

October 27, 2014

PIMCO UPDATE

BACKGROUND

Following the departure of Mohamed El-Erian earlier this year, Galliard had been actively monitoring PIMCO and the new Deputy CIO structure put in place under then-CIO Bill Gross. As part of our monitoring and evaluation, Galliard's External Manager Team met with key PIMCO individuals in Newport Beach in the second quarter, including Mihir Worah, Saumil Parikh and Sudi Mariappa. Galliard's opinion of the changes earlier this year was that they served as a distraction within the organization, but that the Deputy CIO model provided a potential succession plan for the eventual departure of Mr. Gross. Galliard's External Manager Team continued to closely monitor PIMCO throughout the summer with an eye on both portfolio positioning and the evolution of the Deputy CIO model.

Following the abrupt departure of Mr. Gross in late August, Galliard formally placed PIMCO on our watch list, downgraded our manager rating of PIMCO from Superior to Good and restricted any further asset placements. Since making our initial assessment, we have been focused on continuing our evaluation in order to form a complete, well-considered opinion consistent with Galliard's conservative, measured approach to investing. We believe it is important to carefully consider what additional actions, if any, are appropriate in light of Mr. Gross's departure. In evaluating any manager, Galliard considers a number of factors, including people, process, performance, organizational stability, support and compliance functions and how the broader firm is managed.

Specific to the PIMCO situation, we identified the following factors as key to our evaluation:

- Potential disruption to PIMCO's investment process
- Assessment of how key a role Mr. Gross played in strategy formulation
- Assessment of new CIO and Investment Committee members and team dynamics
- Increased workload for PMs managing our portfolios
- Potential for additional departures
- Financial impact of declining AUM on ability to attract/retain talent and invest in the business
- Protracted focus on servicing to retain clients vs. investing

While the portfolios PIMCO manages on behalf of Galliard clients have underperformed since mid-2013, this is not the primary driver of our decision making process.

- Galliard continues evaluation of PIMCO
- Meets with Daniel Ivascyn, Mihir Worah and other senior PIMCO personnel
- Reaffirms hold/watch list recommendation

NOTES FROM RECENT MEETINGS WITH PIMCO

Galliard continues to maintain close communication with PIMCO, including hosting a visit with representatives from PIMCO's New York office and meeting with senior PIMCO investment professionals in PIMCO's Newport Beach headquarters. In Newport Beach, we met with Daniel Ivascyn (Group CIO), Mihir Worah (CIO and member of the Investment Committee), Sudi Mariappa (Senior Portfolio Manager) and Jay Jacobs (PIMCO President). During these meetings, we gained confidence that PIMCO is continuing to focus on investment performance and is continuing their disciplined top-down investment process. Daniel Ivascyn presents as a thoughtful investor with significant experience in leadership roles at PIMCO and a nearly innate feel for PIMCO's investment process. We came away feeling that Mr. Ivascyn is a natural leader and possesses the ability to strike the necessary balance between effective collaboration and individual accountability which we believe is key to PIMCO's process.

In his role as Group CIO, Mr. Ivascyn does play the role of official tie-breaker for Investment Committee decisions, but he readily offers that he intends to weigh the opinions and views of others who are more knowledgeable in specific areas. Mr. Ivascyn spoke at length about the evolution and refinement of the firm's investment process over time and the central role the process itself plays in creating steady, predictable outcomes. Despite Mr. Ivascyn's background in managing structured credit and income-oriented products, he communicated a strong commitment to "macro" strategies and "structural" trades which have been a focus for PIMCO over the last 20 years or more. Mr. Worah, who we met during a visit earlier this year, spoke about the support and respect he and the other CIOs have for Mr. Ivascyn and his selection as the Group CIO.

PIMCO President Jay Jacobs discussed PIMCO's planning and management process for the transition following Mr. Gross's departure. He acknowledged that a continued decline in assets would reduce profitability, but noted that the impact of outflows in Core Fixed Income were not as significant to the overall firm due to continued product diversification and the growth of other strategies. Mr. Jacobs indicated that approximately 50% of PIMCO's costs are variable, as opposed to fixed, including all back-office processing which has been outsourced to State Street for some time. This fact, plus PIMCO's significant margin cushion, will help to temper the impact of the decline in AUM on profitability. Mr. Jacobs indicated that PIMCO expects to announce significant staff retention programs and is actively hiring new talent to assist during the transition. He further communicated that Allianz (PIMCO's parent) has been tremendously supportive, and PIMCO fully expect Allianz to maintain a hands-off role.

GALLIARD'S OPINION

Through meetings and discussions with PIMCO, Galliard's External Manager Team has gained comfort that PIMCO's core investment process—including the top-down macro focus that is an important component of the diversification PIMCO brings to the overall Stable Value portfolios—remains largely intact. Ideally, the Deputy CIO model would have had additional time to develop, but all-in-all the transition appears to be proceeding relatively smoothly. Mr. Ivascyn has a history of serving in key executive roles at PIMCO, including on the PM Management Committee, the Compensation Committee and others.

While Mr. Gross is widely recognized as a great fixed income investor, he has also developed and grown an organization comprised of a number of talented and thoughtful investors. From a macro perspective, some of the key Investment Committee members (or rotating members) include Mohsen Fahmi, Sudi Mariappa, Tony Crescenzi, and Scott Mather. Additionally, Rich Clarida led the Secular Forum earlier this year and Saumil Parikh continues to lead the Cyclical Forum, a role he has held since 2010.

We believe that during the last decade at PIMCO, Mr. Gross most likely played a role of orchestra conductor for a talented group of musicians, rather than a composer of original work. Reading between the lines – and reading the press – it seems to us that Mr. Gross had grown increasingly frustrated with the evolution of his role within the team structure following Mr. El-Erian's departure, and, at least partly as a result of those changes, he had become increasingly difficult to work with. We sense a great deal of positive energy and optimism surrounding Mr. Ivascyn's appointment to lead the firm. PIMCO's senior managers are clearly energized to take heightened roles and greater individual accountability for PIMCO's next phase. As such, we are comfortable with Mr. Ivascyn in this role; although, we clearly will be watching events closely.

Jay Jacobs provided comfort that PIMCO understands the risks of losing additional personnel and is actively focusing on retention. He also indicated an understanding within the organization, and acknowledgement from their parent, Allianz, that PIMCO should likely experience a temporary decline in profit margin in order to continue to invest in their people and the broader organization during the transition due to the decline in assets.

Galliard is continuing our evaluation process of the recent changes and PIMCO's ability to deliver results. We will be hosting a PIMCO visit in mid November as part of the ongoing dialogue. Absent further notable turnover or other material event, Galliard's External Manager Team continues to remain comfortable with PIMCO. As noted earlier, PIMCO is on our watch list and new placements are restricted at this time.

GALLIARD'S EXPOSURE TO PIMCO

As we have noted, neither Mr. Gross nor Mr. El-Erian were directly managing any of Galliard's client assets. The named portfolio managers at PIMCO for Galliard client portfolios have not changed following Mr. Gross's departure. In managing portfolios for Galliard's Stable Value clients, PIMCO manages assets either in client Separate Accounts or Collective/Commingled Funds exclusively for Galliard clients. We believe this offers substantial insulation against the impact of any immediate outflows experienced by PIMCO. Additionally, the investment guidelines under which PIMCO manages for Galliard client portfolios are tighter than in many of the other portfolios they manage which provides additional protection. These restrictions include portfolio duration bands, liquidity minimums, sector maximums, quality restrictions (including a minimum rating of AAA on structured securities), limits on derivative exposure and the types of derivatives that may be employed, and a prohibition against any leverage.

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