PIMCO

Your Global Investment Authority

PROTECTING YOUR PORTFOLIO WITH BONDS

Bond strategies for an evolving market

Market uncertainty has left many investors wondering how to protect their portfolios during periods of volatility. Here we explore how bonds can provide a portfolio cushion during periods of uncertainty, help to balance stock market volatility, generate income and enhance return potential.

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Anchoring your portfolio with bonds

Bonds have historically provided capital preservation, income and growth, and low-to-negative correlations to equities. They have also been less volatile than stocks, making an extreme market shock highly unlikely. As the chart below shows, bond declines have been significantly less severe and quicker to recover.

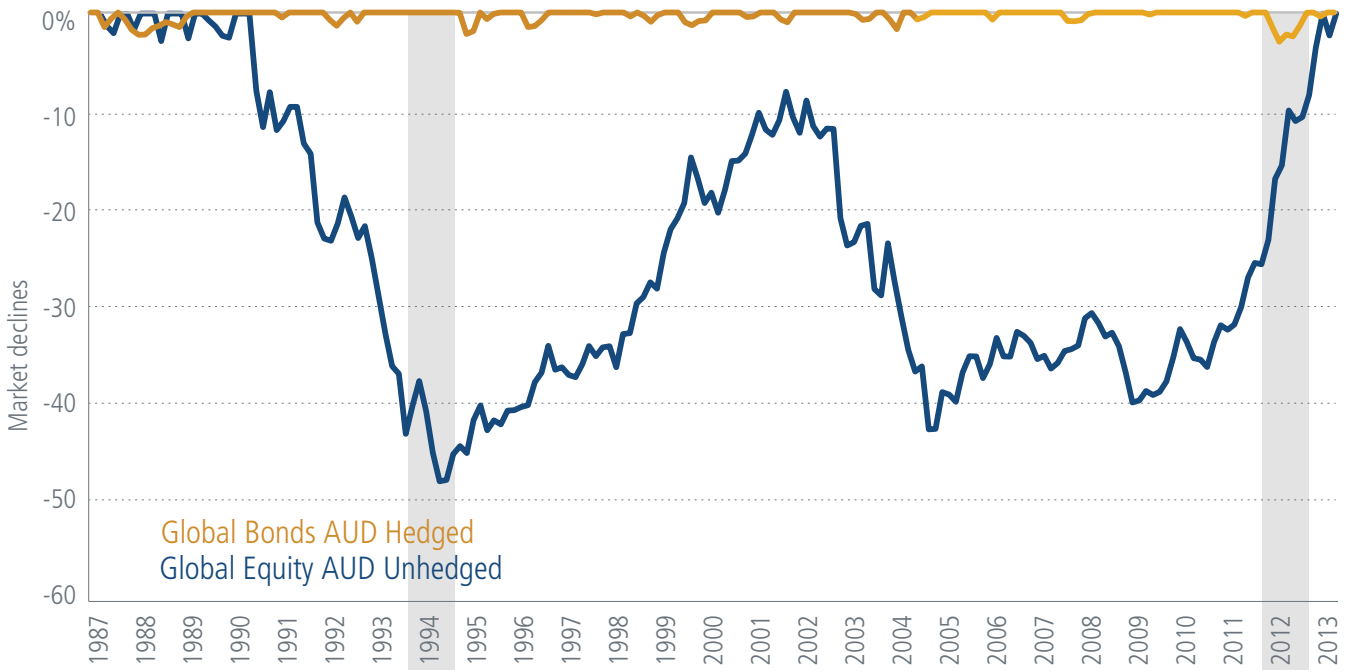
Capital preservation: Bond market dips have tended to be significantly milder than those for stocks. Protecting principal is a key objective for those with a lower risk tolerance or less time to recover from a sharp market shock.

Income: Consistent, compounding interest from bonds can help build a sustainable income stream to meet expenses; as rates gradually rise, so can income over time. Bonds also offer growth potential from price appreciation.

Steadier returns: Bond prices can fluctuate, of course, but because the bulk of their returns are derived from income, they tend to deliver a smoother ride than assets such as stocks.

Diversification: Bonds typically have a low or negative correlation to stocks, which can help smooth overall portfolio volatility. The bond market's breadth also provides unique opportunities to enhance returns. Diversification does not ensure against loss, however.

Maximum Drawdowns Experienced by Bonds vs Equities



Performance quoted represents past performance. **Past performance is not a guarantee or a reliable indicator of future results.** It is not possible to invest directly in an index. Worst years are calendar years.

Source: Bloomberg, PIMCO. Global Equities: MSCI World Net TR AUD unhedged, Global Bonds: Barclays Global Aggregate AUD Hedged

As of: February 28, 2014

An inflection point for bonds

Bond markets are evolving. After three decades of steadily declining interest rates, returns from duration, or interest rate risk, are likely to recede. This shift means that bond investors will need to think differently about how to pursue and reach their long-term financial goals.

Fortunately, today's "market of bonds" has much to offer long-term investors. Opportunities have become more diverse and global in nature, expanding the options and strategies available to increase return potential and cushion against declines.

An active bond fund manager can also add value in this environment by highlighting sources of return other than duration, and moving among them as market conditions change (see below).

What drives bond returns?

While interest rate risk, or duration, is a dominant driver of returns, there are a number of other risk/reward factors that contribute to a bond's expected return. These factors are known as "carry," and bond fund managers such as PIMCO will diversify and actively manage the level and composition of carry in their portfolios, in order to add return potential and minimize downside risk.

Below are the most common sources of bond carry:

Duration (interest rates):	A portfolio's sensitivity to changes in prevailing interest rates; rising rates are a drag on bond prices.
Credit quality:	The likelihood of a bond issuer making good on its debt obligation, and not defaulting.
Yield curve:	How the shape of the yield curve may affect relative prices across the maturity spectrum.
Volatility:	The way changes in expected interest rate volatility affect the prices of callable or prepayable bonds.
Currency:	Fluctuations in currency exchange rates and the effect on global bonds.

About PIMCO

PIMCO is a leading global investment management firm, with offices in 12 countries throughout the Americas, Europe and Asia. Founded in 1971, PIMCO offers a wide range of innovative strategies to help millions of investors worldwide meet their needs. Our goal is to provide attractive returns while maintaining a strong culture of risk management and long-term discipline.

A word about risk: Past performance is not a guarantee or a reliable indicator of future results. All investments contain risk and may lose value. 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. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. **Equities** may decline in value due to both real and perceived general market, economic and industry conditions. 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. **Currency rates** may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. **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 securitie**s 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. Income from **municipal bonds** may be subject to state and local taxes and at times the alternative minimum tax. Sovereign securities are generally backed by the issuing 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. **Inflation-linked bonds (ILBs)** issued by a government are fixed income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. **Treasury Inflation-Protected Securities (TIPS)** are ILBs issued by the U.S. government. **Commodities** contain heightened risk, including market, political, regulatory and natural conditions, and may not be suitable for all investors. 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. Diversification does not ensure against loss. It is not possible to invest directly in an unmanaged index.

The Barclays Global Aggregate Index provides a broad-based measure of the global investment-grade fixed income markets. The three major components of this index are the U.S. Aggregate, the Pan-European Aggregate, and the Asian-Pacific Aggregate Indices. The index also includes Eurodollar and Euro-Yen corporate bonds, Canadian Government securities, and USD investment grade 144A securities. The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of the following 24 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

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