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PIMCO Recap: Flows, Ratings, and Firm-Level Views

Weighing in on PIMCO six weeks after Bill Gross' sudden departure.

Executive Summary

It's been just over a month since Bill Gross abruptly departed PIMCO on Sept. 26, 2014. That day, Morningstar Manager Research moved all of its Morningstar Analyst Ratings on PIMCO-advised or subadvised funds to Under Review.

Since then, we have:

- Updated and republished Morningstar Analyst Ratings on 50 PIMCO-advised and subadvised funds domiciled in North America
- Updated PIMCO's Stewardship Grade
- Published more than 20 other pieces on topics including fund flows, the ramifications of Bill Gross' departure, and his nascent operation at Janus

This has been a group effort, involving more than a dozen analysts covering PIMCO funds in North America, each of our four ratings committees, our Markets Research Team, and several of our colleagues from Morningstar Institutional Equity Research Services.

In this report, we:

- Assess recent PIMCO fund flows through October
- Recap our ratings changes and current views on PIMCO's portfolio-management operation
- Provide our framework for assessing PIMCO's financial stability
- Provide an update on the closed-end funds Bill Gross managed

Our key conclusions:

- The data suggests heavy outflows for PIMCO Total Return have not materially affected recent performance.
- PIMCO is likely more stable than it was prior to Bill Gross' departure—yet it will take time to see how the post-Gross PIMCO jells, with many key players taking on new responsibilities.
- Firmwide outflows have been heavy but not heavier than anticipated—we estimate PIMCO could withstand additional outflows of up to $300 billion-$350 billion over the next two years before its ability to function at a high level would be impeded.
- The collapse in premiums for PIMCO's closed-end funds that some investors feared would happen has not come to pass.

Flows Update

The aftershock of Gross' departure is still strong but beginning to diminish. PIMCO's Total Return Fund had an estimated[1] outflow of $32.3 billion in October, which is almost double the $17.9 outflow in September. After the departure of Bill Gross on Sept. 26, investors withdrew a record amount of assets. PIMCO's press release, however, points out that nearly half of the outflow occurred in the first seven trading days after Gross' departure, when investor concerns were at their peak. Recently, outflows have slowed, but they are still at elevated levels compared with before Gross' departure.

Our $32.3 billion estimate differs from PIMCO's reported $27.5 billion because the flow estimates that PIMCO provided included redemption requests made on Sept. 30 but not reflected in fund shares outstanding until Oct. 1. This is known as a "T+1 settlement cycle" and applies to all PIMCO U.S.-domiciled funds. PIMCO has indicated to Morningstar that $5.6 billion in net redemptions were requested on Sept. 30, and these redemption requests were included in the estimate for October, not September, as illustrated in Exhibit 1 below:

Exhibit 1
Comparison of PIMCO and Morningstar's Estimated Outflows From PIMCO Total Return
Source: PIMCO, Morningstar

Total Return Flows ($ bil)	September	October	Total
PIMCO Reported Flows	−23.5	−27.5	−51.0
Morningstar Estimate	−17.9	−32.3	−50.2

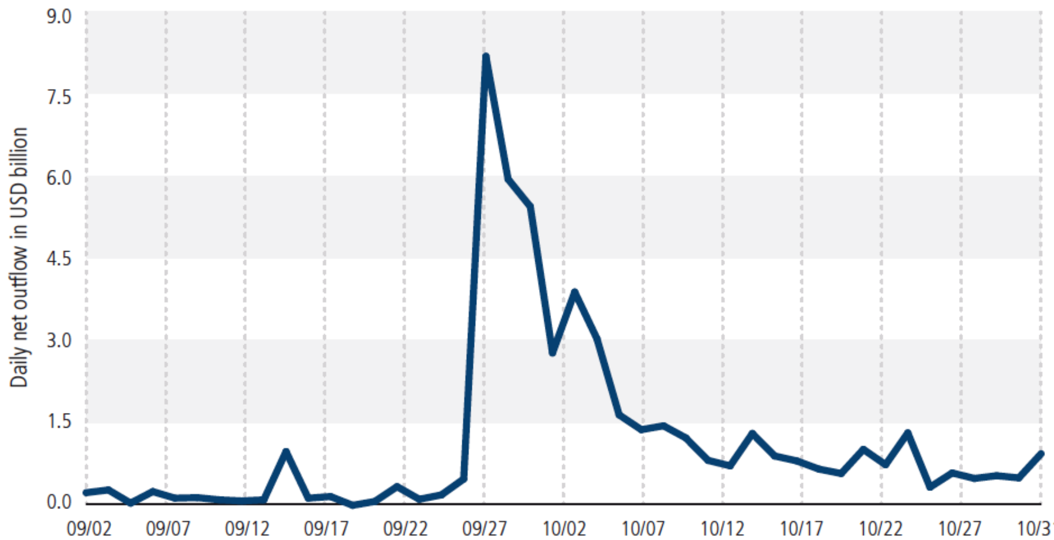
The $32.3 billion October outflow amounts to 16% of the fund's $201.6 billion September-end assets. This leaves the fund with $170.9 billion at the end of October. Outflows totaled $50.2 billion for September and October, which is the largest amount of money ever withdrawn from a fund in a two-month time frame.

According to PIMCO, outflows were heaviest in the five days following Gross' departure and then began to taper off. By the last week of October, daily outflows remained elevated but had fallen below the $1 billion per day mark, except for a blip upward on the last day of the month. Prior to Gross' departure, the fund had been averaging about $135 million per day in outflows during 2014. Given a number of conversations we had over the past year with Gross, and with the fund's new managers over the past six weeks, we were confident the fund had ample liquidity to manage significant outflows without radically altering the sector concentration or other portfolio characteristics of the fund. That has turned out to be the case during October.

[1] Morningstar estimates open-end fund net flows by computing the change in assets from one month to the next that is not explained by the performance of the fund. The fund's actual flows may differ from Morningstar's estimates for a variety of reasons, including the timing of actual purchases and redemptions versus our assumptions and the timing and type of dividend distributions, for example. Click here for a full explanation of Morningstar's estimated flow methodology.

Exhibit 2
Daily Net Outflows for PIMCO Total Return for September and October
Source: PIMCO

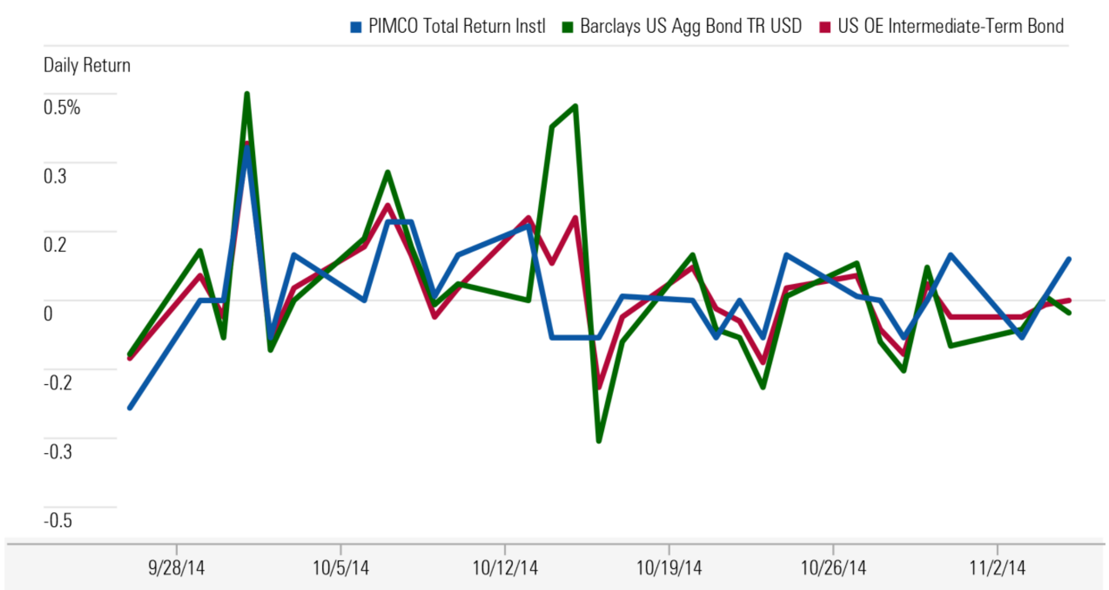
In Exhibit 2 we show daily net outflows for PIMCO Total Return for September and October:



Source: PIMCO

Recent outflows don't appear to have harmed short-term performance. We find little evidence that PIMCO Total Return's performance suffered during October by having to deal with large redemptions. That lack of evidence is not entirely surprising, given management's ample portfolio liquidity and its well-regarded trading operation. In Exhibit 3, we highlight the daily returns for PIMCO Total Return, its Barclays US Aggregate Bond Index benchmark, the open-end intermediate-term bond Morningstar Category average, and the category average ex-PIMCO Total Return over the period Sept. 26 through Nov. 5:

Exhibit 3
Daily Returns for PIMCO Total Return Inst Relative to Benchmark and Peer Group, Sept. 26- Nov. 5, 2014
Source: Morningstar



The most straightforward way to explain the fund's October performance is simply to look at its duration positioning in light of the volatile bond market during the month. Treasury yields fell sharply and unexpectedly mid-month, in part due to renewed worries about the global economy. At one point on Oct. 15, the yield on the 10-year U.S. Treasury fell below 2% for the first time since June 2013. Investor concerns had moderated by month-end, and the yield on the 10-year U.S. Treasury stood at 2.35% on Oct. 31, down from 2.52% at the end of September. Like most actively managed intermediate-term bond funds, PIMCO Total Return had a duration shorter than that of the BarCap U.S. Aggregate Bond Index and therefore trailed the benchmark in October's falling-rate environment. But the fund was in good company, as more than three fourths of its intermediate-term bond peers also lagged the index for the month. PIMCO Total Return I PTTRX finished in the 50th percentile for October, 4 basis points ahead of the category average.

In aggregate, the fund's outflows did not materially harm its performance over the one-month period, as reflected in Exhibit 4 below:

Exhibit 4
October 2014 Performance for PIMCO Total Return Inst Relative to Benchmark and Peer Group
Source: Morningstar

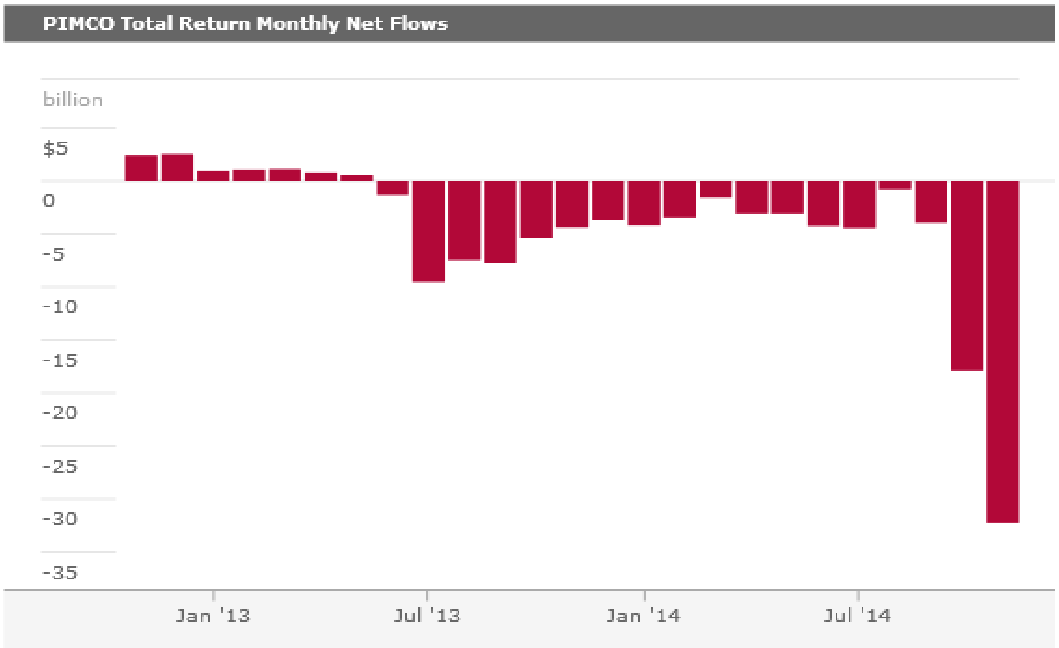
	October Return (%)	**Category Rank (Percentile)**
PIMCO Total Return Instl	0.80	50
Barclays US Aggregate Bond TR USD	0.98	
U.S. Open-End Intermediate-Term Bond	0.76	

While the fact that PIMCO Total Return's monthly performance was positive relative to its category and its underperformance relative to the benchmark is explainable in terms of its portfolio duration, it remains possible that the fund's 0.80% gain could have been higher had it not been managing its record outflows. To test this, we used a tool made by our quantitative research team that creates a custom index for PIMCO Total Return that aims to achieve as close a correlation as possible to the fund using long-only investments in passive indexes. The performances of the fund and the custom index track closely over time. Any significant deviation between PIMCO Total Return and the custom index during the past month can be interpreted as idiosyncratic behavior perhaps caused by having to manage large outflows over the course of the month. The custom index's 0.81% return for October, however, was virtually identical to that of PIMCO Total Return. This adds to our confidence that the fund has thus far been able to handle redemptions without sacrificing returns.

