

Example 2: The BofA Merrill Lynch Long U.S. Treasury Principal STRIPS Index

ETF investors have demonstrated that there is significant demand for a tradeable instrument with a high price change for a given change in yields (i.e., a long duration product). Some ETF offerings have been created using double or triple leverage in an attempt to deliver this type of duration effect. However, daily rebalancing of leverage typically creates a different return pattern than simply multiplying a return series by the leverage factor. This phenomenon may be of particular concern to investors with a multi-day horizon seeking a long duration product as a hedge for long-dated liabilities. For such investors, a predictable and relatively stable duration should be a desirable characteristic in a long-duration ETF.

Other indexes that form the basis for non-levered ETFs include long maturity, coupon-bearing Treasuries and, as such, are significantly shorter in duration than indexes comprised of zero-coupon bonds. Zero-coupon indexes extend duration beyond the level offered by indexes containing coupon paying bonds. However, by including both coupon and principal STRIPS, these indexes contain less liquid components (the coupon STRIPS) that may inhibit an ETF market makers' ability to trade or hedge the underlying basket securities. Having to acquire all the coupon STRIPS may be a meaningful burden on ETF market makers, a burden which typically translates to higher bid-ask spreads for ETF investors.

The BofA Merrill Lynch Long US Treasury Principal STRIPS Index includes only principal STRIPS with maturities of 25 years or greater. The graph below shows durations through time for several indexes currently used for non-levered ETFs. The time line for this chart begins when the Treasury resumed issuing 30-Year Bonds on a regular basis. As displayed, the BofA Merrill Lynch Long US Treasury Principal STRIPS Index has the longest and most stable duration of Indexes currently used for non-levered Treasury ETFs.

A number of indexes are used for levered ETF products. While double or even triple leverage could theoretically double or triple the duration of the index used on a daily basis, the use of derivatives may distort the duration on a daily basis upon rebalancing the ETFs' exposure. An investment time horizon greater than a day can potentially result in very volatile duration per dollar invested. Further, volatility may cause a leveraged fund's returns to behave

very differently than the corresponding Index return and its multiplier would imply over periods longer than a day.

The BofA Merrill Lynch Long US Treasury Principal STRIPS Index is designed to provide investors with the highest and most stable duration in an ETF product, and it should exhibit greater liquidity in its components than a zero-coupon index containing coupon STRIPS.

Understanding Tracking Error and its Implications

Tracking error is usually held in high regard by index investors, but as with many important indicators, individual measurements should not be the sole means to judge a product's efficacy. Many investors also have the misconception that tracking error is a measure of risk. Tracking error actually measures the volatility of a fund's excess returns (either over or under the index). Ultimately, underperformance of an index is undesirable, but performance variations around an index may be tolerable given certain trade-offs. For example, a fund that uses a different time than its index to price underlying securities will likely show high tracking error (or variability of index-relative returns) due to different pricing times, but the fund may perform in line with the benchmark during trading hours and over the course of a longer measurement horizon. Importantly, tracking error is not an economic penalty or cost to investors.

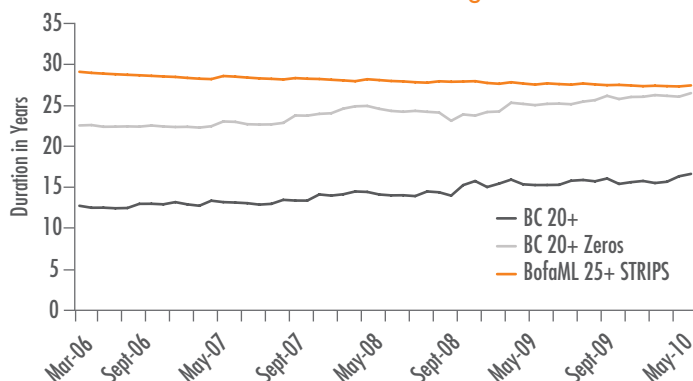
Conversely, bid-ask spreads are economic costs that investors absorb, and do not recover, when buying and selling securities on the market. To the extent an ETF is designed to minimize bid-ask spread, it may reduce costs and actual economic losses to investors. Similarly, premiums and discounts to NAV may also result in tangible economic penalties (more on these concepts later in the discussion of Optimized Portfolios).

In some cases, tracking error can result from a lack of diversification, such as with a fund that only invests in 200 stocks, but seeks to track a 1,000 stock index. A lack of diversification in this case is a legitimate concern since the investor is exposed to more concentrated issuer-specific risk. However, unlike equity or corporate bond indexes where diversification is a key element of risk management, Treasury indexes consist of securities of only one issuer, so diversification to avoid issuer-specific risk is a less meaningful concept.

A focus on effective duration-matching in Treasury index funds may result in the essential return and volatility elements that investors value in these funds. A Treasury index fund that uses fewer bonds than the index will not match returns of the index exactly on a daily basis, and therefore will exhibit greater tracking error than a full replication strategy. However, such a fund will not necessarily display systematic over or under performance of the index. It should be noted that...

1. Variability of index-relative returns (tracking error) does not necessarily increase risk, nor does it generate an economic penalty or un-recoverable cost to investors, particularly in the case of an all-Treasury index.

