



Presentation to the PortfolioConstruction Conference 2008

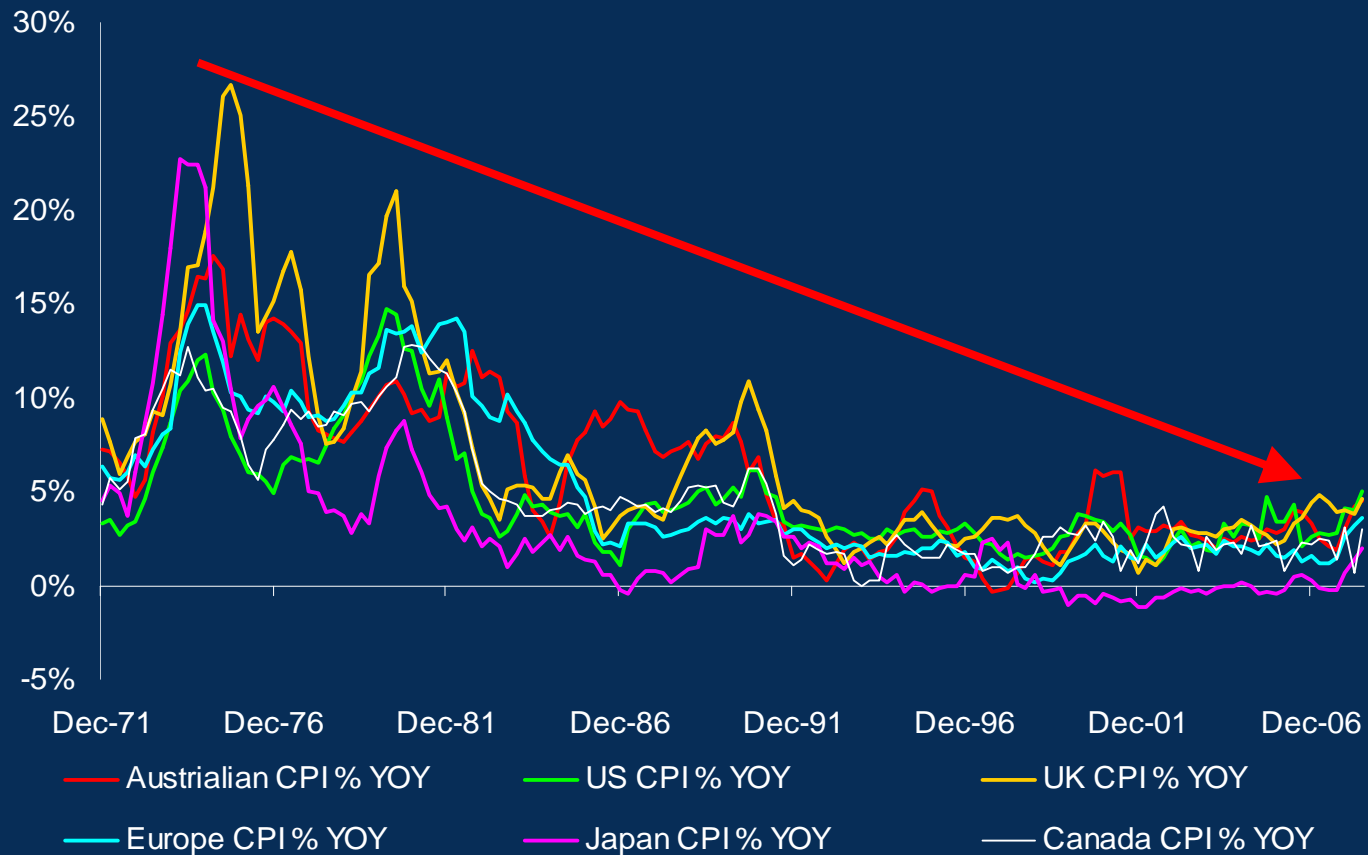
Defensive Asset Allocation in an Inflationary Environment

Doug Hodge

Managing Director, Head of PIMCO Asia Pacific

This presentation contains the current opinions of the manager and such opinions are subject to change without notice. This presentation has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this presentation may be reproduced in any form, or referred to in any other publication, without express written permission of Pacific Investment Management Company LLC. ©2006, PIMCO.

Since the 1970's, inflation has been in persistent decline



Central bank success in its inflation targeting or were there other factors involved?

