

# Is the PIMCO Dynasty Over?

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Sports fans are drawn to dynasties, either to emphatically “jump on the bandwagon” or oppose them as a member of the group that “loves to hate ’em.” If you have any interest in sports, you may have found yourself choosing sides with these teams in years past: the New York Yankees in the late 1990’s, the San Francisco 49’ers in the 1980’s, and the Green Bay Packers in the 1960’s. All hold special places in the pages of sports history. The faithful emerged as well as antagonists who just couldn’t stand the hoopla because, well, they wanted to see someone else win. Under Joe Torre, the Yankees won four World Series Championships between 1996 and 2000 and finished 1<sup>st</sup> in their division 9-straight years while Torre was manager until 2007. Bill Walsh led the 49ers to three Super Bowl Championships between 1981 and 1988, and Vince Lombardi raised five football championship trophies for the Packers between 1961 to 1967. In time, the turnover of coaches or players altered the chemistry of these winning franchises. The dynasties ended leaving the bandwagon crowd to reminisce about the “the good ole days” of their team’s imperial success while a sigh of relief is heard from the opposition.

Investment management organizations have similar attributes to sports teams. Both demand exceptional coordination of human resources to be successful and bring out the most competitive of personalities. Investment management firms that succeed often see economies of scale kick-in, leading a firm to accumulate substantial amounts of business and grow profit margins at an accelerating rate due to large operating leverage. PIMCO, Pacific Investment Management Company, did just that. PIMCO’s founder, the “Bond King” Bill Gross, had reigned supreme, building his firm into a \$2T behemoth and at one time guided the largest actively managed mutual fund on the globe, PIMCO Total Return. PIMCO currently manages the equivalent of 11% of the U.S. economic output as measured by GDP and nearly the entire GDP produced on the African continent. PIMCO’s success and enduring CNBC and Bloomberg news presence earned it “rockstar” status becoming one of the greatest dynasties in investment management along with the likes of Fidelity, Vanguard, and Capital Group.

Gross achieved his 70<sup>th</sup> birthday in April of this year and billionaire status a few years before. Most investors saw the naming of several Co-CIOs, following the surprising departure of Mohamed El-Erian, as part of a succession plan for the day when Gross decided enough was enough. So while a day was approaching when Gross would no longer be at the helm of PIMCO, few anticipated the events which came to pass: Gross resigning his position the morning of September 26<sup>th</sup> and going to of all places, Janus Capital Group.



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With Gross out of PIMCO, has the abdication of the throne by the Bond King permanently impaired the investment thesis for holding PIMCO products? We don't think so. Our confidence in that statement comes from years of due diligence, dozens of conference calls, and on site visits with portfolio managers, traders, technology professionals, and compliance personnel. Simply put, even with Gross no longer at the firm, PIMCO's hundreds of other investment professionals are among the very best in the industry and capable of effectively serving clients.

Let's address the firm's flagship product, PIMCO Total Return formerly managed by Mr. Gross. On the day of Gross's resignation, PIMCO appointed Dan Ivascyn its Global Chief Investment Officer. Ivascyn also retained his role as head of the mortgage credit portfolio management team as well as responsibilities for PIMCO's credit hedge fund and mortgage opportunistic strategies. Ivascyn is a member of both PIMCO's Executive Committee and the Investment Committee. Morningstar named him Fixed-Income Fund Manager of the Year (U.S.) for 2013. Additionally, three portfolio managers were named to lead the PIMCO Total Return Fund: Scott Mather (lead), Mark Kiesel (co-portfolio manager), and Mihir Worah (co-portfolio manager). Scott Mather is CIO of U.S. Core Strategies and a managing director in the Newport Beach office. Morningstar named him as a finalist for Fixed-Income Fund Manager of the Year (U.S.) for 2011. Mark Kiesel is CIO Global Credit and a managing director in the Newport Beach office. Morningstar named him Fixed-Income Fund Manager of the Year in 2012 and a finalist in 2010. He has written extensively on the topic of global credit markets and established the firm's Global Credit Perspectives publication. Mihir Worah is CIO of Real Return and Asset Allocation and a managing director in the Newport Beach office; he has a Ph.D. in theoretical physics from the University of Chicago. We believe the newly installed leadership team on the PIMCO Total Return Fund is about as highly trained, experienced, and accomplished as you will find anywhere. They are also backed-up by some of the most sophisticated technological and human resources in the fixed income industry which we have witnessed firsthand.

In addition to being highly proficient, the team reiterated its commitment to utilizing the classic top-down framework for which this fund is well-known. Management believes that they can reduce the fund's volatility profile by integrating more bottom-up security selection and reducing the strategy's turnover ratio. Given co-portfolio manager Mark Kiesel's global credit background, we think it is reasonable to expect the fund to take on more corporate credit exposure in the future. We are comfortable with the nuanced shift in strategy as PIMCO's research platform is extensive.

Some are rightfully concerned about the size of the PIMCO Total Return Fund (\$202B) and impact sudden liquidity requirements would pose to the strategy; we believe that PIMCO's trading platform can efficiently raise massive amounts of liquidity if needed while not materially impairing the strategy long-term.

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But the PIMCO Total Return Fund isn't the only product offered by the firm. In fact, the Total Return mutual fund is only 10% of the firm's overall total AUM (Assets Under Management). PIMCO's product portfolio includes offerings specializing in international investing, strategies helping pension plans match liabilities to their assets, "real return" focused products utilizing TIPS and commodities, hedging strategies using the firm's proprietary models, and asset allocation options such as target retirement date solutions for 401(k) plans. Indeed, the product suite at the firm is diverse and affords PIMCO a stable asset base which is conducive to supporting business operations.

Francis Investment Counsel currently conducts ongoing due diligence on the following products:

- PIMCO Total Return
- PIMCO Real Return
- PIMCO CommoditiesPlus
- PIMCO Commodity Real Return

Our recommendation is for clients and fiduciaries to place all of the above products onto the "Watch List" due to the significant qualitative change as the result of Gross leaving; however, we are not recommending replacement for any of them at this time. We are confident that the depth of the portfolio management teams in place and the technological resources available to them are enduring competitive advantages independent of the departure of Gross. As of the time of this writing, no other high level PIMCO executives have joined Gross at Janus Capital Group.

So, is the PIMCO dynasty over?

We don't think so. Our opinion is based on years of due diligence on the firm and speaking with numerous members on site. While we acknowledge the asset base of the firm is decreasing, we do not see the momentum of the organization being stopped by Gross's departure. PIMCO is in the first innings of its new life without its founding architect.

As the world gazes on the new line-up for the flagship PIMCO Total Return fund, it will take some getting used to seeing the new names on the backs of the jerseys. While the "Love to hate 'em" crowd is ebullient, mainly comprising PIMCO's competitors and select members of the financial press, we believe PIMCO's team will be able to distinguish itself and ultimately prosper. Lest we forget, the New York Yankees won the World Series in 2009, 2-years after the departure of Joe Torre. In the year following Bill Walsh's departure, the 49ers won the Super Bowl and did it again 5-years later. The Green Bay Packers following Vince Lombardi? Let's just say that when the Packers won the Super Bowl again in 1997, the baby boomer generation had a flash back to "the good ole days."