The fund has been in outflows since May 2013's so-called taper tantrum. From May through December 2013 investors were moving out of bond funds in general, but as flows into the asset class returned to positive in 2014, PIMCO Total Return's flows remained negative, a product of uncharacteristically lagging relative performance and fallout from the resignation of CEO Mohamed El-Erian and Gross' reaction to it.

In Exhibit 5, we show monthy flows activity for PIMCO Total Return over the trailing two years:

Exhibit 5
Monthly Net Flows for PIMCO Total Return Over the Trailing Two Years
Source: Morningstar



It isn't just PIMCO Total Return that has been losing assets. Last month, PIMCO as a firm had U.S. fund outflows of $48 billion and 74% of its funds had outflows. Outflows for some other large funds, such as PIMCO All Asset All Authority PAUIX, PIMCO Short-Term PTSHX, and PIMCO Emerging Local Bond PELBX, have been relatively heavy over the trailing 12-month period. In Appendix 1, we include a summary of October flow activity and 12-month organic growth rates for all PIMCO's U.S.-domiciled funds.

To reiterate, at this point we do not think recent outflows from PIMCO Total Return have been debilitating, and we believe the fund's new managers have ample flexibility to navigate an extended period of orderly outflows. We will continue to monitor flows for PIMCO Total Return and the firm's entire lineup more broadly and will reassess our views in light of material changes in either the amount or velocity of outflows.

PIMCO Fund Ratings Recap

Manager changes stemming from Gross' departure led to ratings downgrades for many PIMCO funds, but many remain Morningstar Medalists. Our reratings process has been rigorous, requiring analysts to revisit their theses in light of how directly or indirectly the funds they cover have been affected by the portfolio manager changes and other changes—including those to PIMCO's Investment Committee—stemming from Gross' departure. That process included more than a dozen analysts, our four ratings committees, countless hours of debate, and ultimately, the committees signing off on each and every rating.

In Exhibit 6, we summarize the ratings updates we've completed since Gross' departure:

Exhibit 6
Summary of Morningstar Analyst Ratings Changes for PIMCO-Advised and Subadvised U.S.-Domiciled Funds
Source: Morningstar

Fund Name	Ticker	Current Rating	Previous Rating	Morningstar Analyst
AMG Managers Total Return Bond	MBDFX	Bronze	Gold	Eric Jacobson
Harbor Bond Institutional	HABDX	Bronze	Gold	Eric Jacobson
Harbor Commodity Real Return ST Instl	HACMX	Silver	Gold	Michael Herbst
Harbor Real Return Instl	HARRX	Silver	Gold	Michael Herbst
Harbor Unconstrained Bond Instl	HAUBX	Neutral	Neutral	Eric Jacobson
PIMCO All Asset All Authority Inst	PAUIX	Silver	Silver	Kevin McDevitt
PIMCO All Asset Instl	PAAIX	Gold	Gold	Kevin McDevitt
PIMCO CommoditiesPLUS Strategy Inst	PCLIX	Silver	Silver	Michael Herbst
PIMCO Commodity Real Ret Strat Instl	PCRIX	Silver	Gold	Michael Herbst
PIMCO Corporate & Income Opps	PTY	Neutral	Bronze	Cara Esser
PIMCO Diversified Inc Instl	PDIIX	Silver	Silver	Eric Jacobson
PIMCO Emerging Local Bond Instl	PELBX	Silver	Gold	Karin Anderson
PIMCO Emerging Markets Bond Instl	PEBIX	Silver	Gold	Karin Anderson
PIMCO Emerging Markets Currency Instl	PLMIX	Neutral	Silver	Anthony D'Asaro
PIMCO EqS Pathfinder Instl	PTHWX	Neutral	Neutral	Greg Carlson
PIMCO EqS® Long/Short Institutional	PMHIX	Neutral	Neutral	Jason Kephart
PIMCO Floating Income Instl	PFIIX	Neutral	Neutral	Eric Jacobson
PIMCO Foreign Bond (Unhedged) I	PFUIX	Bronze	Silver	Karin Anderson
PIMCO Foreign Bond (USD-Hedged) I	PFORX	Bronze	Silver	Karin Anderson
PIMCO Fundamental Advtg Abs Ret Strat I	PFATX	Neutral	Neutral	Eric Jacobson
PIMCO Fundamental IndexPLUS AR Instl	PXTIX	Neutral	Silver	Eric Jacobson
PIMCO Global Advantage Strategy Bd Instl	PSAIX	Bronze	Bronze	Karin Anderson
PIMCO Global Bond (Unhedged) Instl	PIGLX	Bronze	Silver	Karin Anderson
PIMCO Global Bond (USD-Hedged) I	PGBIX	Bronze	Silver	Karin Anderson
PIMCO Global Multi-Asset Instl	PGAIX	Neutral	Neutral	Michael Herbst
PIMCO High Yield Instl	PHIYX	Bronze	Bronze	Sumit Desai
PIMCO High Yield Spectrum Instl	PHSIX	Bronze	Bronze	Sumit Desai
PIMCO Income Instl	PIMIX	Silver	Silver	Eric Jacobson
PIMCO Inflation Response Multi-Asst Instl	PIRMX	Neutral	Silver	Michael Herbst

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Fund Name	Ticker	Current Rating	Previous Rating	Morningstar Analyst
PIMCO Investment Grade Corp Bd Instl	PIGIX	Silver	Silver	Sumit Desai
PIMCO Long Duration Total Return Instl	PLRIX	Bronze	Silver	Sarah Bush
PIMCO Low Duration Instl	PTLDX	Bronze	Gold	Sarah Bush
PIMCO Monthly Income A	(na)	Silver	Silver	Vishal Mansukhani
PIMCO Municipal Bond Instl	PFMIX	Bronze	Neutral	Cara Esser
PIMCO Municipal Income II	PML	Neutral	Neutral	Cara Esser
PIMCO Real Return Instl	PRRIX	Silver	Gold	Michael Herbst
PIMCO RealRetirement 2015 A	PTNYX	Bronze	Bronze	Jeff Holt
PIMCO RealRetirement 2020 A	PTYAX	Bronze	Bronze	Jeff Holt
PIMCO RealRetirement 2025 A	PENZX	Bronze	Bronze	Jeff Holt
PIMCO RealRetirement 2030 A	PEHAX	Bronze	Bronze	Jeff Holt
PIMCO RealRetirement 2035 A	PIVAX	Bronze	Bronze	Jeff Holt
PIMCO RealRetirement 2040 A	POFAX	Bronze	Bronze	Jeff Holt
PIMCO RealRetirement 2045 A	PFZAX	Bronze	Bronze	Jeff Holt
PIMCO RealRetirement 2050 A	PFYAX	Bronze	Bronze	Jeff Holt
PIMCO RealRetirement Inc&Distrbtn A	PTNAX	Bronze	Bronze	Jeff Holt
PIMCO Short-Term Instl	PTSHX	Silver	Gold	Sarah Bush
PIMCO StocksPLUS AR Short Strat Instl	PSTIX	Neutral	Neutral	Jason Kephart
PIMCO StocksPLUS Instl	PSTKX	Neutral	Neutral	Eric Jacobson
PIMCO Total Return Instl	PTTRX	Bronze	Gold	Eric Jacobson
PIMCO Unconstrained Bond Instl	PFIUX	Neutral	Neutral	Eric Jacobson

Investors can review our assessment of each fund in the Morningstar Global Fund Reports available in Morningstar Direct. Below we recap notable changes, starting with PIMCO Total Return.

PIMCO Total Return enters a new era with uncertainty but also a good deal of promise. Morningstar remains positive overall on **PIMCO Total Return** PTTRX after the departure of Bill Gross but is downgrading the fund to Bronze because of the resulting uncertainty regarding outflows and the reshuffling of management responsibilities. When Gross resigned, PIMCO quickly selected Dan Ivascyn as its new group chief investment officer and announced that three PIMCO veterans—Mark Kiesel, Mihir Worah, and Scott Mather—would take over this fund, with Mather leading the effort.

It will take some time to see how Ivascyn and the new managers coalesce as a team in their new roles, but there are a number of reasons to believe they will be successful after the dust settles. This is an experienced and well-respected group, with both Kiesel and Ivascyn earning Morningstar Fixed-Income Fund Manager of the Year accolades in recent years. As sector specialists, they were often credited by Gross for feeding him their best bottom-up ideas.

The challenges posed by outflows from the fund remain a wild card, but a hefty stake in a mix of U.S. Treasury bonds, agency mortgages, and cash equivalents, in addition to cash flows received from coupon payments and maturing securities, is grounds for cautious optimism that the fund should be able to withstand a significant storm. The fund's Morningstar Analyst Rating of Bronze reflects Morningstar's high level of confidence in PIMCO's resources and overall abilities but also the uncertainty as to exactly how all of these parts will mesh in the wake of Gross' departure.

PIMCO Unconstrained Bond PFIUX was already rated Neutral before Gross left. Like other non-traditional-bond funds, this one hasn't made much of its additional flexibility, as the October 2014 Treasury rally illustrated. Now the fund is in the hands of Ivascyn, Mohsen Fahmi, and Saumil Parikh, with Parikh as lead manager. That's the third manager change for the strategy in one year. Parikh is a PIMCO veteran, but he doesn't have much in the way of a public record. The strategy's new group of managers and a reshaped Investment Committee guiding it leave a lot of questions about just how this fund will use its wide latitude, resulting in its Neutral rating. PIMCO applies some tenets of the Unconstrained strategy to a number other absolute return-oriented funds, such as **PIMCO Fundamental Advantage Absolute Return Strategy** PFATX and **PIMCO Fundamental IndexPLUS** PIXIX, so PIMCO really needs to get it right.

PIMCO Short-Term and PIMCO Low Duration have been downgraded but remain Medalists. Jerome Schneider remains at the helm of **PIMCO Short-Term** PTSHX nearly four years into his tenure. Short-term debt is a big deal at PIMCO as it runs huge sums in the strategy including portions of other big PIMCO funds, so his lengthening tenure is a plus. The fund's downgrade to Silver from Gold is unrelated to Gross' departure—its fees have remained stubbornly high even as yields have come down and competitors have lowered their fees, resulting in its downgrade. The formerly Gross-managed **PIMCO Low Duration** PTLDX has gone to Bronze from Gold, largely due to the changes in its management and forthcoming adjustments to its approach. Though the fund lands in the hands of the capable Scott Mather and Jerome Schneider, we'll reassess our stance after they get settled in.

We remain generally positive on PIMCO's income and real return-oriented funds. Ivascyn and Alfred Murata have done a brilliant job at **PIMCO Income** PIMIX, and we think that can continue. Although Ivascyn was elevated to the group chief investment officer position, he retains portfolio-management duties on this multisector fund. We named Ivascyn and Murata Morningstar Fixed-Income Fund Manager of the Year for 2013 because they've done a deft job of shifting among bond sectors over the years. Yes, Ivascyn has more on his plate, but this fund's $39 billion asset base remains manageable, and Ivascyn has not assumed any additional portfolio-management duties. We have maintained the fund's Silver rating.

PIMCO Diversified Income PDIIX is staying at Silver. Led by Curtis Mewbourne, the fund's emphasis on sector rotation and bottom-up security selection buffer it somewhat from changes in PIMCO's Investment Committee, and Mewbourne's deep involvement is another constant. For similar reasons, Mewbourne's **PIMCO Floating Income** PFIIX is staying at Neutral. Gross' departure didn't have a big effect, but the fund has its own challenges. Unlike a true floating-rate fund, this one has an implicit, built-in bet against the Treasury market given its use of swaps. This has the unexpected impact for a floating-rate fund of hurting returns when Treasuries rally hard, given that the swaps are necessarily marked down during that kind of environment.

PIMCO Corporate & Income Opportunities PTY was lowered to Neutral from Bronze in light of changes to its management. To replace Gross as manager of this and four other closed-end funds, PIMCO tapped Alfred Murata, comanager of **PIMCO Income** PIMIX, **PIMCO Dynamic Income** PDI, **PIMCO Dynamic Credit Income** PCI, and **PIMCO Income Opportunity** PKO. Clearly Murata is capable, but how he will adapt the closed-end funds' strategies remains to be seen.