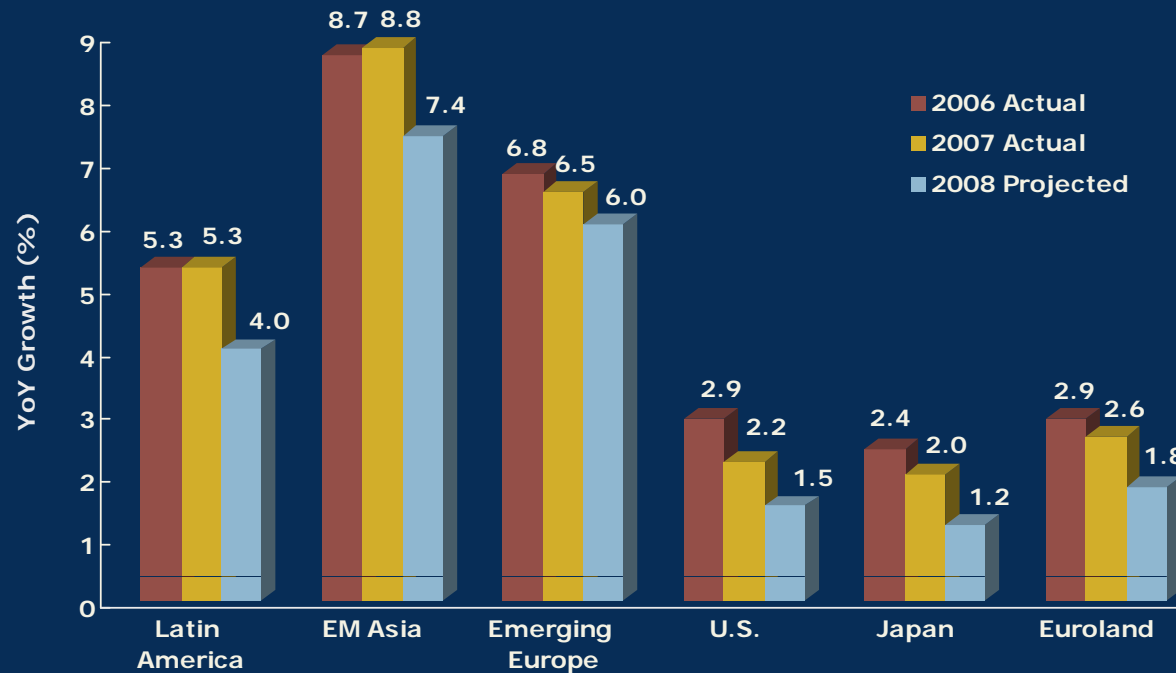
The Fall of the Iron Curtain



Agrarian Reform by the Communist Party of China

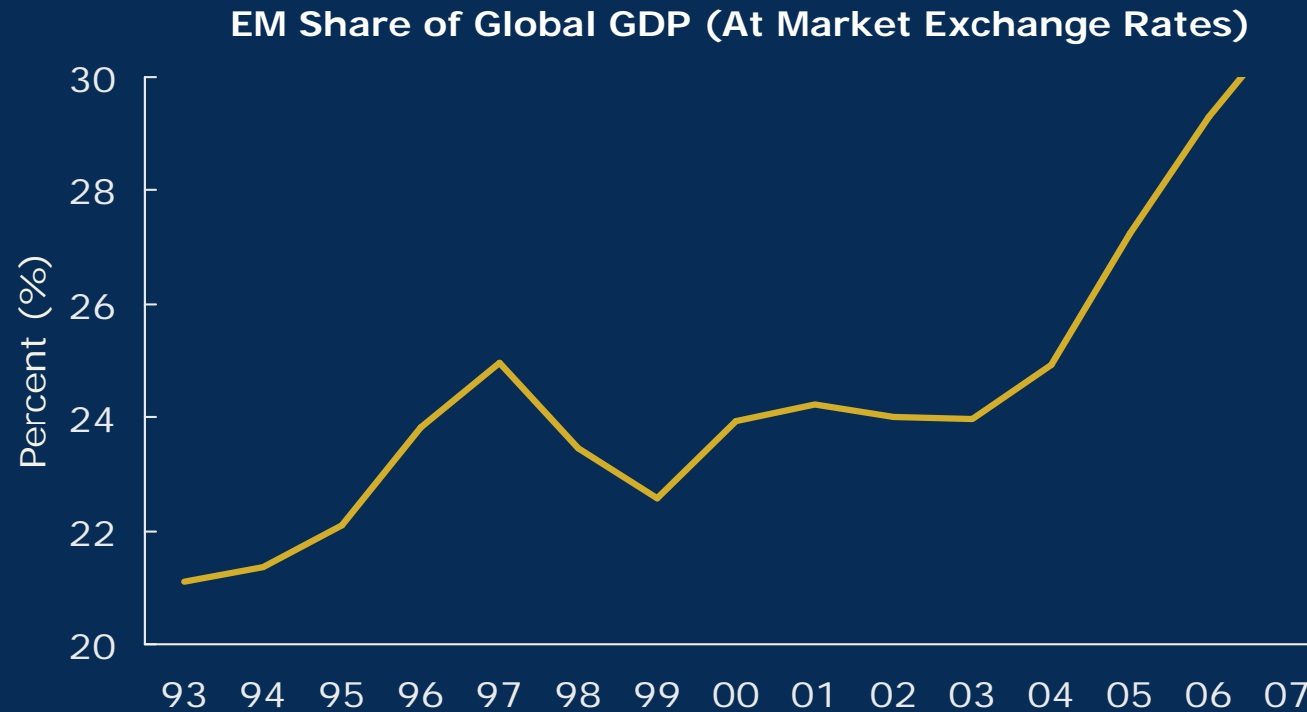


