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Featured Solution

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Tide Turns for Structured Credit

The term "structured credit" either frightens or excites depending on whether an investor is reflecting on the first couple years of the most recent financial crisis or looking forward in 2012. In addition to the ongoing benefit of historically low interest rates for the foreseeable future, this sector looks poised to experience positive supply and demand dynamics and should offer investors attractive risk adjusted return potential, PIMCO believes.

Many investors remain skeptical. But the market environment for structured products – from U.S. and European residential and commercial mortgage-backed securities (CMBS) to consumer asset-backed securities (ABS) and collateralized loan obligations (CLOs) – has changed markedly since the onset of the crisis nearly five years ago. The sector as a whole has undergone significant deleveraging as impaired balance sheets rapidly shed exposure.

Current pricing now reflects a more realistic view of the underlying fundamentals, namely the ongoing weakness in the global economy, including the U.S. housing market. Last year – particularly the second half of 2011 – was a difficult one for structured products, as risk premiums widened in unison with nearly all credit risk assets amid concern that the European debt crisis was worsening.

Although volatility remains elevated, we believe the economic events of 2011 have created an exceptionally attractive investment environment in high quality structured products for investors willing and able to bear price volatility and ratings risk. While investors can't completely eliminate the risk of principal loss, those dangers can be lessened by focusing on senior, current-pay securities. We believe it is possible to maintain a relatively defensive posture without completely sacrificing capital appreciation in an economic recovery scenario. Finally, the increased potential of asset sales by European banks will likely provide investors with a rare opportunity to invest at attractive prices on a large scale in a sector that has experienced multiple years of net negative supply.

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What Is Structured Credit?

A structured credit investment is a bond that is backed by a pool of assets such as residential or commercial mortgage loans, bank loans or a variety of other consumer loans. The asset pools are structured into classes with varying maturities, payment schedules and levels of risk. Common examples include residential mortgage-backed securities, commercial mortgage-backed securities, consumer asset-backed securities and collateralized debt obligations.

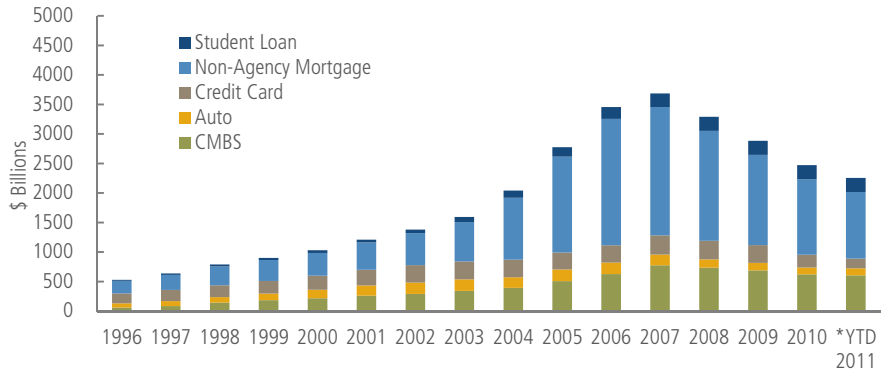
What is a CLO?

A collateralized loan obligation (CLO) is a type of securitization backed by the receivables on commercial bank loans. The pool of assets is structured with varying maturities and risk profiles.