We lowered ratings on Mihir Worah's funds due in part to concerns over his workload, but those concerns are beginning to subside. **PIMCO Commodity Real Return Strategy** PCRIX and **PIMCO Real Return** PRRTX were lowered to Silver from Gold. Worah took on additional duties in early 2014 when he assumed leadership of the firm's global multiasset strategies, including the struggling, Neutral-rated **PIMCO Global Multi-Asset** PGAIX. He had begun to build out that team, while his Real Return team experienced two departures during the year.

Even so, we feel a little better about that than we did when we first downgraded the funds because key team member Jeremie Banet has returned to the fold in the interim, and the build-out of Worah's global multiasset team is nearing completion, with his lieutenant Rahul Seksaria beginning to take on more global duties. Mixed performance also contributed to a lower rating on **PIMCO Inflation Response Multi-Asset** PIRMX from Silver to Neutral. **PIMCO CommoditiesPLUS** PCLIX retains its Silver ratings, as its more active commodity-centric strategy and lengthening track record stand out under skipper Nic Johnson, who has run the fund since its inception.

We're maintaining our ratings on several PIMCO credit-oriented funds. Mark Kiesel has a lot on his plate as chief investment officer of global credit, lead manager of **PIMCO Investment Grade Corporate Bond** PIGIX, and comanager of PIMCO Total Return, as well as a couple of smaller funds. We're keeping our Silver rating on his main charge because Kiesel and his team's execution—particularly in issue selection, sector selection, and use of credit default swaps—has led the fund to outstanding performance since he took over in 2002. PIMCO has built a 50-analyst-strong team devoted to credit, and Dan Ivascyn has been vocal in his intention to build out necessary resources around Kiesel, so he has plenty of support.

PIMCO High Yield PHIYX and **PIMCO High Yield Spectrum** PHSIX retained their Bronze ratings. Veteran manager Andrew Jessop remains at the helm of both funds. He's done a fine job since taking over in 2010, supported by PIMCO's 15-person high-yield credit team.

We've downgraded a number of PIMCO's global-bond funds but remain positive. Upon assuming his current role as CIO of U.S. core strategies and lead manager on PIMCO Total Return, Scott Mather turned over his global- and foreign-bond mandates to Andrew Balls. Mather had a long, appealing track record on these global-bond mutual funds, whereas Balls' public track record in the space is less extensive. He comanaged the Bronze-rated **PIMCO Global Advantage Strategy Bond** PSAIX since 2011 and became lead manager in 2013. However, his record over both time periods was middling compared with the world-bond category average. As a result, **PIMCO Foreign Bond (Unhedged)** PFUIX, **PIMCO Foreign Bond (USD-Hedged)** PFORX, **PIMCO Global Bond (Unhedged)** PIGLX, and **PIMCO Global Bond (USD-Hedged)** PGBIX were downgraded to Bronze from

Silver. Balls has been successful on a handful of European fixed-income strategies since 2008 and intends to use the same strategy employed by Mather, though we may see some nuanced differences over time. Sachin Gupta and Lorenzo Pagani were named comanagers on the funds in the wake of Mather’s promotion.

We reassessed PIMCO’s emerging-markets bond funds in light of recent personnel changes and a lengthening stretch of lackluster performance. Michael Gomez remains at the helm of the firm’s emerging-markets strategies, but comanager Ramin Toloui left earlier this year to take a job in the U.S. Department of Treasury. That departure and mediocre performance nudged the ratings on **PIMCO Emerging Local Bond** PELBX and **PIMCO Emerging Markets Bond** PEBIX to Silver from Gold. PIMCO Emerging Local Bond’s slump is partly due to its local currency mandate; a U.S. dollar rally has hurt relative performance, but that part can’t be held against it. PIMCO Emerging Markets Bond has enjoyed better performance because of the difference in currency exposure. **PIMCO Emerging Markets Currency** PLMIX was dropped to Neutral from Silver. Toloui’s departure, along with strategy changes and waning performance, weighed on our decision to downgrade the fund. That said, Gomez and team are still among the best in emerging-markets bonds.

PIMCO's muni team hasn't been much affected by the upheaval. What mattered to us is that manager Joe Deane has continued to build his team so that it now looks like a cohesive group, so **PIMCO Municipal Bond** PFMIX was raised to Bronze from Neutral. It has been a little more than three years since Deane came to PIMCO from Western Asset. The fund's three-year returns are excellent, but Deane's long track record prior to PIMCO is also important.

PIMCO Long Duration Total Return PLRIX was downgraded to Bronze from Silver. The good news is that the fund still has manager Steve Rodosky at the helm. The bad news is that there has been a big shakeup at the firm’s Investment Committee, which exerts quite a lot of influence on this fund.

Underlying funds are the main issue for the All Asset funds, as Rob Arnott and his team remain in place. Despite some of the downgrades mentioned above, Arnott and team still have some excellent PIMCO funds at their disposal, so we’ve maintained our ratings of Silver for **PIMCO All Asset All Authority** PAUIX and Gold for **PIMCO All Asset** PAAIX. PIMCO All Asset is now the only Gold-rated PIMCO fund.

The PIMCO RealRetirement target-date funds retain their Bronze rating. Although the series’ relative performance has been poor versus more-conventional target-date funds, its focus on protecting investors from the ravages of inflation by using Treasury Inflation-Protected Securities and other tools has given them appeal. The generally strong range of underlying funds and unique glide path also argue in their favor.

Bill Gross’ departure removes any doubt around PIMCO’s commitment to building out its equities team, but the fundamental equity funds haven’t otherwise been affected. We are keeping **PIMCO EqS Pathfinder** PTHWX at Neutral. The fund made a splash bringing over Anne Gudefin and Chuck Lahr from Mutual Series. But performance has been poor and Lahr has departed.

PIMCO EqS Long/Short PMHIX retains its rating of Neutral. It's one of the funds that plugs in the unconstrained portfolio and runs a concentrated long/short portfolio. The fund converted from hedge fund to open-end fund in 2012, and the jury is still out.

After several missteps under previous leadership, the firm's equity effort is likely on stronger footing with PIMCO equity CIO Virginie Maisonneuve now at the helm. She has made a number of new hires over the past year to build out the various equity teams and will likely continue to do so. Seeing how that effort comes together bears watching.

We've assigned Neutral ratings for a few of the Pluses. We are maintaining **PIMCO StocksPlus'** PSTKX and **StocksPlus AR Short Strategy's** PSTIX Neutral ratings. StocksPlus aims to beat the S&P 500 by buying futures and then actively managing the cash held against those futures to give the fund an edge over its benchmark. Sometimes it works and sometimes it doesn't—and that limits its appeal versus a traditional index fund. Neutral-rated StocksPlus AR Short Strategy is even more of a niche player; it's a decent fund to rent but you don't want to own it. **PIMCO Fundamental IndexPlus AR** PIXIX was cut to Neutral from Silver as new lead manager has had mixed success running portfolios similar to this one. He was also joined by recent hire Mohsen Fahmi, who has experience in the hedge fund industry but lacks a public record.

PIMCO Firm-Level Views

While it's too soon to tell how all of the manager changes and other shifts in responsibilities that have occurred in the wake of Gross' departure will jell, most of the new key players are not new faces to PIMCO and have been contributing to the success of the firm for many years.

We've also gotten to know them better over the course of more than three dozen conversations and in-person meetings over the past six weeks following Bill Gross' departure. The three managers named to take over PIMCO Total Return and PIMCO's new group CIO Dan Ivascyn were all members of the deputy CIO group appointed in early 2014 following Mohamed El-Erian's departure. It was long anticipated that Bill Gross' eventual successor would come from that group. As such, the four had already been taking on increasing leadership and held rotating responsibility for chairing the firm's Investment Committee, which is responsible for setting the firm's macro outlook and guidelines for portfolio allocations. They were also familiar faces to Morningstar over the past 15-plus years. In the following section, we provide a who's who of the post-Gross PIMCO, highlight some of these key players' past track records, and provide our current assessment.

Dan Ivascyn, Group CIO. Ivascyn has played a significant role both behind the scenes and more publicly during his 16-year tenure at PIMCO. Ivascyn was formally named a deputy CIO in early 2014 and at that time took up a permanent spot on the firm's Investment Committee. Prior to being appointed to the role of group CIO, Ivascyn was the chair of the firm's internal portfolio management group that oversees PIMCO's investment personnel. In addition, he heads the mortgage credit portfolio management team and, in recent years, he has overseen the fund's expansion into income and alternative strategies.

PIMCO's CIO search committee had already started work on the search for a replacement for Gross in the weeks leading up to his departure and interviewed a number of candidates for the position. The committee selected Ivascyn and once Gross' departure was official, his selection was unanimously approved by the firm's managing directors. A number of managers within PIMCO note that Ivascyn was not a surprising choice. He has said that among his early priorities will be increasing the rigor and discipline of the firm's macro process and working to make sure that the ideas of the firm's extensive army of bottom-up researchers make it into the firm's core portfolios. Initial signs that Ivascyn is opening up additional lines of communication across the investment team are encouraging.

As for Ivascyn's formal portfolio-management responsibilities, he has headed up the $39 billion PIMCO Income PIMIX since its 2007 inception. Working together with comanager Alfred Murata, Ivascyn has built a strong record with this multisector fund, investing heavily in nonagency mortgages to meet the fund's income mandate. The fund also dodged some of the performance issues that haunted other PIMCO portfolios in recent years. So, while PIMCO's decision to take on greater interest-rate risk and maintain its emerging-markets exposure hurt many of its funds in 2013, Ivascyn and Murata also got many things right that year and security selection in the mortgage sector, corporate credit, and currencies all worked to the fund's credit that year. The two were co-recipients of Morningstar's U.S. Fixed-Income Fund Manager of the Year honors in 2013.

Clearly, Ivascyn and the three new comanagers of PIMCO Total Return are an accomplished quartet. In Exhibit 7, we highlight their track record on their main charges:

Exhibit 7
Summary of Dan Ivacsyn and PIMCO Total Return Comanagers' Prior Track Records
Source: Morningstar

Manager	Fund Name	Ticker	Morningstar Category	Fund Return Mgr Tenure Through October 2014 (% Anlzd)	Category Return Mgr Tenure Through October 2014 (% Anlzd)
Mark Kiesel	PIMCO Investment Grade Corp Bd Instl	PIGIX	Corporate Bond	7.77	6.22
	PIMCO Long-Term Credit Institutional	PTCIX	Corporate Bond	14.25	10.11
	PIMCO Credit Absolute Return Instl	PCARX	Nontraditional Bond	4.21	2.84
Mihir Worah	PIMCO Real Return Instl	PRRIX	Inflation-Protected Bond	5.03	3.40
	PIMCO Real Return Asset Instl	PRAIX	Inflation-Protected Bond	6.79	3.40
	PIMCO Commodity Real Ret Strat Instl	PCRIX	Commodities Broad Basket	-3.69	*
	PIMCO Inflation Response MultiAsst Instl	PIRMX	Tactical Allocation	0.17	5.75
	PIMCO Global Multi-Asset Instl	PGAIX	World Allocation	9.07	4.90
Dan Ivascyn	PIMCO Income Instl	PIMIX	Multisector Bond	10.32	5.35
	PIMCO Dividend and Income Builder Instl	PQIIX	World Allocation	9.18	6.36
	PIMCO Balanced Income Institutional	PBITX	World Allocation	2.30	1.17
Scott Mather	PIMCO Foreign Bond (Unhedged) I	PFUIX	World Bond	5.05	3.84
	PIMCO Global Bond (Unhedged) Instl	PIGLX	World Bond	4.98	3.84
	PIMCO Foreign Bond (USD-Hedged) I	PFORX	World Bond	7.16	3.68
	PIMCO Global Bond (USD-Hedged) I	PGBIX	World Bond	6.16	3.68

*Note: The commodities broad basket category launched in November 2009. Since then through October 2014, the PIMCO Commodity Real Ret Strat Instl fund has outperformed the category average by more than 2 percentage points annualized.

Mark Kiesel, CIO for global credit and comanager of PIMCO Total Return. Mark Kiesel, one of the most tenured senior portfolio managers at PIMCO, got his start as a credit analyst then quickly joined the firm's generalist portfolio-manager program. After rotating through various sector desks, he settled on corporate bonds in 1999. He began running PIMCO Investment Grade Corporate Bond PIGIX in 2002 when it had just $23 million in assets, and he eventually became head of the firm's global corporate-bond portfolio managers in 2008. He has oversight responsibility for the firm's investment-grade, high-yield, bank-loan, and municipal teams as well as credit research. In early 2014, he was named one of the firm's six deputy CIOs and following Gross' departure was named CIO for global credit.