GDP Growth Rates are on the Decline



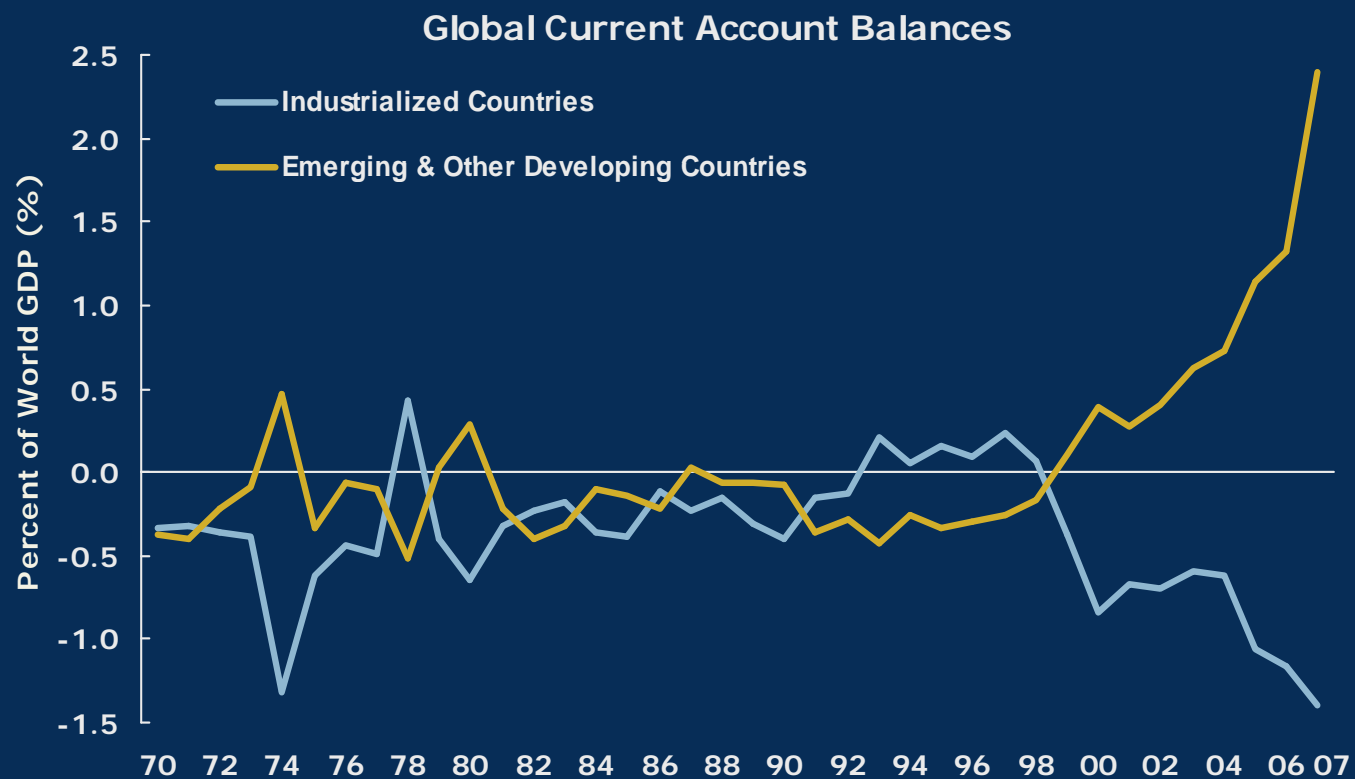
- The PIMCO view: Global growth will remain robust despite a cyclical downturn in the U.S and other developed economies

