PIMCO

STRATEGY SPOTLIGHT

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Active ETFs for Liquidity Management and Capital Preservation

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As reform alters the landscape, investors look beyond money market funds.

Investors and asset managers today are adapting to a paradigm shift in liquidity management. The advent of money market reform measures on 14 October, combined with the New Neutral reality of "lower for longer" interest rates, has made achieving attractive risk-adjusted income while preserving purchasing power top of mind for many investors. Here, Jerome Schneider, PIMCO's head of short-term portfolio management and Morningstar Fixed Income Manager of the Year for 2015, and PIMCO ETF strategist Natalie Zahradnik discuss what's at stake with the pending reform and why active short-term exchange-traded funds (ETFs), like PIMCO's MINT and LDUR, may be an attractive alternative to money market funds.

The deadline for implementing the new money market rules is 14 October. Can you give a synopsis of the reforms and their market implications?

Schneider: The overarching aim of the reform is to prevent the types of risks we saw with the Reserve Primary Fund in 2008, which triggered mass redemptions and was eventually liquidated after being forced to lower its net asset value (NAV) below $1.00. To this end, the pending rules require prime money market managers to move from a stable NAV of $1.00 per share to a floating NAV. And to prevent runs on assets, they also allow prime fund managers to put up so-called "gates" – liquidity fees or redemption suspensions – if weekly liquid assets fall below certain thresholds.

The move to a floating versus fixed NAV has caused assets in prime funds to plummet recently – by over $1 trillion over the past year – as investors move toward government-only funds (which aren't subject to the rule) or other options, including certificates of deposit (CDs). But these options may come with certain drawbacks, including limited liquidity or an inability to adequately protect investors' purchasing power due to anemic net returns (which we believe will remain structurally suppressed over the secular horizon). So it's important for investors to carefully consider whether their cash management options are actually working to meet their goals.

What have you been seeing in the overall short-term and money market space leading up to these reforms?

Schneider: The big story, of course, has been the massive outflows from traditional prime (credit) money market funds, with over $300 billion in redemptions over the past month alone. Much of this has been funneling into government-only funds, which are only partially subject to the new rules. But with nearly $300 billion still in institutional prime funds, the question remains whether the outflows are mostly behind us or will swell again following the implementation of the reforms.

The ongoing shift (along with expectations of slow Fed rate hiking) has pushed short-term funding rates higher as lenders face decreased demand for short-term instruments: The London Interbank Offered Rate (Libor) has spiked to 0.87% currently from just 0.33% a year ago, and we don't expect Libor to recalibrate back to levels seen earlier in the year anytime soon. So what we see is lenders, investors and asset managers adjusting to a true structural change in funding rates – one that will benefit those investors willing to evaluate and embrace this new paradigm.

On the other side, we believe those who don't adapt and who keep overallocating to government money market funds will continue to suffer. Paltry net returns (near 0%) will only look worse when the Federal Reserve chooses to move rates higher. And inflation continues to edge upward. This is notable because over most of the 40 years prior to the global financial crisis, investors in money market funds received handsome positive nominal returns that not only moved up when rates were rising, but also often exceeded inflation. But owing to the structural changes in the market, a positive inflation-adjusted real return for money market fund investors is likely becoming a distant memory.

Do these reforms have a direct impact on the ETF market specifically? And what role might ETFs play in the resulting asset shifts?

Zahradnik: For the first part of the question, the short answer is no. The new rules apply only to money market funds, so their impact on ETFs is more indirect, in that we could see demand pick up for ETFs positioned to offer an effective alternative for cash and liquidity management.

ETFs provide the benefit of both portfolio and price transparency, given that holdings are posted daily and the funds trade on exchanges at market prices throughout the day. ETFs have always featured floating NAVs, which are calculated at the end of each trading day. Additionally, investors in ETFs avoid the potential for liquidity gates that will accompany prime money market funds following the reform. With these factors in mind, we believe the reform could shift some of the prior demand for prime money market funds to short-duration ETFs that meet investors' needs for liquidity and capital preservation.

What are you seeing now with Treasury index ETFs, and how should investors think about their use versus actively managed ETFs for cash management?

Zahradnik: The big issue for pure Treasury index ETFs is that yields continue to be suppressed. Although flows for these funds have been mixed, in aggregate they have seen outflows in 2016 to date.