In his 12-year-plus tenure managing PIMCO Investment Grade Corporate Bond, Kiesel has built an impressive record. Although PIMCO's broad views play a key role, the fund's portfolio also reflects opportunities that the team has pinpointed through deep, fundamental research. Kiesel's success with the fund has also owed in part to his astute sector calls. In 2012, for example, he turned bullish on certain corporate sectors at a time when PIMCO's overall credit outlook was fairly conservative. Investments in bonds positioned to benefit from a recovery in housing did particularly well that year and Kiesel was named Morningstar Fixed-Income Fund Manager of the Year in 2012.

Scott Mather, CIO U.S. Core Strategies, lead manager of PIMCO Total Return. PIMCO veteran Scott Mather amassed wide-ranging fixed-income experience prior to taking over as the firm's CIO of U.S. core strategies and the lead in the trio of mangers behind flagship PIMCO Total Return. He joined the firm in 1998, bringing experience as a mortgage-backed securities trader at Goldman Sachs, and went on to co-head PIMCO's mortgage and asset-backed securities team. Mather later built out the firm's European portfolio-management team, and in early 2008 he became head of global portfolio management. He has served as a permanent member of PIMCO's Investment Committee since early 2011.

Prior to the late-September reshuffling of responsibilities, Mather had run PIMCO Global Bond PGBIX and PIMCO Foreign Bond PFORX since 2008. He built strong records on the unhedged and U.S.-dollar hedged versions of those strategies through smart macro-driven calls and relative valuation moves. While his approach tended to be benchmark-centric, he was willing to make the occasional move into off-benchmark areas including financial corporates and nonagency mortgages.

Mihir Worah, CIO Real Return and Asset Allocation, comanager of PIMCO Total Return. Worah joined PIMCO in 2001, and since 2007 he's done an impressive job heading up the firm's Real Return strategies including PIMCO Real Return PRRIX and PIMCO Commodity Real Return PCRIX. He's also built out the research effort backing those strategies, laying the groundwork for more active, commodity-centric offerings such as PIMCO CommoditiesPLUS PCLIX, managed by Nic Johnson. Over the past five years Worah and Johnson have built out the firm's commodities expertise, and at this point Johnson is heading up all of the commodities-related execution for those strategies. Similarly, Rahul Seksaria and the returning Jeremie Banet head up execution on the inflation-protected securities side.

That core is supported by a crew of more than a dozen inflation-protected securities and commodities specialists, who in turn draw on the research of a number of other sector teams throughout PIMCO. As the team has expanded, Worah has also gotten more involved in multiasset strategies, including PIMCO Inflation Response Multi-Asset PIRMX. In the wake of Mohamed El-Erian's early 2014 resignation, Worah was promoted as one of the firm's six deputy CIOs and assumed leadership of the firm's global multiasset strategies. That latter assignment wasn't planned for in advance, and Worah inherited the unenviable task of setting those strategies, including PIMCO Global Multi-Asset PGAIX, on firmer footing. Then when Bill Gross left, he was named a CIO and assumed a comanager slot on PIMCO Total Return and a co-lead role overseeing the portfolio-management group.

Other PIMCO managers have cited Worah as a very adept team-builder, which is key going forward. At various points over the past year, we've been concerned that he may have been stretched thin. Global multiasset strategies require several areas of expertise—deep asset class knowledge, a familiarity with asset allocation and making relative value assessments across asset classes, a well-oiled trading operation, and risk management that can highlight unintended risks across global asset classes and currencies. Given than challenge, Worah has built out his global multiasset team with a combination of internal and external hires. According to Worah, he is nearly done building out that team, with one or two additional hires forthcoming. Although that team remains a work in progress, early results are encouraging. That build-out and Jeremie Banet's return somewhat lessen our concerns regarding Worah. He is also very well situated to delegate additional responsibilities or add resources in various areas.

PIMCO's Investment Committee continues to evolve. At the core of PIMCO's macro research effort is its Investment Committee, the group responsible for forming the firm's macroeconomic outlook and providing key guidelines to portfolio managers on duration, yield curve, and sector positioning. This group has historically been dominated by a number of macro heavy hitters, led by Gross and including former co-CIO Mohamed El-Erian and the recently returned Fed guru Paul McCulley. Gross and El-Erian are both gone and our understanding is that McCulley might also be considering an exit. The Investment Committee had already seen significant change in the months prior to Gross' departure, following El-Erian's resignation and the resulting addition of a number of new faces with the introduction of the deputy CIO structure in early 2014. In Exhibit 8, we summarize changes to the Investment Committee thus far in 2014 through October:

Exhibit 8
Changes to PIMCO's Investment Committee for 2014 through October
Source: Morningstar

Mohamed El-Erian	Departed January 2014
Tony Crescenzi	Joined January 2014
Dan Ivascyn	Joined January 2014
Mark Kiesel	Joined January 2014
Mihir Worah	Joined January 2014
Paul McCulley	Returned June 2014
Bill Gross	Departed September 2014

Note: Marc Seidner and Chris Dialynas both came off the committee during the year. Dialynas returned to the committee when he came back from his sabbatical and Seidner will rejoin shortly.

With Gross gone, all eyes are on the Investment Committee to provide continuity and lay the groundwork for the investment success. There are reasons for optimism. For starters, the firm's system of secular and cyclical forums—critical to shaping its long-term and nearer-term outlook—remains intact and arguably has become more robust in recent years. In addition, the early 2014 expansion of the Investment Committee—then including deputy CIOs Kiesel, Ivascyn, Balls, Mather, and Worah in particular—promised to better integrate the perspectives of portfolio managers deeply plugged into the firm's bottom-up fundamental research engine. At that time, the committee, which had previously been dominated by Gross, also moved to a rotating chair schedule, which upped the odds of greater debate. Today each member of the committee takes turns in the chair role, and with Gross out of the room, moreover, it's likely that the group's discussions are more collegial and inclusive. Ivascyn intends to bring even more quantitative rigor to the firm's macro decision-making process.

PIMCO has taken additional steps to shore up the Investment Committee since Gross' departure. In late September, Chris Dialynas, a long-time Investment Committee member and former portfolio manager on PIMCO Unconstrained Bond PFIUX, returned to the firm from a sabbatical. Then, in early November, PIMCO announced that Marc Seidner will return to the firm as CIO for nontraditional strategies and will be a permanent Investment Committee member. Seidner will be based in New York and his return is a big one. He left PIMCO on the same day that Mohamed El-Erian resigned to serve as CIO for fixed income at the well-regarded institutional money manager Grantham, Mayo, Van Otterloo, & Co. In his prior stint at PIMCO, he'd played a significant leadership role, heading the portfolio-management team and serving as a regular member of the Investment Committee. Our understanding is that he was to play a significant role in succession planning for Gross' eventual retirement. In Exhibit 9, we highlight composition of the current Investment Committee:

Exhibit 9
Current PIMCO Investment Committee
Source: PIMCO

Name	Title	Joined PIMCO	Experience (Years)
Andrew Balls	CIO Global Fixed Income	2006	16
Tony Crescenzi	Market Strategist, Portfolio Manager	2009	32
Chris Dialynas	Portfolio Manager	1980	36
Dan Ivascyn	Group Chief Investment Officer	1998	23
Mark Kiesel	CIO Global Credit	1996	22
Scott Mather	CIO U.S. Core Strategies	1998	20
Paul McCulley	Chief Economist	2014*	30
Saumil Parikh	Portfolio Manager	2000	15
Christian Stracke	Head, Global Credit Research	2008	15
Mihir Worah	CIO Real Return and Asset Allocation	2001	13
Marc Seidner	CIO Nontraditional Strategies	2014*	27
Rotating Members			
Mohsen Fahmi	Portfolio Manager	2014	30
Sudi Mariappa	Portfolio Manager	2014*	27
Steve Rodosky	Portfolio Manager	2001	19

*Each of these team members was rehired in 2014 and had worked at PIMCO previously.

Exhibit 10 also reflects the degree of change and continuity in the leadership of PIMCO's portfolio-management operation:

Exhibit 10
Before/After Gross Departure PIMCO Portfolio-Management Leadership
Source: PIMCO

Before	**After**
CIO	**Group CIO**
Bill Gross	Dan Ivascyn
Deputy CIOs	**CIOs**
Dan Ivascyn	Andrew Balls
Andrew Balls	Mark Kiesel
Mark Kiesel	Virginie Maisonneuve
Virginie Maisonneuve	Scott Mather
Scott Mather	Mihir Worah
Mihir Worah	Marc Seidner
Secular Forum Leader	**Secular Forum Leader**
Rich Clarida	Rich Clarida
Cyclical Forum Leader	**Cyclical Forum Leader**
Saumil Parikh	Saumil Parikh

While recent additions are encouraging, it will take some time to see whether the new Investment Committee will be more than the sum of its admittedly impressive parts. For investors in the firm's absolute return strategies, which feature broad flexibility on duration positioning, these changes are of particular concern. However, for flagship PIMCO Total Return and other core, benchmark-conscious strategies, the impact may not be as significant. While Gross drew great scrutiny for his every adjustment to duration, broad interest-rate bets played a limited role in his success. Given more robust input from PIMCO's best bottom-up thinkers, there's good reason to believe that the committee can be successful at making broad sector decisions, which might ultimately be more important to the success of the flagship fund in the years ahead than its duration bets.

PIMCO has taken powerful steps to retain investment management personnel. Observers are also closely watching PIMCO for significant investment staff departures, and the leadership team has made staff retention a top priority, reporting that they started working on a new compensation structure the day after Gross' departure. Thus far, we have not seen any senior-level departures from the firm. Based on multiple conversations with Ivascyn, CEO Doug Hodge, President Jay Jacobs, and other portfolio managers, it would be surprising to see significant departures in the near term. That's not to say there will be none, but in many respects the portfolio-management and research operations appear to be more stable now than they were prior to Gross' departure.

The firm has announced an updated retention policy that's likely to be a key arrow in PIMCO's quiver. Under the $279 million plan, executives and certain senior portfolio managers will receive three deferred cash payments in addition to regular bonuses. These are spread over the next two and a half years, presumably the highest risk period for defections, and culminate in mid-2017. Meanwhile, the firm plans to increase bonus payouts in 2014 over 2013 levels for nonmanaging director level staff. All reports are that PIMCO's parent, Allianz, is supportive of these investments, even against the backdrop of significant outflows.

In light of the fact that Gross did not take a team with him, no additional portfolio managers have left since Gross departed, and PIMCO is taking powerful steps to retain its key portfolio-management personnel, in our opinion the firm's portfolio-management operation remains formidable.

Exhibit 11
Snapshot of PIMCO's Portfolio-Management Team as of September
Source: PIMCO

In Exhibit 11, we provide a snapshot of that operation, totaling 261 portfolio managers as of September:

PIMCO has also continued its active hiring program unabatedly. Since 2009, the firm has added 29 new managing directors to its portfolio-management team. This number encompasses internal promotions and external hires and includes eight new faces in the managing-director ranks in 2014. Ivascyn has reiterated his commitment to continuing to hire in key areas of need. In particular, he has signaled that investing in the team backing Kiesel is a particular area of focus, especially in the months to come. Recent promotions for Mohit Mittal, who heads the firm's investment-grade credit desk and shares portfolio-management duties with Kiesel on a number of strategies, and Jon Horne, who heads the firm's high-yield trading desk, stand out. Kiesel has described Mittal, who oversees a team of seven portfolio managers on the desk and is responsible for managing buys and sells, as his "right-hand man." Kiesel also works closely with Christian Stracke, who handles day-to-day management of the firm's 50-odd credit analysts.

Other areas for additional resources may include Worah's global multiasset team, active real estate capabilities, and additional hires for the fundamental equity effort led by Maisonneuve.

In the weeks after Gross' departure, there have not been any big shifts in the strategies of key funds in the PIMCO lineup. That's not surprising as PIMCO has sought to reassure nervous investors. However, there have been some early hints of adjustments to how some of the highest profile funds are run.

At PIMCO Total Return, the first change is the formal shift to a multimanager structure. In his role as lead portfolio manager, Scott Mather heads up the execution of the fund's strategy and has final decision-making power. However, the portfolio managers report that their approach to decision-making is collaborative. As a result, it's unlikely for a sizable bet to make it into the portfolio without general assent from all three. Additional input will come from the Investment Committee. That said, each of the portfolio managers has an area of expertise, so Worah, who comes from the Real Return team with a background in inflation-linked bonds and derivatives, has significant input into those decisions, while Kiesel is no doubt playing a key role in credit-related decisions.

Meanwhile, Ivascyn and Mather have repeatedly said that they seek to strike a better balance between the role of big macro shifts in large funds like PIMCO Total Return and contributions from bottom-up fundamental research. After significant investments in its team coming out of the credit crisis, PIMCO today counts more than 50 credit analysts; the team has contributed to excellent records at more-specialized funds such as Kiesel's PIMCO Investment Grade Corporate Bond.