But Emerging Markets Have Picked up the Slack



- Growth will be driven to a greater extent by emerging markets that are in the midst of a breakout development phase

Leading to a Divergence in Current Account Balances



Source: PIMCO, IMF

P I M C O

Heeeeeeere's INFLATION!



- The inflationary pressures we are witnessing in emerging markets are spilling over into developed economies.
- Inflation pressures will spring from several sources;
 - Commodity Price Pressures
 - Rising wages in emerging economies
 - Increased social spending in developed economies
 - Depreciating developed currencies vs emerging currencies
 - Loose US monetary policy that may be inflationary globally

Why Should We Be Worried About Inflation?

- Inflation has the effect of reducing the purchasing power of money, which is at odds with the long term goal of most investors
- Over time, it can chip away at real savings and investment returns.
- Inflation affects all aspects of the economy, from consumer spending, business investment and employment rates, to government programs, tax policies and interest rates

How can I Protect my Portfolio From Inflation?

- Rather than think about an investment portfolio as a range of asset classes, investors should think about their portfolios as a set of inflation hedges.
- Inflation hedges can be divided into three main buckets;
 - Leading inflation hedges
 - Contemporaneous inflation hedges
 - Lagging inflation hedges

Effective Hedging requires a recognition of where we are in the inflation cycle, followed by an appropriate allocation to the corresponding hedge



Leading Inflation Hedges

- Tend to perform in advance of inflation becoming visible in the broader economy
- Leading inflation hedges include commodities and equities
- Over longer periods, equities have shown a negative correlation to inflation and can be especially hurt by unexpected inflation

US Equities & Inflation	-0.25	Australian Equities & Inflation	-0.11
------------------------------------	--------------	--	--------------

- Unlike equities, commodities show a positive correlation with inflation

Commodities (USD) & Inflation	0.33	Commodities (AUD) & Inflation	0.45
--	-------------	--	-------------

Australian Equities represented by the ASX 200, US Equities represented by S&P 500. Figures are based on 1 year returns compared to 1 year CPI figures for Australia and the US from 1992-2007. Commodities are represented by the DJAIG commodity index denominated in AUD and USD. Figures are based on rolling 1 year returns measured quarterly from 1992-2008.

P I M C O

Commodities Diversify Equity Risk and Hedge Inflationary Drivers

Inflation Hedging

- Positively correlated to inflation
- Positively correlated to changes in rate of inflation

