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THE DRAMA AT PIMCO: 6 THINGS YOU NEED TO KNOW

by Andrew S. Zito, Executive Vice President and Robert W. Little, Jr., CFA, CPA, VP, Investment Strategy & Research

PIMCO is the world's largest bond firm. In fact, many experts maintain that PIMCO is the bond market, which is why the corporate drama playing out in the top levels of its management is concerning.

For many years, the public faces of PIMCO were that of Bill Gross, PIMCO's Co-Founder and Co-Chief Investment Officer, and Mohammed El-Erian, Chief Executive Officer and Co-Chief Investment Officer. Together, the two built PIMCO into the fixed income empire that it is today. Bill Gross once described El-Erian as the *"heir apparent"* for PIMCO.

So on January 21st, when Allianz (PIMCO's parent company) announced the surprise resignation of Mohammed El-Erian, the investing community was left with a lot of questions and curiosity. That type of abrupt departure will always lead to speculation, and with a firm as large as PIMCO, that means media attention. When the media gets involved, stories get sensationalized.

Given the important role that PIMCO funds play in our client portfolios, LAMCO is monitoring the situation closely. We have compiled the following summary of the situation, and will keep you updated on any new developments:

1. **PIMCO can be successful without El-Erian** – Mohammed El-Erian's departure from PIMCO does not, in itself, warrant a great deal of concern regarding the stability of the funds. The personality conflicts, to some degree, were inevitable. Bill Gross is known as the *"King of Bonds",* a title that is as large as his ego is reported to be. It's a fairly well-known fact that for all of his investing skill and intelligence, Gross can be difficult to get along with. Conversely, El-Erian is a big thinker, team oriented leader who has aspirations of writing a book and sitting on the Board of the Federal Reserve. He was widely credited with being the driving force to broaden PIMCO's investment platform to include equity and alternative strategies. This appears to be a classic case of two chefs in one kitchen… with two different recipes. Regardless, from a fund management perspective, Gross is widely accepted to be the stronger of the two, and there is little question that he can manage the funds successfully going forward.

2. **Succession Plan?** - El-Erian's departure does leave some lingering questions regarding succession planning. If he was the *"heir apparent",* who now? In response to the departure of El-Erian, PIMCO rolled out a new executive structure with six deputy Co-Chief Investment Officers. We view this structure as a positive. This structure should enable Gross to let go to let others take control of other asset classes or segments of the investable universe. The irony is that it is widely speculated that El-Erian was actually the architect of the structure that was rolled out in response to his departure.

3. **Poor Public Relations** – In the past few weeks, Gross and El-Erian have allowed this public feud to spill over into the media. Last week Gross made some off color comments to a news outlet, accusing El-Erian of trying to undermine him by secretly assisting the Wall Street Journal in writing an "*overblown*" expose article about the fallout at PIMCO.

PIMCO promptly back pedaled on Gross's comments, and the whole thing actually backfired on Gross, drawing more attention to the WSJ article and the rift between him and El-Erian. The result of this increased media exposure is the perception of a larger problem at PIMCO than we actually believe exists. Both men, as well as Allianz, should be more mindful that their public actions can have a direct result on their investors.

4. **This is a distraction that they can't afford** – The larger concern with PIMCO has little to do with the very public breakup of the legendary fixed income duo. The larger concern is a recent period of underperformance experienced by some of PIMCO's larger funds. PIMCO's flagship fund, PIMCO Total Return, has struggled as of late and this public feuding is not helping to sure up investor confidence. Bill Gross would be better served by focusing on his portfolio than his personal rift with El-Erian. The PIMCO Total Return fund is the largest mutual fund in the world, and the perception that the El-Erian situation is taking Bill Gross's eye off the ball could weaken investor confidence.

5. **Outflows could be a problem, but could be a benefit** – PIMCO Total Return saw cash outflows of $41 billion in 2013. Another $1.6 billion in outflows occurred in February when other bond funds in general had approximately $3 billion in net inflows. This indicates a growing lack of confidence in the fund, but is not catastrophic. If cash outflows continue to increase, however, it could put pressure on the fund. Conversely, many believe that the PIMCO Total Return fund had gotten too large to manage efficiently, so a draw down in the fund's assets could be helpful, but only if Gross and his team get the fund back on track.

6. **LAMCO is monitoring the situation** – Taken separately, the departure of El-Erian and the resulting media feud are not immediate grounds for redemption. That said, they cannot be ignored either. LAMCO's research department is actively monitoring all PIMCO funds. We have been in contact with several members of the PIMCO team, and are actively engaging them in conversations regarding any changes to the firm or the funds.

The bottom line is that the El-Erian departure and resulting media coverage is probably 90% noise and 10% substance. The substance portion of the story needs to be viewed in the context of the funds' performance struggles, but can't be overreacted to. There is no denying the trailing one-year return is below average, but the fund's return for the three-, five-, and ten-year periods beat the benchmark Barclays Aggregate Index and rank in the top 40th percentile in the Morningstar Intermediate-term bond category, as of March 11, 2014. In fact, the strategy has outperformed the index by 2.42 and 1.52 percentage points for the three- and five-year periods, respectively.

What PIMCO needs to do is reign-in Bill Gross. Instead of airing his resentment publicly, Mr. Gross should focus his efforts on the investment management. Actions speak louder than words and delivering top tier performance will speak volumes.

Aside from the negatives from the media circus and the asset outflows, we believe PIMCO version 2.0 has the potential to be stronger. El-Erian will be missed by many at PIMCO, however, they have a deep bench of investment professionals, and most importantly, the fundamental investment process has not changed with El-Erian's departure. We will continue to closely monitor PIMCO and the various strategies our clients are invested in.▪

For more information contact:
Lauren Bloom, Director of Business Development
lbloom@lamcogroup.com or call 407.585.1171

LAMCO Advisory Services, Inc.
1525 International Pkwy, Ste. 2071 ▪ Lake Mary, FL 32746
www.lamcoadvisory.com