Table 1: Yields on Treasury index ETFs have been persistently low

Fund Type	Total AUM ($ millions)	Total YTD flows ($ millions)	Weighted average return	Weighted average yield
Prime money market funds	494,802	(742,353)	0.24%	0.37%
Index ultra-short-term Treasury bond ETFs	5,239	(348)	0.24%	0.25%
Actively managed ultra-short-term bond ETFs	8,443	1,380	1.41%	1.30%

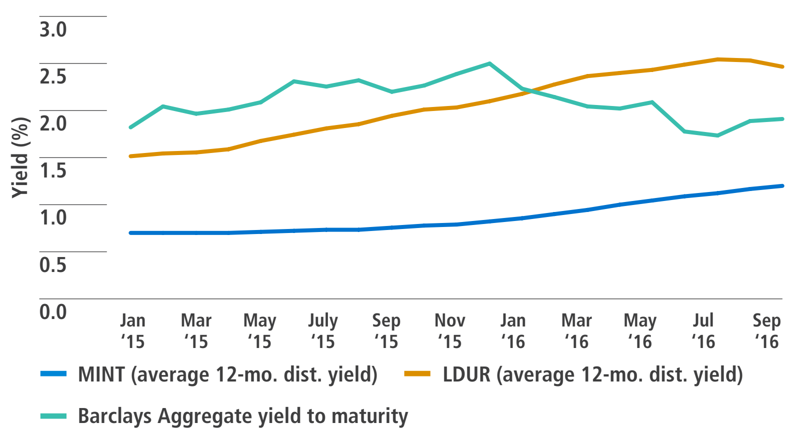
Source: Cranes for prime funds as of 30 September 2016; Bloomberg, Citi Research and PIMCO for ETFs as of 30 September 2016

That may seem counterintuitive, given the recent moves into government securities. But because yields on three-month Treasury bills have continued to compress, return potential for Treasury ETFs has been very low, even considering these funds' generally low fees. Over the past few years, yields on Treasury ETFs have barely exceeded total expenses; and while the Fed's December 2015 rate increase led to a slight uptick, yields remain low (see Table 1). So we can expect low returns to persist for pure passive Treasury index ETFs that have limited ability to deviate from their indexes, given that reform-driven demand for the underlying bonds will keep the pressure on yields.

Given these considerations, we believe actively managed ETFs invested in securities beyond the index and able to take advantage of reform-driven dislocations in the market may be the better choice in the current environment. Options such as PIMCO's MINT (Enhanced Short Maturity Active Exchange-Traded Fund) and LDUR (Low Duration Active Exchange-Traded Fund), which target short-term or short-duration investments outside the scope of regulated money markets, may be attractive to investors looking for money market alternatives and who can tolerate modestly higher volatility than that in government money funds. Short-duration ETFs like MINT and LDUR emphasize capital preservation, but because they have the flexibility to trade in assets beyond regulated money markets, they can exploit targeted opportunities for enhanced yield and total return potential. And an active, risk-focused approach helps to limit volatility while still taking advantage of pockets of value outside the benchmark. These attributes may appeal to investors who are seeking to go beyond simply maintaining par to protect their purchasing power.

In a world where exposure to interest rates is a major source of volatility for many portfolios, especially at the front end of the yield curve, active management may help mitigate that risk with the goal of producing potentially better risk-adjusted returns (see chart).

Active management can help mitigate volatility



Source: PIMCO as of 30 September 2016

Table 2: Returns (after fees)	1-year	3-year	5-year	S.I. returns	Inception date
PIMCO Enhanced Short Maturity ETF (MINT) (NAV total return after fees)	1.81%	0.95%	1.20%	1.16%	16 Nov '09
PIMCO Enhanced Short Maturity ETF (MINT) (market price returns)	1.81%	0.96%	1.18%	1.16%	
Citigroup 3 Month Treasury Bill Index	0.20%	0.09%	0.08%	0.09%	
PIMCO Low Duration ETF (LDUR) (NAV total return after fees)	3.50%	–	–	2.53%	29 Jan '14
PIMCO Low Duration ETF (LDUR) (market price returns)	3.70%	–	–	2.58%	
BofA Merrill Lynch 1-3 Yr Treasury Index	0.88%	–	–	0.93%	

LDUR 30-day SEC Yield =1.20%* Total expenses 0.36%
MINT 30-day SEC Yield = 1.18%* Total expenses 0.57%

Performance quoted represents past performance. Past performance is not a guarantee or a reliable indicator of future results. Current performance may be lower or higher than performance shown. Investment return and principal value will fluctuate, so that Fund shares may be worth more or less than their original cost when redeemed. Performance data current to the most recent month-end for the ETFs is available at www.pimcoetfs.com or by calling 888.400.4ETF.