Diversification

- Negatively correlated to equities
- Negatively correlated to bonds

Return Potential

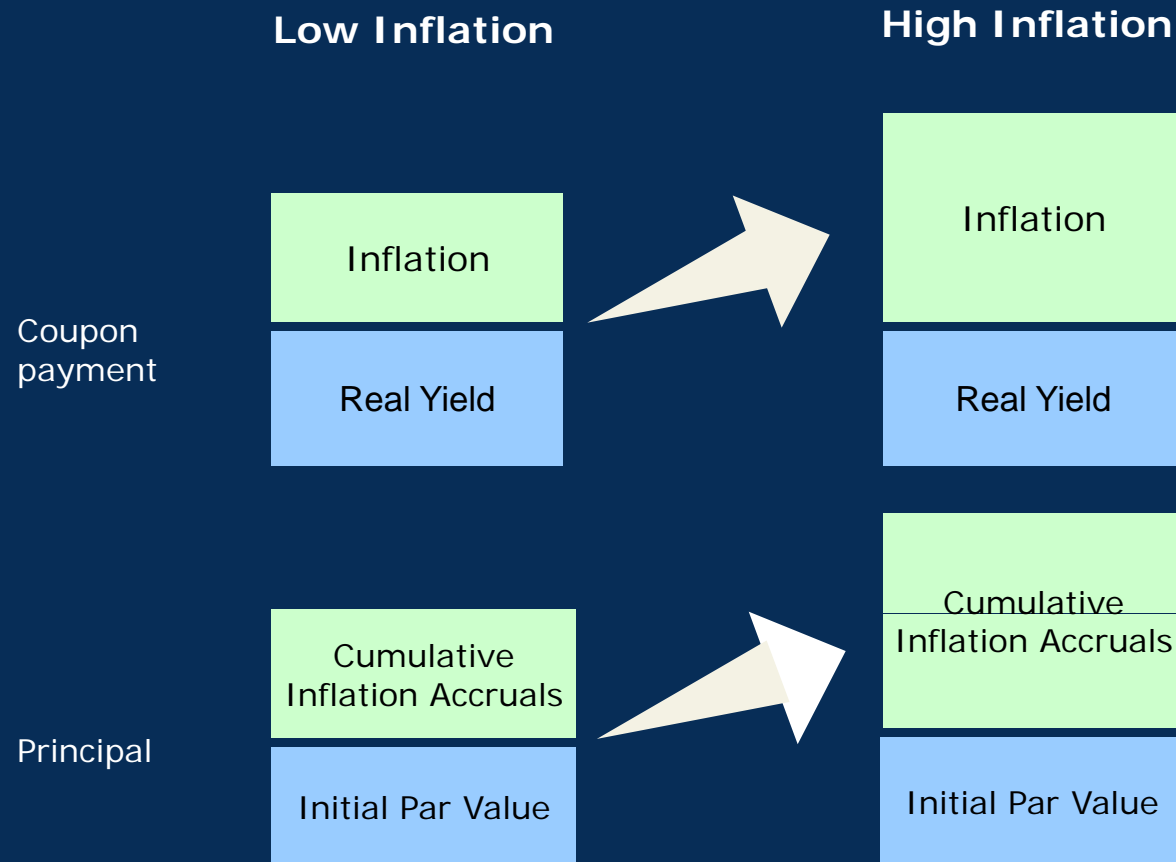
- Magnitude of returns comparable to equities (1970-2007)
- Volatility comparable to equities

Once inflation becomes visible, it is time to move assets away from leading hedges, such as equities, into contemporaneous inflation hedges

Contemporaneous Inflation Hedges

- Contemporaneous hedges tend to perform in-line with inflation
- Examples of contemporaneous hedges include inflation Linked Bonds (ILBs) or CPI Swap contracts
- Both strategies provide explicit inflation protection and preserve real purchasing power. The difficulty with both strategies is a lack of supply of suitable instruments and securities in Australia
- However a high level of correlation between Australian and Global inflation means that investment in a portfolio of global ILBs offers a practical solution to hedging domestic inflation

ILBs Diversify the “Disinflationary Bias” of Traditional Fixed Income



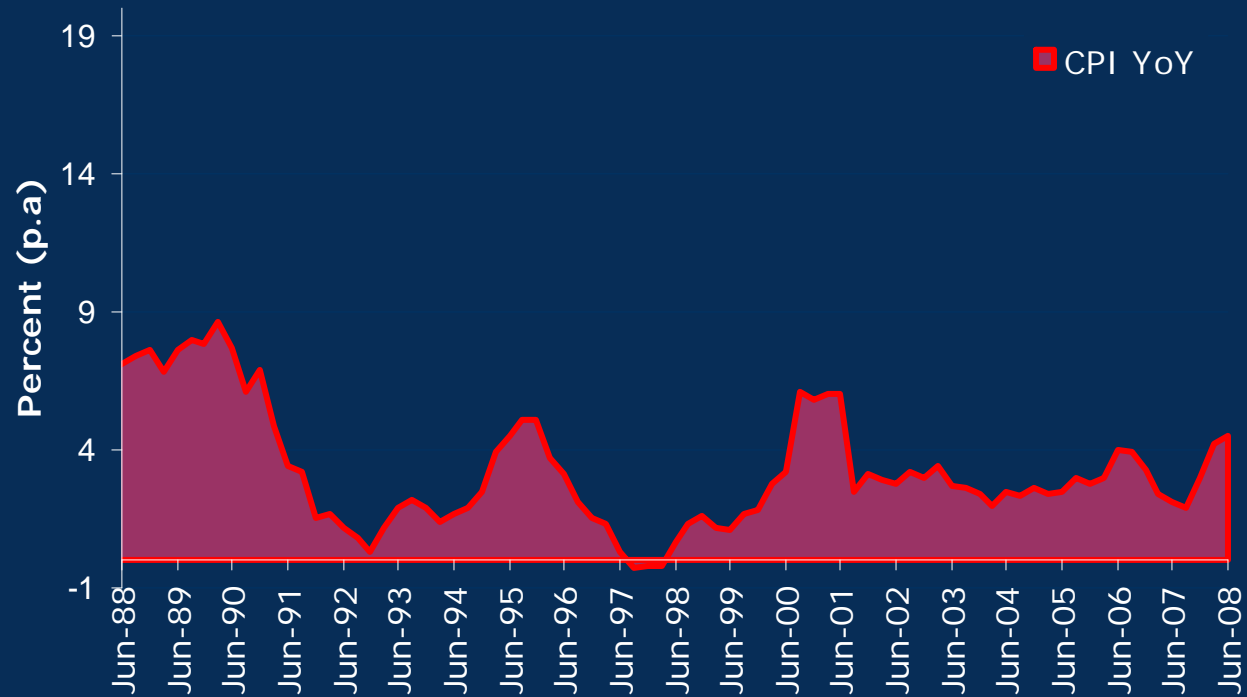
Once the presence of inflation is well established, investors should look to take advantage of government policy response