The question is how much individual security selection can move the needle at the fund, given its still significant girth. True, the fund has shrunk by roughly 40% from its peak in net assets in mid-2013. However with roughly $170 billion in net assets as of the end of October 2014, a 1% position would still account for $1.7 billion, limiting the universe in which the fund could take significant stakes. Looking at the 700-plus investment-grade corporate issuers in the Barclays U.S. Aggregate Index—albeit just a subset of the fund's opportunity set—there are only 60 or so large enough that PIMCO could build a position of that size without exceeding 10% of the firm's outstanding issuance. It is more conceivable, though, that a combination of smaller positions, say of up to 50 basis points in size, could start to make a modest impact.

The insights of bottom-up thinkers like Kiesel, Ivascyn, Balls, and Worah will likely have a bigger impact on the deliberations of the Investment Committee. That impact may be reflected in portfolios such as PIMCO Total Return, perhaps showing up in the fund's corporate sector allocations or even its overall allocation to corporates. Ivascyn has been adamant that there will be no structural bias toward corporates because of Kiesel's involvement in the fund, but there's no doubt that Kiesel will have more say about the size of that allocation in the months and years ahead.

Given the number of other portfolio-manager changes on PIMCO funds, the evolution of the post-Gross Investment Committee, and other adjustments the managers may have in store for their funds, it would not be surprising to see slight alterations or gradual changes affecting funds across the firm's lineup over the next year. We'll weigh in on those changes in each of the funds' Morningstar Global Fund Reports and will follow up with additional updates should the changes be more sweeping or dramatic than we initially assume.

PIMCO's culture remains very much intact, with some notable changes. Although ultimately very important to the success of the firm, one of the hardest things for outsiders to handicap is an investment management company's culture. And with just six weeks since Gross' departure, PIMCO's culture in the post-Gross era is likely to evolve gradually.

Initial signs point to a more collaborative environment under Ivascyn's leadership. While Ivascyn notes that he and others value the firm's hard-driving, results-driven culture, he's publicly committed to maintaining a more collegial atmosphere. And there are some signs that such changes are underway. PIMCO's trading floor, once famous as a completely silent space dominated by Gross, is reported to have a more collaborative feel since his departure, with talking allowed and with Ivascyn and other top investment staff reportedly sitting in close proximity to recently hired MBAs. Meanwhile, Ivascyn's oversight of the Investment Committee is said to be more collaborative and inclusive than his predecessor's with contributions from other senior investment staff more actively encouraged. All in all, the lines of communication appear to be more open, empowering a wider range of the investment team. The return of a number of investment-management professionals—including Banet who had reportedly left the firm in mid-2014 after a tussle with Gross—is also a vote of confidence.

One fairly consistent observation from our many recent conversations with PIMCO managers over the past six weeks is a palpable sense of relief that the El-Erian/Gross departures are now beginning to recede into history, and everyone can get back to the task at hand. Clearly, tensions had been building over the past year between key personalities and, more importantly, over the future direction of the firm.

What appears clear at this point is that PIMCO's hard-driving, high-achieving culture remains intact, with some of the rough edges smoothed out. Also, where there had been debate over whether PIMCO should remain focused on fixed income or continue to build out other capabilities such as equities, asset allocation, and alternatives, the commitment to continue building out those areas is clear, both from PIMCO and from Allianz. Clarity over that business direction, resolution of high-profile and too-public conflicts over key individuals' future roles, and the widespread and vocal support for Dan Ivascyn, Jay Jacobs, and Doug Hodge—from Allianz and their PIMCO colleagues—are all beneficial and should reduce distractions from PIMCO's unswerving focus on investment results.

Please see Appendix 3 for additional discussion of PIMCO's culture in our most recent Stewardship Grade, published Sept. 29, 2014.

PIMCO Remains on Solid Financial Ground

We've also considered the ripple effects of Gross' departure on PIMCO as a firm, as well as its corporate parent Allianz. We've received many queries asking what level of overall outflows from PIMCO's funds and institutional accounts would crimp the firm's ability to manage its portfolios effectively, retain key personnel, and maintain the depth and breadth of its portfolio-management operations.

As noted in the Flows Update section above, PIMCO has experienced roughly $189 billion in open-end fund outflows since its asset peak just prior to May 2013's taper tantrum, not including outflows in the firm's institutional and separate account business. The latter are harder to assess given the more-limited disclosure of assets under management in those private accounts. As a result, our flows discussion focuses on open-end fund flows and does not explicitly take institutional client activity into account. Our working assumption is that PIMCO has experienced institutional outflows over this trailing 18-month period, though likely not as heavy and not as concentrated as those around Gross' departure. We also assume that some more-sophisticated institutional investors will begin to consider the firm more attractive as the El-Erian/Gross drama moves into the rear-view mirror, leading to new institutional clients in the not-too-distant future.

We believe PIMCO could sustain total additional outflows of up to roughly $300 billion-$350 billion (or 15%-20% of its total assets under management as of September 2014) over the next two to three years without hindering its ability to manage client assets effectively and without hindering its overall business model. Below we walk through our rationale for this conclusion. We'll also continue to publish regular updates on the firm's flows and personnel situations and will reassess our views in light of any material developments.

Even after 18 consecutive months of outflows at the firm, PIMCO remains a behemoth in the asset-management industry with almost $1.9 trillion in assets under management as of Sept. 30, 2014. According to estimates from parent company Allianz and Morningstar's equity analysts, the firm generated about EUR 8 billion in revenue, before commissions paid in 2013 (approximately $6.5 billion). And like many asset managers, PIMCO is extremely profitable, as demonstrated by operating margins near 37% displayed in Exhibit 10 below, in line with some of the most profitable publicly traded asset-management firms:

Exhibit 12
Operating Margins for Selected Asset-Management Firms
Source: Morningstar

	AUM ($ bil)	Revenue ($ mil)	Op. Profit ($ mil)	Op Margin (%)
PIMCO	1,870	8,611*	3,167*	36.80
BlackRock	4,525	10,697	4,622	43.21
Franklin Resources	898	8,491	3,221	37.94
T. Rowe Price	731	3,890	1,851	47.58
Legg Mason	708	2,298	467	20.32
AllianceBernstein	473	2,865	535	18.67
Eaton Vance Corp	294	1,358	453	33.36
Janus	177	925	276	29.84

*Estimates in euros based on Allianz's asset-management segment data.

Basically the inverse of operating margins, cost/income ratios in the asset-management industry generally range between 65% and 70%, with equity-focused or smaller firms slightly on the higher side and fixed-income-focused firms on the lower end. Given PIMCO's emphasis on fixed income, we assume its cost/income ratio lands well below that general range, which supports the fund's high operating margins. PIMCO runs a fairly lean operation, which helps it maintain a low-cost structure and high profitability.

PIMCO's two main costs are its people (including fixed and variable compensation) and back-office operations. In 2000, PIMCO outsourced its entire back-office operation to State Street, thus converting a big fixed cost into a variable one—State Street's bill rises or falls with PIMCO's asset base. This arrangement provides a huge benefit to navigating a period of outflows.

There are a few things to keep in mind when looking at PIMCO's sizable compensation expense. The primary concern is that a sustained period of outflows would affect the firm's bonus pool or force the firm to cut staff. This, in turn, would likely disrupt the investment processes, which could affect investment performance, and so on. Managing PIMCO for short-term bottom-line results would likely cause business decisions that would not favor the investors of its funds. We've seen that short-term perspective work out poorly for other asset-management firms.

Based on multiple conversations with PIMCO over the past decade and scores more over the past six weeks, we're confident the firm's focus on results for its fund investors has not changed. If anything, the firm's focus has intensified. PIMCO has expanded its workforce from roughly 1,100 in 2008 to closer to 2,500 today and continues to add to its research and portfolio-management teams at all levels, with more than 20 managing director hires over the past year and more in the works, specifically around asset allocation, real estate, global and opportunistic credit, and both fundamental and quantitative equities.

By most accounts, PIMCO compensates its portfolio-management personnel extremely well, landing well above industry averages if not near the top of the range. On one hand, this sets high internal expectations for compensation, which could be challenging to meet if PIMCO's revenues fell precipitously. Yet it also lessens the risk that key personnel could get poached by other firms. To further reduce that risk, the firm recently implemented its additional $279 million retention package, which comprising significant, additional cash payouts over the next three years for folks who choose to stay with the firm.

PIMCO's stable, supportive relationship with corporate parent Allianz is a big plus. PIMCO's profitability and explicit support from Allianz give it plenty of autonomy and ample firepower to maintain its compensation practices in the intermediate term, even if post-Gross outflows continue over the next two to three years. Even after significant outflows over the past two years, the departures of Gross and El-Erian have freed up a sizable chunk of cash to distribute to other professionals. Even beyond the cash, PIMCO's equity-sharing program is broad and significant, with more than 400 personnel owning actual equity in a very profitable operation. There is also a precedent at the firm for its senior-most managing directors to push down significant chunks of cash and equity to lower levels, so the chance is high they would do so again if necessary.

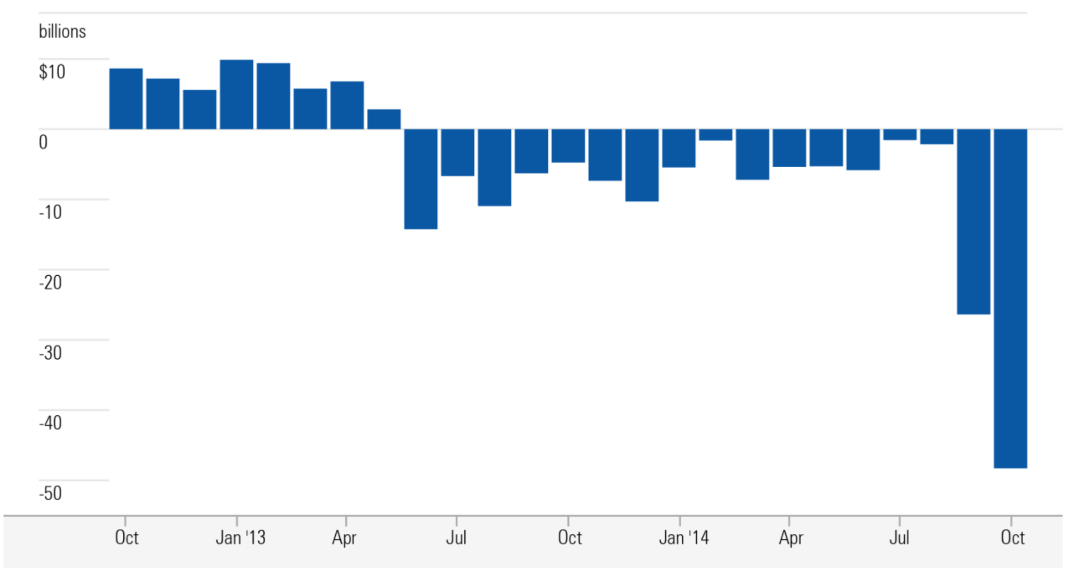
In other cases in the past, the pressures of being part of a publically traded company have turned up the heat on asset-management organizations or given them a much shorter leash. In PIMCO's case we believe those pressures have been mitigated, at least in the near to intermediate term. As a result, we think PIMCO has time to right its ship. Allianz is in strong financial shape and doesn't currently face heavy regulatory or financial pressure that could otherwise force executives to put unneeded pressure on PIMCO executives. Our understanding is that Allianz remains supportive of PIMCO's hiring and compensation practices going forward. Our working assumption is that Allianz will remain supportive over the near-to-intermediate term, even if supporting those areas results in slightly lower operating margins over the next few years.

From our perspective, that support means PIMCO's ability to control its own destiny also remains intact, which gives it ample flexibility to retain the professionals it chooses to retain. That autonomy, coupled with its lean cost structure, means PIMCO is starting from a strong financial position as it navigates a period of continuing outflows.

A key question surrounding PIMCO is the extent of client redemptions the firm will face and how large an exodus the firm can withstand. While PIMCO has reported that roughly 70% of October's open-end fund outflows came from funds that had been managed by Gross, it isn't just PIMCO Total Return that has been losing assets. Last month, 74% of PIMCO U.S.-domiciled funds had net outflows, and the firm overall had U.S. fund outflows of $48 billion.

