PIMCO

Your Global Investment Authority

Strategy Spotlight

January 2015

Time to Get Off the Merry-Go-Round

Since the financial crisis in 2008, markets have been buoyed by the supportive monetary policies of central banks. Investors have generally enjoyed a series of positive return cycles over the past few years – not unlike the relatively smooth ride on a merry-go-round. In 2015, however, the ride is likely to become bumpy, even disorienting.

Jerome M. Schneider
Managing Director

Mr. Schneider is a managing director in the Newport Beach office and head of the short-term and funding desk. Prior to joining PIMCO in 2008, Mr. Schneider was a senior managing director with Bear Stearns. There he most recently specialized in credit and mortgage-related funding transactions and helped develop one of the first "repo" conduit financing companies. Additionally, during his tenure at Bear Stearns he held various positions on the municipal and fixed income derivatives trading desks. He has 19 years of investment experience and holds an undergraduate degree in economics and international relations from the University of Pennsylvania and an MBA from the Stern School of Business at New York University.

While near-zero interest rates have made traditional "safe" allocations such as money market funds and Treasury bills relatively unattractive, investors have been able to reach for yields greater than 0% without experiencing significant volatility. However, as we embark on a cycle of higher rates, investors need to consider not only the yield of their cash alternatives, but also the prospect that these higher-yielding securities could encounter price volatility and reduced liquidity.

In particular, investment managers who focus on the front end of the yield curve will need macroeconomic forecasting acumen and fundamental economic research to correctly evaluate investments that seek to preserve investor capital. For investors, the time has arrived to plan for a new economic landscape.

Time to wake up

If you have been lulled to sleep on the easy merry-go-round, it's time to wake up. Complacent front-end investing should end now.

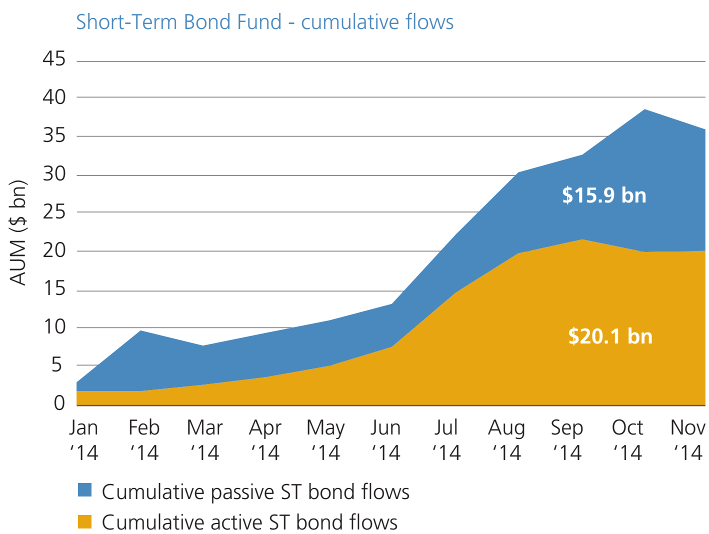
In 2014, many investors fearful of higher rates de-risked their portfolios by moving into shorter-duration passive strategies. While an outright reduction in duration may help to protect portfolios from capital losses associated with rising rates, there are periods when this simply does not provide enough protection. In 2014 alone, investors steered almost $16 billion to passive short-duration strategies (see Figure 1). But the potential for capital preservation derived from these strategies may face challenges. Why?

For one, passive benchmarks in the front end are generally in the direct path of rate hikes by the Federal Open Market Committee (FOMC); they lack the ability to steer clear of rate recalibrations. In fact, these shorter-duration passive and indexed strategies could backfire: If investors seek to "de-risk," or reduce their duration exposure by allocating to these strategies, they are potentially heading directly *into* the volatility instead of *avoiding it*.

Two, strategies with pre-specified, structural interest rate exposure have little to no flexibility around their positioning, and may push investors into the heart of the proverbial storm. So even though investors may have chosen to reduce their aggregate interest rate exposure, they still have exposure to the precise location where rates may be most volatile.

Instead of simply stepping off and carefully exiting the merry-go-round when it slows, they may instead be jumping off when it is moving at full speed.