Lagging Inflation Hedges

- Lagging hedges are centered in those assets that offer returns following bouts of inflation
- In countries where the central bank uses monetary policy to combat inflation, cash or bank bills can offer the most basic form of inflation hedge
- Other securities include Floating Rate Notes (FRNs)- where an interest margin is paid over the cash or bank bill rate- also offer a good, lagged, inflation hedge
- In Australia this strategy is particularly effective considering that aside from one brief period, the RBA have managed to maintain a *real* cash rate

Australia's Inflation Experience...

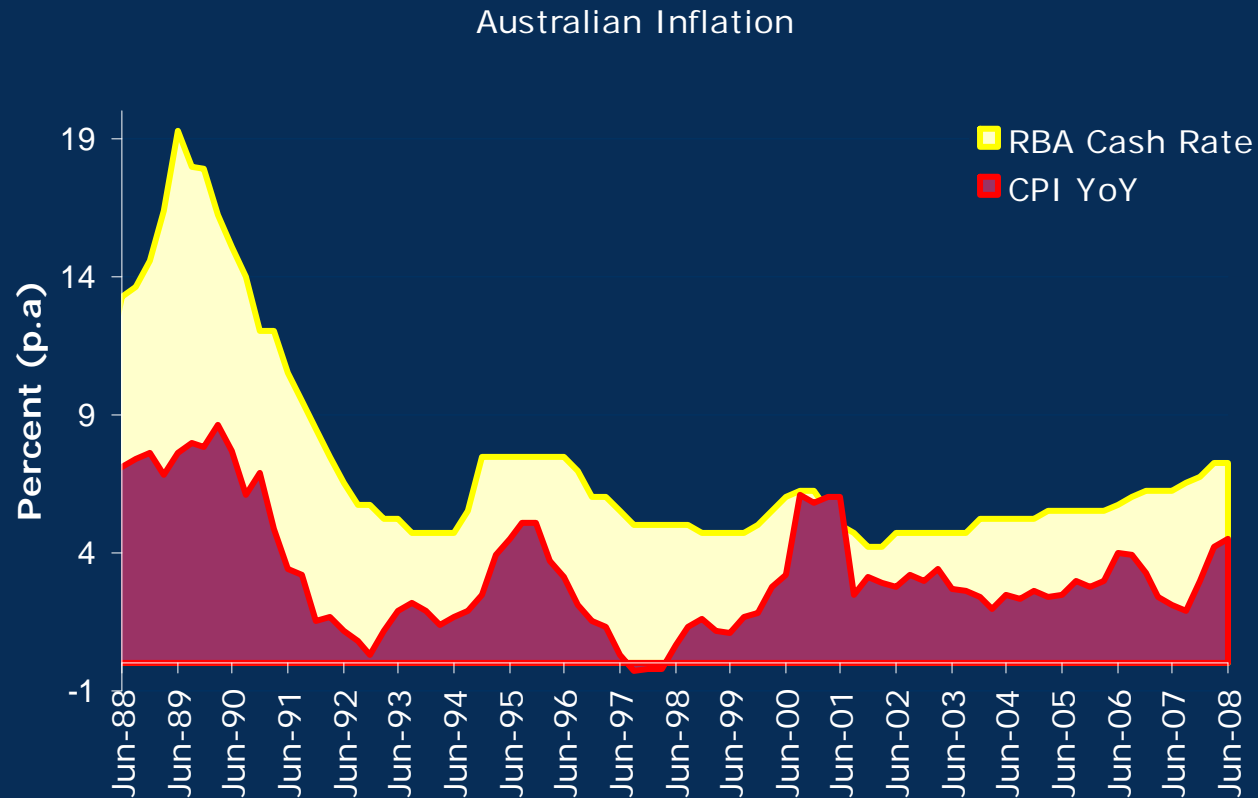
Australian Inflation



Source: PIMCO, Bloomberg

P I M C O

...and the RBA response



- Add a margin for active management and cash plus strategies become compelling ways to achieve high real rates of return as well as a hedge against inflation in the current environment of elevated rates.

Conclusion

REAL GROWTH	High/Rising	<u>Best</u> : Equities <u>Mixed</u> : Commodities & Nominal Bonds <u>Worst</u> : ILBs	<u>Best</u> : Commodities <u>Mixed</u> : Equities & ILBs <u>Worst</u> : Nominal Bonds
	Low/Falling	<u>Best</u> : Nominal Bonds <u>Mixed</u> : Equities & ILBs <u>Worst</u> : Commodities	<u>Best</u> : ILBs & Cash Plus <u>Mixed</u> : Commodities & Nominal Bonds <u>Worst</u> : Equities
		Low/Falling	High/Rising
		INFLATION	

Questions

PIMCO Commodity Real Return Fund

- The **PIMCO Commodity Real Return Fund** is designed for investors seeking commodity exposure complemented by a core fixed interest allocation
- The fund uses derivatives linked to commodity indices to gain exposure to the asset class
- The collateral backing the commodity index positions is invested in a wide range of fixed interest strategies

PIMCO Global Real Return Fund

- The **PIMCO Global Real Return Fund** is designed for investors who recognise that their liabilities are often in real terms and wish to protect against a rise in inflation
- The fund utilises PIMCO's core global fixed interest strategy of seeking active investment returns whilst moderating risk
- The fund is benchmarked against the Lehman Brothers Global Inflation Linked Bond index and hedged into AUD

PIMCO Diversified Fixed Interest Fund

