for long-term returns are derived from income and using the current Lehman Brothers Aggregate yield to maturity of 4.437% as of April 21, 2004, we get expected returns from bonds to be about 5%[2] from an actively bond portfolio.

In summary, PIMCO expects both bond and stock returns to be lower than recent past. PIMCO observed the advantage of bonds is that these instruments track liabilities a lot better than equities (or match with cash flow needs) and tend to reduce overall risk. However, although both bonds and stocks are needed, as balance is critical, they may not be adequate to meet all investment objectives.

The Importance of Reliable Equity Market Alpha

It is a well-known fact in the investment world that it is very difficult to gage future performance of active managers based on past performance. It is even harder in the equity world as it suffers from a higher volatility than the fixed income world. PIMCO studies have shown that best performing managers when tracked over time were found not to repeat or continue their excellent performance over time. Beacon Pointe studies also show that predicting future strong performers can be extremely difficult[3].

In addition to the potential underperformance in the equity market due to higher volatility, there are other issues to contend with including:

- Challenges associated with efficient market which implies that all security priced efficiently and so it is difficult to achieve excess returns
- Dilemma of having cash versus having full exposure in volatile market environments

[1] This data has been derived from Bloomberg Financial Markets and returns as are of 02/29/2004. The source has been adapted in to the presentation materials by PIMCO.
[2] 4.4% + 1.0%(from actively managed bond portfolio - estimated) –0.4% (fees) = 5.0%
[3] See our whitepaper, "Past Performance is not a Guarantee of Future Results".

- High transaction and management costs.

PIMCO illustrated a hypothetical example of how an investor could construct an asset allocation in the light of a low return environment in an attempt to generate excess returns. In developing this scenario, the following assumptions were made:

- Using S&P 500 Index as a proxy, 5-year S&P return is 6%
- By extension, S&P 500 Equity Futures return is 6%
- S&P 500 Futures return less financing cost is 4%
- Passive bond portfolio return is 4%
- Active bond portfolio return is 5%

PIMCO was making a case for using Equity Futures and active bond management to earn returns in excess of what one can earn from equities alone. By using futures, you don't need to put money up front and still gain exposure to the equity world. However, financing costs for futures will reduce returns from the equity markets and PIMCO estimates this return be 4%. This return in combination with an actively managed bond portfolio with expected return of 5% can potentially lead to about 9% return instead of the 6% return one can expect from the equity market with S&P 500 used as a market proxy. With a passively managed bond portfolio and S&P Equity Futures, we can expect a return of 8%.

Maximizing Portfolio Return Potential – Benefiting from Reflation

PIMCO believes that mild reflation is likely especially in the light of low short-term interest rates, aggressive fiscal policy stimulus, increasing government share of GDP, reregulation, and protectionism. Stocks and bonds have low or negative correlation with CPI, a measure of inflation while TIPS, Real Estate, and Commodities have positive correlation to CPI.

Pension plans, endowments and foundations, insurance companies, and individual retirement plans are all affected by inflation and it becomes imperative to design a portfolio that can withstand detrimental inflationary effects.

Pension plans have liabilities that have an inflation component and are subject to volatile returns that may impact contributions. Endowments and foundations have funding requirements that are in real, not nominal, terms and need stable multi-year funding. Property & Casualty insurance companies' liabilities are based on replacement costs. Finally, individual retirement plans have real requirement, not nominal requirements and have a need for diversification in order to reduce volatility of the portfolio.

Based on information from Federal Reserve, Goldman Sachs, and Bloomberg, PIMCO observed that TIPS[4] and Commodity Futures indices such as the Goldman Sachs Commodity Index (GSCI) act as good inflation hedges. Although exposure to commodities can be achieved by owning actual commodities, owning shares of commodity producers, or traditional active commodity trading, PIMCO believes that commodity index presents the best vehicle for investors as it has a systematic approach to the asset class and the inherent returns are driven by economic factors rather skill or luck.

[4] For more on TIPS, please refer to our whitepaper " TIPS – Treasury Inflation Protected Securities" dated December 2003

For investors seeking real estate exposure without facing liquidity issues, REITs are an attractive avenue while long-term investors with little or no liquidity requirement, direct real estate investments can be considered.

Maximizing Portfolio Return Potential – Utilizing Higher Yielding Assets

PIMCO observed that improving Corporate America and structural improvements in emerging markets make these asset classes competitive with stocks. At current levels, S&P 500 yield of just 1.5 in comparison with about 4.3% bond yields, significant growth in earnings or P/E expansion is needed to close the gap.

PIMCO's studies show that with the high yields and the emerging markets capped at 10% in a sample portfolio and an allocation of 55% to the S&P 500 and 25% to fixed income, we can expect portfolio return of about 5.8% with a volatility of about 10.7%. The return assumptions and the correlation between the asset classes are:

			Correlations			
	Returns	**Std. Dev**[5]	**S&P 500**	**Lehman Aggregate Bond Index**	**Merrill Lynch High Yield**	**JPM EMBI+**
S&P 500	6.00	17.00	1.00			
LBAG	3.95	3.75	0.26	1.00		
ML US High Yield, BB	7.03	8.24	0.52	0.28	1.00	
JPM EMBI+	8.21	10.96	0.54	0.23	0.47	1.00

Source: PIMCO

The returns for LBAG, ML High Yield and JPM EMBI returns are based off approximate yield to maturity as of February 29, 2004.

PIMCO briefly elaborated on how some of their products these two strategies – benefiting from reflation and utilizing higher yielding assets – can lead to enhanced returns with lower volatility to minimize asset liability mismatching.

Conclusion – How to Prosper in a Low Return Environment

- PIMCO stressed that asset allocation should be able to withstand reflation and deflation.

- PIMCO believes that broad asset class inclusion can add to returns and reduce risk.

- In the event of low returns with perhaps higher volatility due to inflationary fears, and current high levels of valuation, minimizing liability risk has become critical.

- This paper summarizes the opinions and recommendations made by PIMCO for its investors. Beacon Pointe believes that long-term strategic asset allocation best serves our clients in meeting their risk and return investment objectives. We do understand

[5] Std deviation numbers based on monthly returns from January 1994 – February 2004

that the investment market is dynamic and changing. Although we do recommend strategic asset allocation for our clients, Beacon Pointe does recommend investment managers such as PIMCO to our clients that are allowed investment flexibility to best protect our clients' investment interests. PIMCO for example, within certain funds, has almost 13% in TIPS, which acts as a hedge versus inflation. PIMCO has also made a significant investment in emerging market debt (with an 5% weighting in the Total Return Bond Fund), which have a high correlation to commodities as emerging markets countries generally tended to be exporters of commodities besides some finished goods.

- Please contact your Beacon Pointe consultant should you have any questions.