In Exhibit 13 below, we show monthly outflows from PIMCO's U.S.-domiciled fund lineup over the trailing two years:

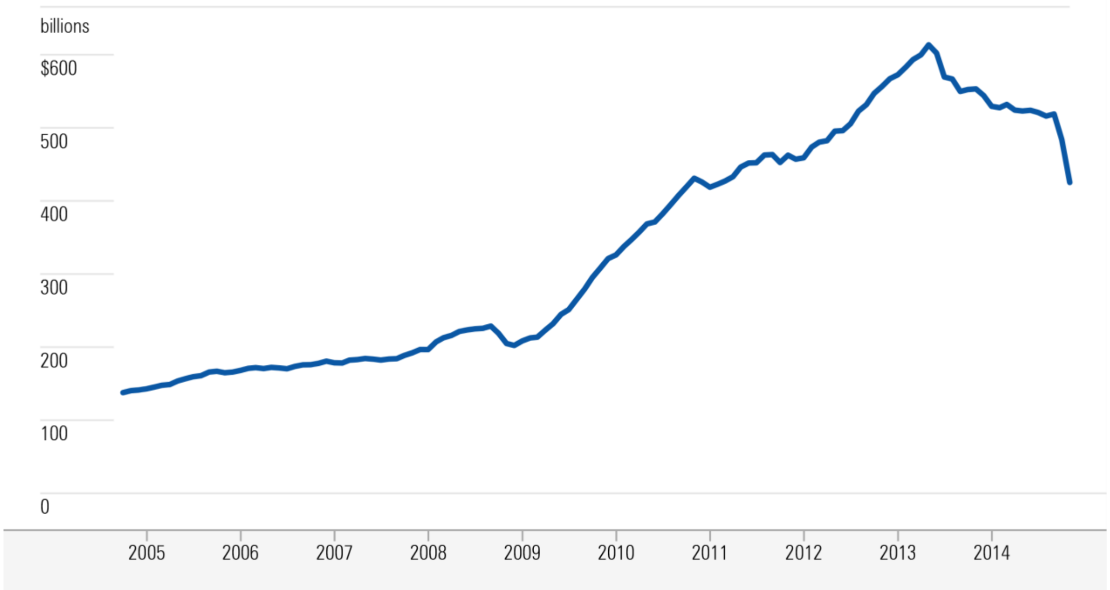
Exhibit 13
Monthly Net Flows for PIMCO's U.S. Fund Assets Over Trailing Two Years
Source: Morningstar



PIMCO Total Return now accounts for roughly 40% of PIMCO's long-term, U.S.-domiciled fund assets (excluding money market funds, separate accounts, and subadvised funds). Fund assets at the firm peaked at $614 billion in April 2013, making it the fourth-largest provider of U.S funds. By the end of

October 2014, PIMCO's firm-level fund assets had shrunk to $425.3 billion, a 31% decrease from the peak. In Exhibit 14 below, we show the firm's fund assets over the trailing decade:

Exhibit 14
Growth and Decline of PIMCO's Fund Assets Over Trailing Decade
Source: Morningstar



To assess the potential impact of outflows on the firm's financial and economic stability, it's important to understand how PIMCO generates its revenue and where its assets under management come from. Our visibility into PIMCO's institutional asset base is limited, so within our framework we make a number of assumptions. Of the $1.9 trillion that PIMCO managed as of Sept. 30, 2014, we estimate that roughly $400 billion is managed by the firm on behalf of its parent company, Allianz. It's safe to assume that these assets are the stickiest for PIMCO and aren't going anywhere.

The remaining $1.5 trillion that PIMCO manages comes from a variety of third parties, including retail investors, insurance companies, defined contribution plans, and many other institutional investors. It's difficult to get a completely accurate read of the firm's split between retail and institutional assets, given the technicalities of data reporting. For example, some 401(k) investments are housed in the firm's retail funds but are often controlled by institutional gatekeepers and consultants. Similarly, more than a few of PIMCO's institutional clients likely invest through the institutional shares of its mutual funds.

According to Allianz, approximately one third of the firm's third-party assets, or about $500 billion, are held in retail accounts, with another two thirds, or $1 trillion, in institutional accounts.

We assume that PIMCO's retail-oriented assets are where we are likely to see the most near- to intermediate-term outflow activity. As a general rule, institutional assets are considered stickier to asset-management firms because of those clients' strategic investment policies, generally longer investment horizons, and multistep processes for changes to their institutional portfolios or investment platforms (both of which tend to include gatekeepers, investment committees, and third-party consultants). Less-sticky retail assets, concentrated mostly in funds and subadvised mandates used primarily by individual investors and defined-contribution plan participants, are more likely to leave during rough times. Most of PIMCO's outflow activity so far appears to have come from the retail side.

The institutional side, including defined contribution (401(k)) plans that are overseen by institutional consultants, is more opaque, as these flows are not reported regularly. The decision-making process for institutional asset managers is generally (but not always) slower and more deliberate than the often knee-jerk reaction of retail investors. As such, many institutional investors have only now begun to make decisions regarding whether to stick with PIMCO or move to a competitor. In Appendix 2 we've included a piece focusing on this process as it pertains to the defined contribution market, which concludes it would not be surprising to see an uptick in outflows in early 2015 as a potential second wave of defined contribution plans decide to cut bait.

Importantly, most of PIMCO's assets under management are controlled or influenced by financial advisors, consultants, and other gatekeepers. Whether right or wrong, financial advisors can use the recent turmoil at PIMCO to appear proactive by moving to more stable managers to protect their clients' assets. Similarly, consultants and gatekeepers could face career risk by sticking with PIMCO. One can hardly blame these decision-makers for moving their assets to other managers given the changes at PIMCO over the past year. If PIMCO is able to survive its troubles, they can easily move those assets back to the firm in the future. Unfortunately, whether those decisions are based on credible due diligence or not is almost beside the point—there will likely be some rash or ill-informed decisions made by institutional investors alongside some so-called prudent ones.

It's also important to note there are other factors driving flow activity, including some PIMCO funds' lackluster recent relative performance, and investors' concern over today's low-yielding environment. Going forward, particularly over the next year, investors will still keep PIMCO on watch while the new management structure settles in. PIMCO may also battle external factors that could also cause outflows, including interest-rate volatility and portfolio rebalancing out of fixed-income funds and into equities.

Our understanding is that a number of PIMCO's pure institutional mandates may be ending; given the longer lead times for those redemptions, we do not assume they'll be too disruptive in the near to intermediate term. Should performance not stand out across PIMCO's funds over the next year, it's likely we could see another uptick in outflows in related institutional accounts in late 2015.

Stress-Testing PIMCO

We used our estimates of PIMCO's profitability, cost structure, client base, and asset mix to determine the extent of redemptions the firm can withstand. From a financial point of view, we try to understand how large of a drop in assets under management PIMCO can handle before its bonus pool shrinks enough to motivate its employees to look outside the firm for job opportunities. In our opinion, the firm's cost structure and infrastructure is more than able to manage a gradual trend of outflows if they were to persist over the next couple years. A more dramatic and immediate exodus would likely have a negative impact on the firm and its operations.

We have several examples of fund firms that experienced sizable, rapid declines in assets under management. For example, Legg Mason's business peaked at just over $1 trillion in assets under management as of Sept. 30, 2007, but bottomed out less than two years later at just over $600 billion and has recently climbed back to around $700 billion. Part of the decline was due to plunging asset prices during the financial crisis but was also driven by sizable redemptions from investors dissatisfied with the performance of the firm's funds. The fund firm's operating margin was around 26% in 2008 but plunged to the midteens in 2009 and has yet to fully recover.

AllianceBernstein faced a similar plunge in its business, as assets under management for the firm plunged from $800 billion at the end of 2007 to $410 billion. Since then, total AUM has bounced around between $400 billion and $500 billion and the firm's operating margins shrunk from 32% to the mid- to high-teen levels since.

When stress-testing PIMCO's business model, there are several factors to consider that could cause PIMCO's business to continue to shrink. Obviously, the performance of its funds will remain the most important driver of its clients' behavior. Aside from the relative performance of its funds, a prolonged or unexpected downturn for the bond market could also cause investors to pull assets from PIMCO should they reallocate to equities, cash, or other asset classes. Although PIMCO has generally proved adept at navigating market crises and liquidity-challenged market environments, unforeseen consequences of a broader bond market illiquidity event could also be harmful.

We have several reasons to believe PIMCO won't face potential worst-case scenarios. The examples above were driven at least in part by poor performance. While PIMCO's Total Return and Unconstrained strategies have lagged the market in recent years, the performance for other PIMCO funds is generally better than average to very good, especially over the long term. The firm still benefits from a large pool of talented and highly capable managers and analysts, with a corporate parent that appears very supportive of PIMCO's retention, compensation, and hiring programs. And while firms like TCW suffered significant losses when Jeffrey Gundlach lifted out his entire team to start DoubleLine, Bill Gross left for Janus on his own and took no other PIMCO employees with him. In fact, the firm has already started to see some former employees return, suggesting that a post-Gross PIMCO could very well be a more pleasant place to work.

It's also worth considering the competitive landscape of the fixed-income market. Clearly other firms such as BlackRock, TCW, Vanguard, and Doubleline have benefited from investors pulling assets from PIMCO. That said, we believe there is a floor to the amount of money institutional investors can pull from PIMCO. There are only a handful of other fixed-income investment managers with the infrastructure and scale in place to manage large institutional accounts. While there is a strong case to be made that PIMCO's size is a detriment to its performance in some areas, one can also argue that its size will help it prevent a significant portion of its clients from fleeing.

We believe PIMCO is positioned to withstand continued outflows of up to $300 billion to $350 billion over the next two to three years, or about 10% outflows annually, before its portfolio-management operation is impaired. Clearly it makes sense to keep close watch on the firm's performance, flows, and employee turnover. We feel comfortable that PIMCO has a strong grasp on the sensitivities around its business and the impact continued outflows would have on the performance of its funds. Based on our ongoing conversations with the firm's executives, we have confidence that the new management team is taking the right steps to ensure PIMCO is a sustainable and successful investment manager that can deliver strong results for its clients.

Based on our analysis of PIMCO's revenues, cost structure, current financial position, solid relationship with Allianz, and strong relationship with a diverse set of clients, we believe the company is positioned to withstand continued outflows of up to $300 billion-$350 billion over the next two to three years, or about 10% outflows annually. Under this admittedly tough situation, we think PIMCO can still maintain its profitability at an acceptable level for parent Allianz without having to make changes to its investment processes or cost structure that would cause its investment performance to suffer. However, this working assumption could change based on the timing and magnitude of any continued outflows, so our estimate should be taken with a grain of salt.

The firm is clearly not out of the woods yet, and investors should continue to keep it on watch as it proves its ability to navigate. Even so, at this point, we don't think investors need to fear a worst-case scenario at PIMCO.

Checking In on PIMCO's Closed-End Funds

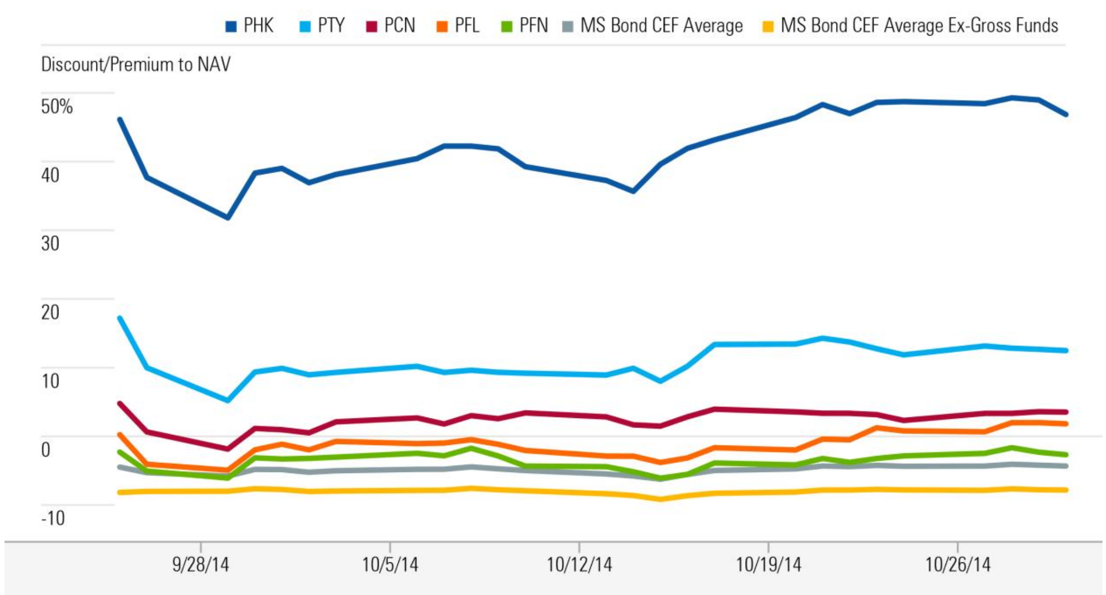
Because several PIMCO closed-end funds had historically traded at relatively high premiums prior to Gross' departure, many CEF watchers predicted extreme share price declines, particularly for the five CEFs that Gross managed. We've been tracking the premium and discount movement of PIMCO CEFs and their respective categories since his departure. It's been a bumpy ride, but that volatility created opportunities for interested investors to scoop up shares at cheap valuations. Here, we check in again on the five multisector bond CEFs Gross managed:

- PIMCO High Income PHK
- PIMCO Corporate & Income Opportunities PTY
- PIMCO Corporate & Income Strategy PCN
- PIMCO Income Strategy PFL
- PIMCO Income Strategy II PFN

Many of these funds' premiums have rebounded after an initial decline. Investors needed to be quick to take advantage of share price dips—by Oct. 20, PIMCO High Income PHK, for example, was trading at a slightly higher premium than it was the day prior to Gross' departure.