FIGURE 1: PASSIVE SHORT-TERM BOND FLOWS ON THE RISE



Reflects short-term bond flows in the U.S.
Source: EPFR Global as of 30 November 2014

What to expect from the Fed

PIMCO's short-term desk has high conviction that the Federal Reserve will raise rates this year as economic data improve. Our base case is that the Fed's first rate hike will come sometime between June and September 2015. Economic data will likely show upward pressures on wages, while lower oil prices will support and spur consumer spending, consistent with our expectation of U.S. GDP growth of 2.75%–3.25%.

Importantly, however, the sequence of rate hikes in 2015 will not necessarily follow the same patterns as past hiking cycles, including 2004. The Fed may take a slow and measured approach this time around, and rates may ultimately peak at levels well below their cyclical highs of the past few decades.

As we approach this period of tightening, our team remains focused on two dynamics:

- First, for front-end investors the market reaction to (positive) economic data will be just as important as the data itself. The "taper tantrum" of mid-2013 showed how the markets can react dramatically to changing economic conditions and updated policy rate forecasts. Increased volatility also would undoubtedly unsettle some investors, while creating opportunities for others.
- Second, a FOMC rate hike directly affects front-end yields. The zero- to 2-year segment of the yield curve would recalibrate upward very quickly once the Fed makes clear it will hike the fed funds rate.

Regardless of the specific timing and magnitude of rate hikes, the implication is clear: After several years when rates did not rise as expected, investors will likely be forced to construct portfolios that seek to deliver attractive returns and downside protection amid volatility emanating from concerns over rising rates.

How PIMCO expects to navigate the front end

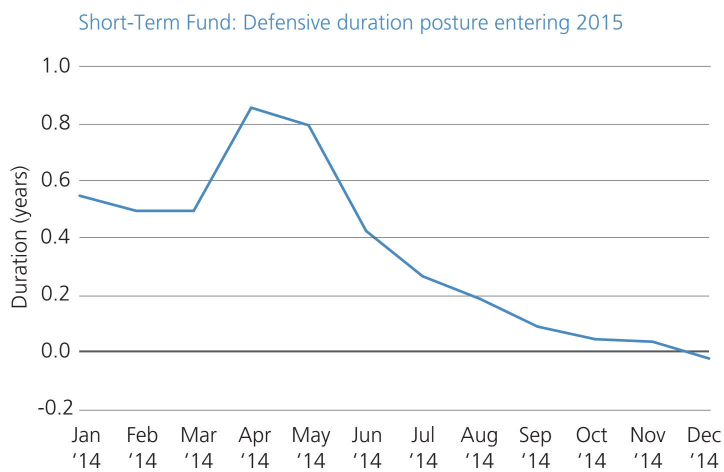
While challenging to certain strategies, rising rates can present opportunities, particularly for those with flexibility to reposition to where they see value on the curve.

Many investors remove all duration from their portfolios by moving to a money market fund or bank deposits, but that may not be the best strategy. Although this preventive action may reduce one's aggregate risk profile, it creates obstacles to generating even nominal positive returns. In addition, these two options will grow increasingly rare for larger investors as regulatory changes force providers, such as banks and 2a-7 money market funds in the U.S., to reduce their size and capabilities.

Others may invest in short duration, passive/indexed strategies to reduce interest rate exposure. This also may not be an optimal solution as these strategies cannot avoid – or are greatly restricted in their ability to avoid – areas on the yield curve that may be most vulnerable to an increase in policy rates.

Active strategies not constrained by benchmark limitations may be optimal for investors as they can seek to limit interest rate exposure. For instance, if we believe there is little value at a point on the Treasury curve, we can reduce our exposure at precisely that point on the maturity spectrum, as we did in PIMCO's Short-Term Fund in 2014 (see Figure 2). Given the level of rates in comparison to anticipated volatility, we significantly reduced duration over the second half of the year to be defensive. Yet the fund still generated a competitive return of 0.97% (net of fees, Institutional Class Shares) over the year.