Index Duration Through Time



- Utilizing a portfolio with fewer, more liquid securities may reduce bid-ask spreads (true economic costs) and premiums and discounts to NAV without penalizing investors from a return or diversification perspective in some circumstances.

Optimized Portfolios

Optimized portfolios refer to portfolios that contain fewer securities than the Index. The potential advantage in using such a strategy would be that the portfolio manager could choose the securities to hold, and thus reduce transaction costs in replicating an index both within a portfolio, as well as for market makers who create trading markets for ETFs. A more liquid basket of securities may allow market makers to post prices

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closer to NAV, as they can more easily trade the bonds that are required for a creation or redemption. Since bid-ask spreads and premium/discount to NAV are, in significant part, functions of liquidity in the underlying portfolios, more liquid bonds may result in tighter ETF bid-ask spreads and reduced premiums/discouts to NAV over time.

The below U.S. Treasury Indexes are currently optimized in PIMCO ETFs

- The BofA Merrill Lynch 1-3 Year US Treasury IndexSM
- The BofA Merrill Lynch 3-7 Year US Treasury IndexSM
- The BofA Merrill Lynch 7-15 Year US Treasury IndexSM

Investors should consider the investment objectives, risks, charges and expenses of a Fund carefully before investing. This and other information are contained in a Fund's prospectus, which may be obtained by contacting your PIMCO representative. Please read the prospectus carefully before you invest or send money.

The performance figures presented reflect the total return performance and reflect changes in share price and reinvestment of dividend and capital gain distributions. All periods longer than one year are annualized. Shares of an ETF are not individually redeemable and shares may only be acquired from and redeemed to an ETF in Creation Units. Investors may sell or purchase individual shares in secondary market transactions that do not involve the ETF. Shares of the Funds are bought and sold at market price (not NAV). Brokerage commissions will reduce returns. Please see the prospectus for more details.

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. 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. Investing in derivatives could lose more than the amount invested.

ETFs are subject to secondary market trading risks. Shares of an ETF will be listed for trading on an exchange, however, there can be no guarantee that an active trading market for such shares will develop or continue. There can be no guarantee that an ETF's exchange listing or ability to trade its shares will continue or remain unchanged. Shares of an ETF may trade on an exchange at prices at, above or below their most recent NAV. The per share NAV of an ETF is calculated at the end of each business day, and fluctuates with changes in the market value of the ETF's holdings. The trading prices of an ETF's shares fluctuate continuously throughout the trading day based on market supply and demand, which may not correlate to NAV. The trading prices of an ETF's shares may differ significantly from NAV during periods of market volatility, which may, among other factors, lead to the ETF's shares trading at a premium or discount to NAV. Premiums or discounts are the differences (expressed as a percentage) between the NAV and the Market Price of the Fund on a given day, generally at the time the NAV is calculated. A premium is the amount that the Fund is trading above the reported NAV, expressed as a percentage of the NAV. A discount is the amount that the Fund is trading below the reported NAV, expressed as a percentage of the NAV. A discount or premium could be significant. The daily premium/discount is the difference between the daily market price for shares of the Fund and the Fund's net asset value. The market price is determined using the midpoint between the highest bid and the lowest offer on the listing exchange, as of the time that the Fund's NAV is calculated.

The BofA Merrill Lynch 0-1 Year US Treasury IndexSM is an unmanaged index that tracks the performance of the direct sovereign debt of the U.S. Government, excluding Treasury Bills, with at least \$1 billion in outstanding face value and a remaining term to final maturity of at least one month and less than one year. The BofA Merrill Lynch 1-3 Year US Treasury IndexSM is an unmanaged index comprised of U.S. Treasury securities, other than inflation-protection securities and STRIPS, with at least \$1 billion in outstanding face value and a remaining term to final maturity of at least one year and less than three years. The BofA Merrill Lynch 7-15 Year US Treasury IndexSM is an unmanaged index comprised of U.S. Treasury securities, other than inflation-protection securities and STRIPS, with at least \$1 billion in outstanding face value and a remaining term to final maturity of at least 7 years and less than 15 years. The BofA Merrill Lynch 3-7 Year US Treasury IndexSM is an unmanaged index comprised of U.S. Treasury securities, other than inflation-protected securities and STRIPS with at least \$1 billion in outstanding face value and a remaining term to final maturity of at least 3 years and less than 7 years. The BofA Merrill Lynch Long US Treasury Principal STRIPS IndexSM is an unmanaged index comprised of securities representing the final principal payments of U.S. Treasury bonds with at least \$1 billion in outstanding face value and a remaining term to final maturity greater than or equal to 25 years. It is not possible to invest directly in an unmanaged index.

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Premiums or discounts are the differences (expressed as a percentage) between the NAV and the Market Price of the Fund on a given day, generally at the time the NAV is calculated. A premium is the amount that the Fund is trading above the reported NAV, expressed as a percentage of the NAV. A discount is the amount that the Fund is trading below the reported NAV, expressed as a percentage of the NAV. A discount or premium could be significant. The daily premium/discount is the difference between the daily market price for shares of the Fund and the Fund's net asset value. The market price is determined using the midpoint between the highest bid and the lowest offer on the listing exchange, as of the time that the Fund's NAV is calculated.

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