Performance shown for the institutional share class as of 30 September 2016. The total expenses include the accounting treatment of certain investments (e.g. reverse repurchase agreements). The interest expense on these investments is required to be treated as a fund expense for accounting purposes and is not payable to PIMCO.

***The 30-day SEC Yield is as of 30 September 2016.**

What other considerations would you point out to ETF investors?

Schneider: It's more important than ever for investors to understand an ETF's strategy for risk and return management and to have a good understanding of its actual investments. For instance, does the ETF invest in high yield? Does it take non-dollar positions? We believe, for example, that floating rate assets linked to Libor may be a good bet right now because banks will likely continue paying relatively higher funding costs as a result of structural changes. We hold these securities in both MINT and LDUR. However, floating rate index ETFs that do not employ rigorous credit analysis and size their holdings based on the issuer's amount of debt outstanding can have unintended risks.

Investors also must fully understand the strategy behind these funds. Is the fund sufficiently focused on maintaining purchasing power, in addition to providing liquidity and preserving capital? In a "lower for longer" interest rate reality where traditional money market funds have failed to deliver returns that exceed inflation, this has become paramount.

Lastly, it's important to consider an ETF's track record, longevity and management team. Has it benefited in past cycles from responsive management, performing well against its benchmark while mitigating volatility? Time-tested short-duration ETF strategies like those behind PIMCO's MINT and LDUR, which aim to maximize cash potential while protecting against rising rates, may offer an attractive solution to investors in the new reality of liquidity management. Independent evaluators including Morningstar and Lipper have recognized PIMCO's short-term team, which manages these ETFs, for the long-term performance of many strategies as well as the portfolio managers' tenure, diversified skill sets and active management of liquidity through diverse market conditions. With more than 30 years managing liquidity-minded portfolios, our goal is to help our clients successfully balance their needs for liquidity and true purchasing power preservation.

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This material is authorized for use only when preceded or accompanied by the current PIMCO funds prospectus or summary prospectus, if available.

A Word About Risk: Investing in the **bond market** is subject to certain risks including the risk that fixed income securities will decline in value because of changes in interest rates; the risk that fund shares could trade at prices other than the net asset value; and the risk that the manager's investment decisions might not produce the desired results. Investments may be worth more or less than the original cost when redeemed. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. **Mortgage and asset-backed securities** may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. 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. 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. **Mortgage and asset-backed securities** may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. **High-yield**, lower-rated, securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Diversification does not ensure against loss.

Exchange Traded Funds ("ETF") are afforded certain exemptions from the Investment Company Act. The exemptions allow, among other things, for individual shares to trade on the secondary market. Individual shares cannot be directly purchased from or redeemed by the ETF. Purchases and redemptions directly with ETFs are only accomplished through creation unit aggregations or "baskets" of shares. Shares of an ETF are bought and sold at market price (not NAV). Brokerage commissions will reduce returns. Investment policies, management fees and other information can be found in the individual ETF's prospectus.

Buying or selling ETF shares on an exchange may require the payment of brokerage commissions. Due to the costs inherent in buying or selling Fund shares, frequent trading may detract significantly from investment returns. Investment in Fund shares may not be advisable for investors who expect to engage in frequent trading.

Foreign (non-U.S.) fixed income securities will settle in accordance with the normal rules of settlement in the applicable foreign (non-U.S.) market. Foreign holidays that may impact a foreign market may extend the period of time between the date of receipt of a redemption order and the redemption settlement date. Please see the Funds Statement of Additional Information at www.pimcoetfs.com.

Investments made by a Fund and the results achieved by a Fund are not expected to be the same as those made by any other PIMCO-advised Fund, including those with a similar name, investment objective or policies. A new or smaller Fund's performance may not represent how the Fund is expected to or may perform in the long-term. New Funds have limited operating histories for investors to evaluate and new and smaller Funds may not attract sufficient assets to achieve investment and trading efficiencies. A Fund may be forced to sell a comparatively large portion of its portfolio to meet significant shareholder redemptions for cash, or hold a comparatively large portion of its portfolio in cash due to significant share purchases for cash, in each case when the Fund otherwise would not seek to do so, which may adversely affect performance.

Money market funds may only invest in certain high quality short term investments issued by the U.S. government, U.S. corporations, and state and local governments that are subject to strict diversification and maturity standards and ultra-short bond funds are not subject to these requirements. Further, money market funds seek to maintain a stable NAV of $1.00 per share.

LIBOR (London Interbank Offered Rate) is the rate banks charge each other for short-term Eurodollar loans. It is not possible to invest directly in an unmanaged index.

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