There was a considerable uptick in volatility of the premiums and discounts of the five PIMCO funds over the past month compared with the category's average discount. The category average discount, excluding the five Gross-managed CEFs, narrowed slightly over the period but its trading band was narrow--between 7.6% and 9.0%. Including the five PIMCO CEFs, the trading band widened a bit, but for the five PIMCO CEFs, the discount and premium bands were much wider. For example, PIMCO Corporate & Income Opportunities traded at a premium of between 5.2% and 17.2% between Sept. 25 and Oct. 30. Exhibit 15 shows the path of absolute discount or premium between Sept. 25 (the day before Gross' departure) and Oct. 30:

Exhibit 15
Discount/Premiums
for Gross-Managed Closed-End
Funds Sept. 25 to Oct. 30
Source: Morningstar



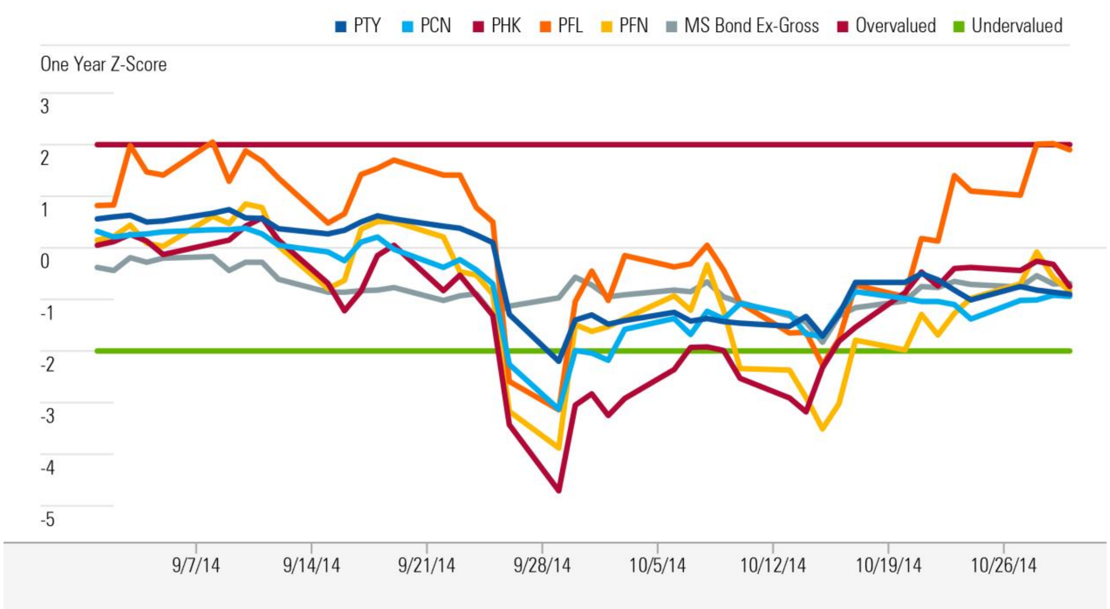
Corporate & Income Opportunities PTY and High Income PHK have generally traded at significantly larger premiums than did the rest of the multisector bond peer group because of their larger-than-average distribution rates. As of Oct. 30, 2014, the former's distribution rate at net asset value was 10% and the latter's was nearly 18%, versus roughly 8% for the other three PIMCO funds and 7.5% for the average multisector bond CEF. Thus, it's understandable to see those funds' premiums experience greater volatility than that of Gross' other funds and the category average.

Although the formerly Gross-managed CEFs thus far have not experienced permanent capital losses following his departure, we remind all investors to avoid purchasing shares of any CEF selling at a double-digit premium as the risk of capital loss is too great.

Gross-managed closed-end funds were cheap relative to their historical premiums, but not for long. Z-scores create a clearer picture of where CEFs' current discounts or premiums look relative to their history. With this added context, investors can determine whether a drop in premium has caused the fund to trade outside of a historically normal range.

Exhibit 16 shows one-year daily z-statistics for the five PIMCO CEFs and the multisector bond CEF category excluding those five funds between Sept. 1 and Oct. 30:

Exhibit 16
Z-scores for Gross-Managed Closed-End Funds Sept.1 to Oct. 30.
Source: Morningstar



On the day of Gross' departure (Sept. 26), there was a noticeable dip in z-score for each of the PIMCO funds and the multisector bond category as a whole, meaning the funds and the broader category looked cheaper relative to their historical premiums. Those valuations rebounded quickly and each of the PIMCO funds reached fair valuation within a few trading days of the announcement. That rebound suggests investors are willing to stick with PIMCO despite a degree of uncertainty around the funds' new managers and their ability to produce Gross-like long-term returns.

New management won't be making big changes, at least for now. During multiple conversations with PIMCO over the past month, the firm made assurances that the new managers of five formerly Gross-managed CEFs, Alfred Murata and Mohit Mittal, will not make significant changes to the funds' underlying strategies. That said, it wouldn't be surprising to see slight changes to the funds' strategies or portfolios, in light of PIMCO Group CIO Dan Ivascyn's stated goal of lessening the performance and portfolio dispersion across funds employing similar strategies. Even so, it's likely that any changes to these five funds will be more gradual than immediate or radical in nature. Other than Murata and Mittal taking the reins of Gross' former charges, PIMCO announced no other manager changes to its CEFs.

PIMCO Corporate & Income Opportunities PTY is the only formerly Gross-managed CEF with a Morningstar Analyst Rating. That rating was lowered to Neutral from Bronze to reflect the uncertainty of new management on the fund's process and performance going forward.

Murata has an impressive track record, particularly in his management of PIMCO Dynamic Income, for which he took over as lead manager in early 2014. He's been on the team since inception, and the fund's outsized stake in mortgages suggests he's played a significant role the whole time. Since its launch in late May 2012, the fund gained 27% on an annualized basis through October 2014, crushing its CEF peers' 8% average gain over the same period. Joining Murata as comanager is Mohit Mittal, a member of the corporate credit team and manager of a number of investment-grade credit, total return, and unconstrained bond accounts for the firm.

PIMCO recently announced a voluntary tender offer for up to 100% of two of its funds' outstanding auction rate preferred shares. While many firms in the industry redeemed outstanding ARPS after that market froze in 2008 (it remains frozen today), PIMCO is one of the last large fund companies that still uses these securities to create leverage. The ARPS fiasco was a publicity nightmare for CEF firms and many decided to repair the damage by redeeming outstanding ARPS for full value in the years following the 2008 crash. Of the largest CEF firms, Nuveen redeemed all outstanding ARPS by October 2011 and BlackRock redeemed 98.8% of outstanding ARPS by mid-October 2014.

Although PIMCO's reluctance to redeem the ARPS created ill will among preferred shareholders, it has benefited common shareholders as other types of leverage have tended to be more expensive. PIMCO notes that it conducted a leverage cost-benefit analysis for each of its CEFs, and, for now, only two funds are offering redemptions to preferred shareholders: PIMCO Income Strategy PFL and PIMCO Income Strategy II PFN. The firm will pay 90% of the liquidation price for any tendered ARPS. The tender offer period began on Sept. 19, 2014, and lasts for one year.

In all, CEF investors remain in good hands should they decide to stick with these funds. PIMCO's breadth and depth remains unrivaled as does the firm's experience managing CEFs. The new lead managers of the five funds highlighted in this piece are well-equipped to manage these funds, though it remains to be seen what changes in strategy or positioning they may have in mind.

List of Related Research

- Morningstar Global Fund Reports on each of the 50 funds in Exhibit 6
- "PIMCO Total Return Fired From Some Retirement Funds," Fund Spy, Nov. 11, 2014
- "Allianz Posts Strong Growth in 3Q, Despite Continued Outflows at PIMCO," Morningstar Equity Research Analyst Note, Nov. 7, 2014
- "PIMCO Total Return Outflows Slowing, But Still Substantial," Video, Nov. 5, 2014
- "PIMCO CEFs Post-Gross," CEF Specialist, Nov. 4, 2014
- "Intermediate-Term Bond Alternatives to PIMCO Total Return," Fund Spy, Oct. 30, 2014
- "Updated Ratings on 18 PIMCO Funds," Fund Spy, Oct. 22, 2014
- "Which Firms Are Capturing PIMCO's Outflows?," Video, Oct. 18, 2014
- "PIMCO's Biggest Outsider Talks Inside Baseball," Fund Spy, Oct. 9, 2014
- PIMCO Total Return Performance Update, Morningstar Manager Research, Oct. 7, 2014
- PIMCO Total Return in DC Plans: Outflows Likely in Early 2015, Morningstar Manager Research, Oct. 7, 2014
- PIMCO September Asset Flows Special Report, Morningstar Manager Research, Oct. 7, 2014
- "PIMCO Total Return Weathers First Round of Outflows," Fund Spy, Oct. 7, 2014
- "A Look at Janus' Big New Hire," Fund Spy, Oct. 2, 2014
- "Should PIMCO CEF Investors Jump Ship?," CEF Specialist, Oct. 1, 2014
- "Key Considerations for PIMCO Total Return Investors," Video, Sept. 30, 2014
- "Downgrading PIMCO Total Return to Bronze," Fund Spy, Sept. 29, 2014
- "Caution Warranted on PIMCO Stewardship," Stewardship Report and Fund Spy, Sept. 29, 2014
- "Some Clarity Gained, Some Questions Remain for PIMCO Funds," Video, Sept. 26, 2014
- "PIMCO Investors: Time To Reassess, Not Panic," Video, Sept. 26, 2014
- "PIMCO Funds Under Review Following Gross' Exit," Fund Spy, Sept. 26, 2014
- "PIMCO Draws On Its Deep Bench," Fund Spy, Sept. 26, 2014

Appendices

- Appendix 1: October Flows and 12-Month Organic Growth Rate for U.S.-Domiciled PIMCO Funds
- Appendix 2: PIMCO Total Return in Defined-Contribution Plans: Outflows Likely in Early 2015
- Appendix 3: PIMCO Stewardship Grade

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Appendix 1: October Flows and 12-Month Organic Growth Rate for U.S.-Domiciled PIMCO Funds

Name	Fund Size (USD)	1-Month Estimated Flow (USD)	12-Month Organic Growth Rate	Morningstar Rating Overall	Morningstar Analyst Rating
PIMCO Total Return	170,898,644,476	-32,250,102,980	-31%	★★★★	Bronze
PIMCO Income	39,309,243,366	380,328,072	35%	★★★★★	Silver
PIMCO All Asset	32,856,235,543	-541,070,512	-2%	★★★★	Gold
PIMCO All Asset All Authority	24,662,295,985	-1,088,476,118	-24%	★★★	Silver
PIMCO Low Duration	17,589,510,214	-2,481,335,383	-27%	★★★★	Bronze
PIMCO Unconstrained Bond	14,802,856,672	-551,133,056	-15%	★★★	Neutral
PIMCO Real Return	14,129,986,204	-447,301,254	-4%	★★★★★	Silver
PIMCO Short-Term	13,843,693,207	-4,467,191,467	-52%	★★★★★	Silver
PIMCO Commodity Real Ret Strat	12,847,484,745	-117,858,607	-21%	★★★★	Silver
PIMCO Emerging Local Bond	11,072,340,553	116,415,053	-33%	★★	Bronze
PIMCO High Yield	10,261,765,870	-637,366,604	-21%	★★★	Bronze
PIMCO Foreign Bond (USD-Hedged)	7,250,605,135	4,755,375	19%	★★★★★	Bronze
PIMCO CommoditiesPLUS® Strategy	6,797,525,651	73,330,465	18%	★★★★★	Silver
PIMCO Emerging Markets Currency	6,280,967,683	26,525,922	-7%		Neutral
PIMCO Investment Grade Corp Bd	6,140,077,044	-68,122,382	-6%	★★★★★	Silver
PIMCO Long-Term Credit	5,418,187,748	320,596,834	N/A	★★★★★	
PIMCO Long Duration Total Return	5,102,999,930	-607,410,078	-14%	★★★★	Bronze
PIMCO StocksPLUS AR Short Strat	4,863,217,355	-763,207,041	-2%		Neutral
PIMCO EMG Intl LowVol RAFI®-PLUS AR	4,422,537,773	-590,005,457	-39%		
PIMCO Long-Term US Government	4,024,348,340	101,086,225	31%	★★★★★	
PIMCO Emerging Markets Bond	3,963,473,915	-174,633,044	32%	★★★★	Silver
PIMCO Wldwd Fdmtl Advtg AR Strat	3,926,065,452	-637,911,175	-43%	★★★	Silver
PIMCO Fundamental Advtg Abs Ret Strat	3,708,870,865	-401,304,785	22%		
PIMCO EM Fdmtl IndexPLUS AR Strat	3,673,935,230	-316,298,468	-52%	★★★★	
PIMCO Fundamental IndexPLUS AR	3,485,021,356	-22,131,794	N/A	★★★★★	Neutral
PIMCO Intl LwVol RAFI®-PLUS AR	3,007,120,273	-326,489,482	-54%		
PIMCO Diversified Inc	2,940,902,855	-1,671,967,409	226%	★★★★	Silver
PIMCO Total Return III	2,730,846,597	306,513,828	-26%	★★★★	
PIMCO Foreign Bond (Unhedged)	2,390,090,443	-25,820,986	-36%	★★★	Bronze
PIMCO Moderate Duration	2,389,679,070	-107,722,863	-17%	★★★★	
PIMCO Global Advantage Strategy Bd	2,355,036,235	127,259,397	-4%	★★★	Bronze
PIMCO Senior Floating Rate	2,109,419,162	-343,611,021	-16%	★★★	
PIMCO Real Estate Real Return Strategy	2,074,283,055	111,624,882	-37%	★★★	