Sleepy market for new issues

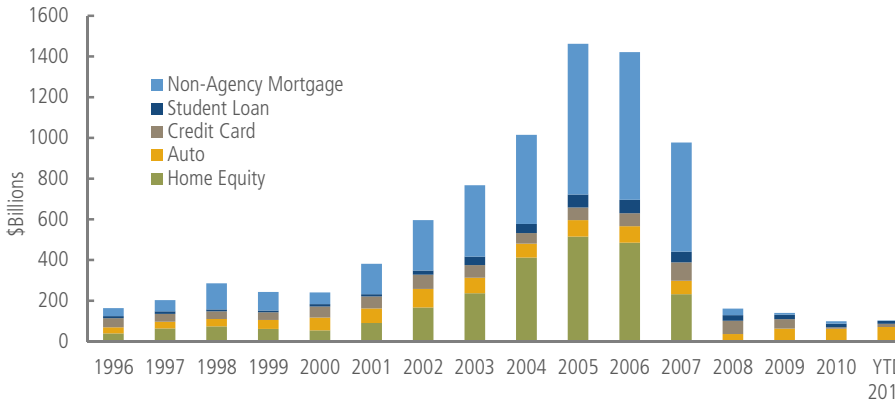
The combination of increasingly stringent lending standards and regulatory reform has largely shuttered the new-issue markets, which once were the primary facilitators of consumer credit in the U.S. The private-label residential mortgage market has been most affected, as the number of deals priced since 2008 can still be counted on one hand. While the commercial mortgage market has fared slightly better, reaching total multi-borrower conduit issuance levels of nearly $33 billion in 2011, the figure still pales in comparison to its peak of more than $228 billion in 2007. Despite modest improvements in several sectors, including the consumer ABS markets, we still expect to see a net issuance decline of more than $200 billion across structured credit this year, eventually creating a scarcity premium on the highest quality assets, especially those that still hold an investment grade rating.

Figure 1: Decline in structured credit outstanding



Source: Federal Reserve, Securities Industry and Financial Markets Association (SIFMA). *Data as of 30 September '11.

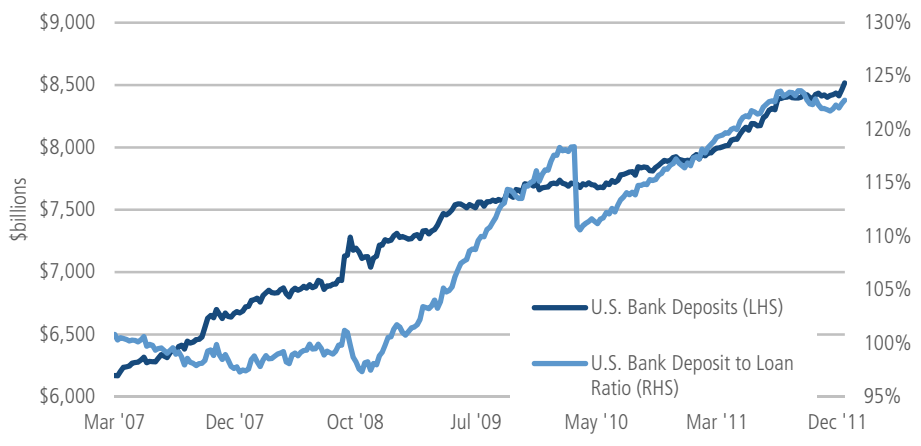
Figure 2: Few new issues



Source: Federal Reserve, SIFMA, Commercial Mortgage Alert. Data as of 31 December '11.

In addition to long-term positive technical dynamics created by minimal new issuance of structured credit, the sector is also benefiting from the rapid increase of U.S. bank deposits as these financial institutions seek ways to invest their growing asset base – primarily within shorter duration, higher quality securities. Deposit growth – as evidenced by the widening in the deposit-to-loan ratio – is attributed to a myriad of factors including but not limited to quantitative easing, flows out of money markets and, most recently, deposits moving from European bank subsidiaries to U.S. institutions. The net result has been a general uptick in demand for everything from high quality corporates, municipal securities and U.S. and European structured credit. In particular, high quality U.S. CLOs have been an area of focus for U.S. banks over the last six months. The floating-rate, senior nature of this asset class is naturally hedged against rising interest rates and can offer an attractive return on equity. To the extent this trend of increasing bank demand continues, we would expect to see profound increases in demand at the short end of the yield curve for high quality fixed income, including structured-credit assets.

