PIMCO Total Return
September 30, 2014

BACKGROUND
On Friday morning, September 26th, we were awakened to the shocking news that Bill Gross, CIO and co-founder of PIMCO, was leaving the firm to join Janus. This departure comes on the heels of former CEO Mohamed El-Erian leaving abruptly earlier this year. Also circling is an SEC investigation of the PIMCO Total Return ETF. It certainly has been an eventful year in Newport Beach!

While fund manager changes are routine, rarely do they involve funds which are this large and successful. PIMCO Total Return is the biggest bond fund in the world. Also, few fund managers are as well known as Bill Gross, who was nicknamed the “bond king”, and who was named Morningstar Fixed Income Fund Manager of the Decade during the 2000s.

But, although Bill Gross may have performed well, by many accounts he was a difficult person to work for. This seems to have been a part of the El-Erian departure, and most likely led to his ultimate divorce from the firm. According to the Wall Street Journal, the week leading up to his departure was filled with numerous visits to the CEO by other PIMCO executives, all demanding Gross’ removal. By Friday, he was gone.

OUR RESPONSE
In response to the news, our investment committee held an emergency meeting Monday morning, immediately following a call with PIMCO concerning the future management structure of the Total Return Fund.

Based on this call, as well as our prior experience working with the firm, we are confident that PIMCO has the talent to step in and manage the Total Return Fund following Gross’ departure. Where Gross used to be listed as the sole portfolio manager, they have now highlighted three co-managers to manage the fund going forward:

- Scott Mather, who specializes in Global bonds and was named Morningstar Fixed Income Manager of the Year for 2011
- Mark Kiesel, who specializes in credit analysis and was named Morningstar Fixed Income Manager of the Year for 2012
- Mihir Worah, who is also the firm CIO of Real Return and Asset Allocation

We like the new co-manager approach, and believe that the new team has the necessary expertise to successfully manage the fund going forward. Furthermore, per discussions with PIMCO, Bill Gross is under a non-solicitation agreement making it harder for people to follow him to Janus, although admittedly that agreement is fairly weak under California law. They have also subsequently put in place a key employee retention plan for management and key personnel on the trading floor. This, in addition to the discord leading up to Gross’ departure, leads us to believe that PIMCO will likely be able to retain most of their key employees.

We are also not overly concerned about the SEC investigation of the PIMCO Total Return ETF. Unlike the equity market, the bond market is relatively illiquid. Often times there may be no trades of a specific holding on any given day. This is especially true of a large operation such as PIMCO, who are often essentially the entire market for a specific issue. Due to this illiquidity, pricing can be difficult. While the
investigation may uncover unintentional mispricing, we do not believe that it will significantly impact the company.

**THE RISKS**
While we don’t think the SEC investigation will amount to much, it does highlight the biggest risk facing PIMCO Total Return in the near term: Liquidity.

As previously mentioned, bonds are relatively illiquid as compared to equities. Furthermore, PIMCO compounds this problem by using more derivatives and futures than most other bond funds.

Reports have already surfaced concerning opposing traders selling off known PIMCO positions, under the assumption that fund redemptions will force them to sell off holdings at undesirable prices. According to the fund company, they have roughly $70 billion in immediate liquidity via holdings in cash, treasuries, and easily marketable agencies, but given that the Total Return fund lost $10 billion in assets on the Friday of the announcement, it is certainly possible that even that amount will be stretched in the coming weeks.

So far, the largest players are saying very little publicly about what they are going to do. Morningstar estimates that the fund will lose fifteen to thirty percent of its assets following the change. On the other hand, CALPERS, the California Public Employee Retirement plan, has recently announced that they are staying with the fund, although they are putting it under formal review. Significant redemptions could impact performance of the fund in the near future.

**RECOMMENDATION**
Given the manager change, we have decided to put the PIMCO Total Return Fund on watch effective immediately. As a fund on the watch list, it is not available for new clients, but existing clients can continue to hold the fund with our full fiduciary support. Our normal process is to allow a new manager at least one year to demonstrate performance. However, in this case, we will monitor the fund closely over the coming few weeks, specifically concerning redemptions. If it appears that redemptions are significantly impacting the performance of the fund, we could recommend removal of the fund without waiting for the full year to play out.