FIGURE 2: SHORT-TERM STRATEGY'S DURATION POSTURE GREW DEFENSIVE IN 2014



Source: PIMCO as of 31 December 2014

Since we are not forced to replicate exposures in a passive benchmark, our active short-duration strategies strive to identify value through tactical security selection. Supported by our internal fundamental credit research and structured credit

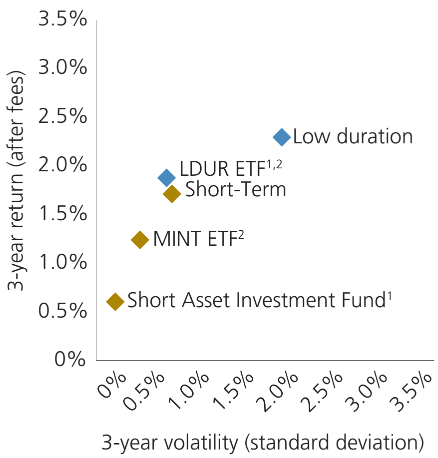
Name	1 YR	3 YR	5 YR	10 YR	Since inception[2]
PIMCO Short Asset Investment Fund at NAV	0.59%	–	–	–	1.12%
PIMCO Enhanced Short Maturity ETF (MINT) at NAV	0.53%	1.24%	1.17%	–	1.14%
PIMCO Enhanced Short Maturity ETF (MINT) at market price	0.55%	1.22%	1.16%	–	1.15%
PIMCO Short-Term Fund at NAV	0.97%	1.74%	1.50%	2.70%	4.60%
PIMCO Low Duration ETF (LDUR) at NAV	–	–	–	–	1.87%
PIMCO Low Duration ETF (LDUR) market price returns	–	–	–	–	1.82%
PIMCO Low Duration Fund at NAV	0.78%	2.31%	2.72%	3.82%	5.97%

Source: PIMCO as of 31 December 2014 for the institutional class shares
Inception dates are 31 May 2012, 16 November 2009, 7 October 1987, 22 January 2014 and 11 May 1987, respectively. Total expense ratios are 0.35%, 0.35%, 0.46%, 0.55% and 0.46%, respectively.

Performance quoted represents past performance. Past performance is not a guarantee or a reliable indicator of future results. Investment return and the principal value of an investment will fluctuate. Shares may be worth more or less than original cost when redeemed. Current performance may be lower or higher than performance shown. For performance current to the most recent month-end, for the mutual fund is available at www.PIMCO.com/investments or call 888.87.PIMCO. Performance data current to the most recent month-end for the ETF is available at www.pimcoetfs.com or by calling 888.400.4ETF.

analysts, PIMCO's portfolio managers are able to buy assets that we believe represent compelling opportunities for optimal risk-adjusted total return. In addition, forward curves are priced on investor expectations of rates and may overshoot their terminal destination. To the extent we think the market is underappreciating the significance of economic data, we are able to recalibrate our positioning to take advantage of cheaper parts of the interest rate curve, in our effort to generate positive excess returns.

FIGURE 3: FAVOR SECURITIES WITH HIGH RETURN TO VOLATILITY PROFILES



The other key consideration for investors will be sectors that offer a) improved return/volatility profiles (see Figure 3) and b) additional yield/carry as we look for opportunities to diversify away from the recalibration toward higher U.S. rates. This will likely mean emphasizing areas such as corporate credit, which offers a spread above Treasury yields and diversification potential. By overweighting front-end credit exposures, portfolios are aligned with our view that the U.S. economy will continue to improve over the near term, further supporting credit fundamentals.

We will also look to areas outside of the U.S. As central bank policies around the world are likely to diverge further, there are many second-order effects on both sovereign and corporate exposure. By relying upon our deep team of analysts located across the globe, we strive to anticipate and position for varying central bank policies.

In summary, actively managed short-term and low-duration strategies may provide an attractive ballast to portfolios that may have exposure to risk assets. PIMCO offers a wide range of solutions that address investors' desire to limit volatility through an allocation to short-duration strategies. These solutions provide potential benefits as they rely and focus on:

	Short Asset Investment Fund[1] (Institutional)	MINT ETF[2]	Short-Term Fund (Institutional)	LDUR ETF[1,2]	Low Duration Fund (Institutional)
Return (annualized, net)	0.59%	1.24%	1.74%	1.87%	2.31%
Volatility	0.21%	0.46%	0.80%	0.76%	1.93%
Return/volatility	2.8	2.7	2.2	2.5	1.2

[1]*Return and volatility figures for PIMCO Short Asset Investment Fund are based on 1-year data as the Fund incepted 31 May 2012; return and volatility figures for PIMCO Low Duration ETF are based on S.I. data as the Fund incepted 29 January 2014.*
[2]*ETF (exchange-traded fund): performance is net asset value total return after fees.*

Performance is three years unless otherwise noted. The 3-year returns are based on monthly returns, or the since inception for SAIF and LDUR. Volatility is standard deviation of monthly returns over the same periods.