Figure 3: Bank deposits rising in the U.S.



Source: Federal Reserve. Data as of 4 January '12

Europe: Asset shuffling may present risks and opportunities

The European sovereign debt crisis has placed increasing pressure on European financial institutions to fortify their balance sheets on a larger scale and at an accelerated pace. For example, European regulators will now require banks to attain a Core Tier 1 capital ratio of at least 9% by June 2012, well in excess of the current regulatory minima. Additionally, various European banks are being forced to sell assets, either because of funding constraints or as a result of government bailouts back from 2008-2009. Such actions combined with ongoing sovereign crisis in Europe can effectively force a multi-year deleveraging process into a much shorter time period, pushing banks to often make uneconomic decisions. Given the unprecedented level of uncertainty, many of these institutions are becoming much more willing to recognize losses than they were just two years ago. Ultimately, the manner in which they address this issue will likely have ramifications for all credit risk assets.

Banks are seeking creative ways to deleverage and strengthen their balance sheets, which may result in the decision to increase retained earnings, further restrict new loan origination, infuse capital and sell assets. However, we believe

the type of asset sales will differ by institution and will likely be defined by their individual goals. For entities seeking to address U.S. dollar funding issues, the types of sales made will likely be characterized by high dollar-priced, U.S. dollar-denominated securities. Conversely, entities with a primary focus of raising equity capital will be more likely to sell higher risk weighting assets such as nonrated/noninvestment grade structured credit and nonperforming loans, which would result in dollar-for-dollar capital relief. A third type of asset sales could be concentrated on business units or asset classes deemed noncore that until now had merely been structurally divided from the rest of the institution. Across the opportunity set, unlevered yields on these types of structured credit investments vary but can range from the low-to-mid single-digit range for the highest quality, highest dollar-priced assets, to mid-to-high single-digit range for noninvestment grade, U.S. structured credit.

With uncertainty across credit markets still elevated, short-term periods of distress could force these firms to further expedite the pace and size of asset sales. In fact, recent announcements indicate $1.9 trillion to nearly $3.2 trillion in assets, or roughly 3% to 5% of total European Union banking assets, will likely either be sold or run-off over the next two years, which could pave the way for investors to acquire structured credit assets at desirable levels. Given the uncertainty in terms of timing and size, strong sourcing capabilities will be essential as sellers will likely look first to investors who have experience in quickly and quietly acquiring these assets.

Outlook for 2012

Investors are facing numerous decisions on portfolio positioning. The search for yield will constantly be tempered by the fear of principal loss. We believe the high quality, current pay nature of senior structured credit assets are unique in that they can offer the appropriate balance of additional support in an environment of weak economic conditions and the opportunity to profit from even a modest recovery in the broader macroeconomic environment. With select issues in the sector, in our view, attractively priced and well positioned longer-term, we believe now is the time to consider entering the structured credit market.

Biographies

Mr. Anderson is an executive vice president and a portfolio manager in the Newport Beach office, focusing on global structured credit investments. Prior to joining PIMCO in 2003, he was an analyst at Merrill Lynch covering both the residential ABS and collateralized debt obligation sectors and was ranked as one of the top analysts by Institutional Investor magazine. He was previously a portfolio manager at Merrill Lynch Investment Managers. He has 16 years of investment experience and holds an MBA from the State University of New York, Buffalo.

Ms. Peterson is a vice president and product manager in the Newport Beach office and is responsible for mortgage-related strategies. Prior to joining PIMCO in 2009, she was an associate at ABN AMRO on the capital markets team. She specialized in a variety of corporate debt products, including investment grade and high yield debt, as well as private placements. Ms. Peterson also previously worked at Bank One as a member of the capital markets analyst program. She has six years of investment experience and holds an MBA from The Wharton School of the University of Pennsylvania and an undergraduate degree from the University of Wisconsin-Madison.

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