- The **PIMCO Diversified Fixed Interest Fund** is designed for investors who wish to have a broadly diversified exposure to both domestic and international fixed interest markets
- The fund invests in a mix of government and semi government bonds, mortgages, corporate and emerging market debt
- The Australian component of the fund is positioned to take advantage of the high cash rates currently on offer

Want More Information on Defensive Assets?

Sign up today

www.rethinkyourdefence.com.au



PIMCO Contact

Matthew Mclenaghan

matthew.mclenaghan@au.pimco.com

Address:

Level 19, 363 George Street

Sydney, NSW 2000

Tel: 02-9279-1771

Fax: 02-9279-2580

Disclaimer

The services and products provided by PIMCO Australia Pty Ltd are only available in Australia to persons who come within the category of wholesale clients as defined in the Corporations Act 2001. They are not available to persons who are retail clients, who should not rely on this communication. Investors should obtain relevant and specific professional advice before making any investment decision. The information contained herein does not take into account the investment objectives, financial situation or needs of any particular investor. Before making an investment decision investors should consider, with or without the assistance of a securities advisor, whether the information contained herein is appropriate in light of their particular investment needs, objectives and financial circumstances.

Investment management products and services offered by PIMCO Australia Pty Ltd are offered only to persons within its respective jurisdiction, and are not available to persons where provision of such products or services is unauthorised.

Past performance is no guarantee of future results. This article contains the current opinions of the author but not necessarily those of the PIMCO Group and does not represent a recommendation of any particular security strategy, or investment product. The author's opinions are subject to change without notice. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. This article is distributed for educational purposes and should not be considered as investment advice or an offer of any security for sale.

No part of this publication may be reproduced in any form, or referred to in any other publication, without express written permission.

Copyright 2008, PIMCO

P I M C O