Source: PIMCO as of 31 December 2014 for the Institutional Class Shares and ETFs

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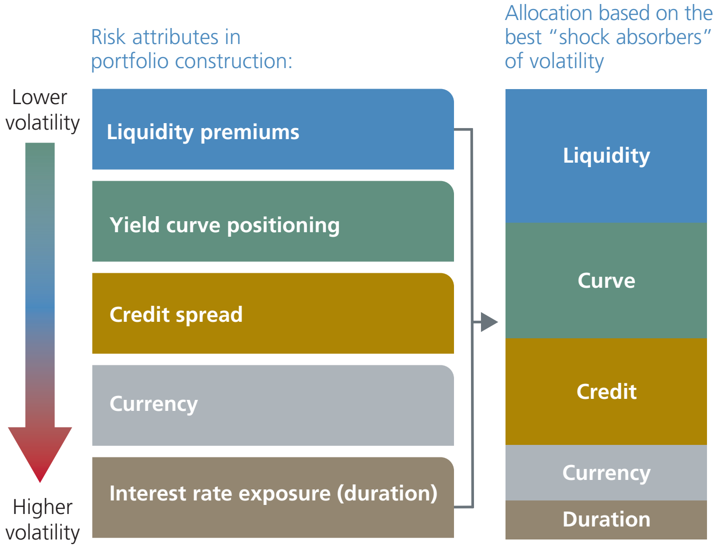
- Macroeconomic influences and their impact on global rate policy;
- Active management of interest rate duration, specifically emphasizing precise yield curve positioning;
- Deep global teams focused on fundamental credit research;
- Dynamic liquidity management, serving as both a defensive buffer and offensive dry powder;
- A stable platform with a dedicated group of specialized portfolio managers with time-tested track records;
- Understanding of the regulatory and market changes that will affect cash management and capital preservation strategies over the next decade.

FIGURE 4: DE-EMPHASIZE SOURCES OF ANTICIPATED VOLATILITY



Source: PIMCO
As of 31 December 2014

For nearly 30 years, PIMCO has provided our clients with a broad range of short-duration investment solutions. Our deep and stable short-duration portfolio management team combines our top-down macroeconomic views with optimal risk-adjusted bottom-up tactical strategies to provide clients with solutions focused on capital preservation, liquidity management and performance potential. As we approach inevitable changes in the investment landscape in 2015, we will continue to focus on protecting our clients' assets and helping them exit the merry-go-round safely.

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 investment professional or PIMCO representative or by visiting www.pimco.com/investments. Please read them carefully before you invest or send money.

Past performance is not a guarantee or a reliable indicator of future results. 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.

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. **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. **Equities** may decline in value due to both real and perceived general market, economic, and industry conditions. **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. **Management risk** is the risk that the investment techniques and risk analyses applied by PIMCO will not produce the desired results, and that certain policies or developments may affect the investment techniques available to PIMCO in connection with managing the strategy. **Diversification** does not ensure against loss.

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.

Different fund types (e.g. ETFs, open-ended investment companies) and fund share classes are subject to different fees and expenses (which may affect performance). They may also have different minimum investment requirements and be entitled to different services. The minimum initial investment for the Institutional class shares is $1 million; however, it may be modified for certain financial intermediaries who submit trades on behalf of eligible investors.

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.

The NAV of the Fund's shares is determined by dividing the total value of the Fund's portfolio investments and other assets, less any liabilities, by the total number of shares outstanding. Fund shares are valued as of the close of regular trading (normally 4:00 p.m., Eastern time) (the "NYSE Close") on each business day. The price used to calculate market returns ("Market Price") of the Fund generally is determined using the midpoint between the highest bid and the lowest offer on the national securities exchange on which shares of the Fund will be primarily listed for trading, as of the time that the Fund's NAV is calculated. The Fund's Market Price may be at, above or below its NAV. The NAV of the Fund will fluctuate with changes in the market value of its portfolio holdings. The Market Price of the Fund will fluctuate in accordance with changes in its NAV, as well as market supply and demand.

Premiums (when market price is above NAV) or discounts (when market price is below NAV) reflect 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 discount or premium could be significant. Data in chart format displaying the frequency distribution of discounts and premiums of the Market Price against the NAV can be found for each Fund at www.pimcoetfs.com.

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 Fund'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 Fund's shares trading at a premium or discount to NAV.

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