Name	Fund Size (USD)	1-Month Estimated Flow (USD)	12-Month Organic Growth Rate	Morningstar Rating Overall	Morningstar Analyst Rating
PIMCO Total Return II	2,002,627,189	-5,546,515	-53%	★★★★	
PIMCO Intl Fdmtl IdxPLUS® AR Strat	1,966,905,912	-823,007,076	-46%	★★★★★	
PIMCO High Yield Spectrum	1,694,598,618	-490,456,150	-41%	★★★★	Bronze
PIMCO Total Return IV	1,548,184,089	15,151,268	35%	★★★★	
PIMCO Credit Absolute Return	1,524,112,210	407,885,388	N/A	★★★★	
PIMCO EqS Pathfinder	1,522,126,841	-2,083,383	-36%	★★	Neutral
PIMCO EqS® Long/Short	1,403,987,793	-43,706,946	-50%		Neutral
PIMCO Mortgage Opportunities	1,298,047,309	-7,415,927	53%		
PIMCO Small Cap StocksPLUS® AR Strt	1,283,930,569	-96,120,373	-8%	★★★★★	
PIMCO Inflation Response Multi-Asst	1,211,071,968	-26,807,735	2%	★	Neutral
PIMCO StocksPLUS Absolute Return	1,158,770,698	-170,449,652	67%	★★★★★	
PIMCO Floating Income	1,136,871,499	-5,418,937	-20%	★★★	Neutral
PIMCO Global Multi-Asset	1,105,832,123	-53,157,672	-63%	★	Neutral
PIMCO Intl StkPLUS® AR Stra (Unhdgd)	1,033,351,949	-72,817,241	27%	★★★★★	
PIMCO LowVol RAFI®-PLUS AR	986,554,286	-183,413,782	-61%		
PIMCO StocksPLUS	891,005,781	-20,258,849	-19%	★★★★	Neutral
PIMCO Real Return Asset	879,460,948	-32,174,882	28%	★★★★★	
PIMCO Dividend and Income Builder	868,657,346	-169,505,403	39%		
PIMCO GNMA	784,136,524	-43,130,436	-15%	★★★★★	
PIMCO Emerging Markets Corp Bd	776,169,751	-503,546,897	10%	★★★	
PIMCO Global Bond (Unhedged)	748,220,078	-157,501,364	-52%	★★★★	Bronze
PIMCO Intl StksPLUS® AR Strat (USD-Hg)	713,373,970	-4,521,940	11%	★★★★★	
PIMCO StocksPLUS Long Duration	592,520,980	-141,167,231	13%	★★★★★	
PIMCO Municipal Bond	584,299,044	13,425,091	7%	★★★	Bronze
PIMCO Low Duration II	476,376,545	9,629,283	72%	★★★★	
PIMCO Global Bond (USD-Hedged)	470,062,198	-96,429,707	-33%	★★★★★	Bronze
PIMCO Emerg Mkts Full Spectrum Bd	458,074,166	-61,854,996	-5%		
PIMCO Sm Co Fdmtl IdxPLUS® AR Strat	441,745,319	-8,702,290	-30%	★★★★★	
PIMCO Unconstrained Tax Managed Bd	371,601,037	-10,130,991	22%	★★	
PIMCO High Yield Municipal Bond	368,701,424	26,047,958	N/A	★★★	
PIMCO TRENDS Managed Futures Strat	361,795,579	3,888,745	58%	★★★	
PIMCO Extended Duration	345,677,933	-35,519,954	-34%	★★★	
PIMCO Short-Duration Muni Income	266,713,742	-12,902,995	-24%	★★	
PIMCO Low Duration III	233,616,127	-24,220,263	-13%	★★★★	

Name	Fund Size (USD)	1-Month Estimated Flow (USD)	12-Month Organic Growth Rate	Morningstar Rating Overall	Morningstar Analyst Rating
PIMCO CA Sh Dur Municipal Income	226,233,004	7,225,393	11%	★★★★	
PIMCO Convertible	212,033,362	-3,065,229	-35%	★★★★	
PIMCO Mortgage-Backed Securities	209,321,664	-4,976,254	-5%	★★★	
PIMCO EqS® Dividend	166,620,804	-24,064,321	25%		
PIMCO Short Asset Investment	166,448,552	-34,028,565	-73%		
PIMCO NY Municipal	139,963,682	-2,430,756	1%	★★★	
PIMCO RealRetirement 2030	139,072,724	-3,866,730	29%	★	Bronze
PIMCO CA Intermediate Muni Bd	126,427,852	-95,741	-11%	★★★	
PIMCO RealRetirement 2020	121,381,905	-2,702,986	27%	★	Bronze
PIMCO RealRetirement 2040	118,558,515	-3,185,324	28%	★	Bronze
PIMCO EqS® Emerging Markets	110,930,443	-1,323,124	-76%	★★	
PIMCO RealRetirement 2025	99,070,880	-1,287,511	33%	★	Bronze
PIMCO RealRetirement 2035	96,830,416	-2,046,203	41%	★	Bronze
PIMCO RealRetirement 2050	91,556,716	295,135	47%	★	Bronze
PIMCO Tax Managed Real Return	69,009,648	-1,218,567	3%	★	
PIMCO RealRetirement 2045	64,600,008	-1,171,548	66%		Bronze
PIMCO RealRetirement Inc&Distrbtn	62,325,663	-2,284,436	1%	★	Bronze
PIMCO RealRetirement 2015	56,525,722	-4,523,255	9%	★	Bronze
PIMCO National Interm Muni Bond	41,990,246	783,776	78%		
PIMCO Emerging Multi-Asset	32,589,231	-1,814,947	-47%	★★	
PIMCO Real Income 2019	10,317,810	-1,109,839	-43%	★	
PIMCO Real Income 2029	9,723,327	675,876	-24%	★★	
PIMCO CommoditiesPLUS® Short Strat	9,301,850	1,169,215	N/A		
PIMCO Balanced Income	8,630,992	-3,621,752	-55%	★	
PIMCO California Municipal Bond	8,082,723	116,489	21%		

Appendix 2
PIMCO Total Return in Defined Contribution Plans: Outflows Likely in Early 2015

PIMCO Total Return in Defined-Contribution Plans: Outflows Likely in Early 2015

Morningstar Manager Research
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PIMCO Total Return in Defined-Contribution Plans: Outflows Likely in Early 2015

PIMCO Total Return has long been a staple in defined-contribution investment lineups, and thus the recent departure of longtime portfolio manager Bill Gross will impact millions of U.S. retirement-plan investors. Approximately $100 billion of the fund's $220 billion of assets were held in defined-contribution plans as of June 2014, according to Pensions & Investments. That number roughly aligns with Morningstar's post-Gross conversations with PIMCO, that just under one third of the fund's assets were held in defined-contribution plans. Whatever the actual amount, these assets are vulnerable to redemptions.

PIMCO Total Return could bleed defined-contribution assets in two ways: Retirement-plan participants may individually elect to withdraw assets, or retirement-plan sponsors may decide to remove PIMCO Total Return from their plans' investment lineups and map assets to a replacement fund.

Although plan participants can move defined-contribution assets at will within a plan, a couple of factors suggest participant transactions may not be a significant source of outflows for PIMCO Total Return. First, participants, in general, do not visit or trade in their retirement accounts frequently. Gross' departure stunned the investment industry, but in our opinion, the news has not yet made a big enough splash on Main Street to spur a significant number of participants to action.

Second, participants often do not have an option similar to PIMCO Total Return featured on their retirement-plan investment menus. When offered, Total Return typically is the only core/core-plus fixed-income option available in a defined-contribution lineup. More-conservative capital-preservation options, such as a money market or stable-value funds, are commonly available to participants, but those lack the same upside potential. Otherwise, the plan may feature specialty fixed-income strategies like Treasury Inflation-Protected Securities and high-yield bonds, but those investments are not broadly diversified across bond subasset classes. The risk profile of high-yield bonds is more akin to equities than bonds.

Plan Sponsors are PIMCO Total Return's Biggest Threat, but How and When Will They React?

PIMCO's vulnerability to outflows mainly lies with plan sponsors, which could decide to strike PIMCO Total Return from their investment lineups and map participants' assets to a replacement fund. Plan sponsors typically go through a lengthy process before making such a change. For example, when a portfolio manager leaves a fund, plan sponsors may place a fund on watch, or if the turnover is considered to be critical, they may initiate a search for a new holding immediately. Plans often receive direction from an external retirement-plan consultant on which route to take. Retirement plans are often governed by committees that have the ultimate decision-making power over the investment lineup. These overseers typically meet on a quarterly basis, 30 to 60 days following quarter-end. At these meetings, consultants present potential replacement candidates for the fund. In scenarios where a plan sponsor has outsourced discretionary control over assets to an outside party, the replacement process could unfold more quickly.

Given the uncertainty surrounding PIMCO during the past year, including Mohamed El-Erian's departure from the firm in early 2014 and now Gross' departure, it would not be surprising if some plan sponsors and their external consultants had already initiated or completed such a review.

In considering potential replacements for PIMCO Total Return, discussions may focus on which candidates would have a similar degree of flexibility within a core/core-plus mandate. On one hand, PIMCO Total Return is not among the most conservative funds in the intermediate-bond Morningstar Category because of its latitude to adjust its interest-rate exposure and invest in non-U.S. bonds, high yield, and emerging markets. On the other hand, there are a number of well-known funds that may concentrate too heavily on certain parts of the market (mortgages or corporate bonds, for example) to meet consultants' or committees' objectives.

Those discussions can also be expected to touch on issues of organizational stability or governance. In PIMCO's case, one could make the case that the firm is actually more stable now than it was in the year leading up to Gross' departure (although that ultimately remains to be seen). Unfortunately, governance at the PIMCO fund board level has taken a turn for the worse, driving Morningstar's decision to lower the Fund Board component of its Stewardship Grade to D from C. Two independent trustees have left each of two PIMCO fund boards during the past 18 months, leaving both boards below the industry standard for independence. Both boards remain relatively slim given the breadth and complexity of PIMCO funds. That aspect is troubling given the turmoil during the past year, the potential for additional bumps in the road in coming months, and stubbornly high expenses on many of the funds' non-institutional share classes.

Once the plan sponsor narrows down a set of potential replacements, the finalists are usually invited to present their cases. Then the plan sponsor decides the course of action. That process may take one or more meetings of the necessary stakeholders.

If the plan sponsor decides to replace a fund, the sponsor must work with its plan recordkeeper to ensure that the new investment is available on the recordkeeper’s investment platform and that the change doesn’t adversely affect the recordkeeper’s revenue. If a fund is not on a recordkeeper’s platform, a plan sponsor can request that it be added, which could take 30 to 90 days. The timing depends on whether or not the recordkeeper already has contracts in place with the new fund’s parent company. In revenue-sharing cases where the fees collected through a fund’s expense ratio are shared with the recordkeeper to defray costs, a plan sponsor must confirm that the replacement fund will similarly cover those costs, adding an additional step to the process. Finally, the recordkeeper must notify participants--usually at least 30 days in advance--of the upcoming investment change.

In the case of PIMCO Total Return, a plan sponsor may take immediate action or apply a wait-and-see approach. If the plan acts quickly on the news, calling an emergency meeting and selecting a replacement fund that is already available on its recordkeeper’s platform, PIMCO Total Return could begin to see retirement-plan outflows in early to mid-November. If the plan sponsor decided to discuss PIMCO Total Return and any possible actions at its next regular quarterly meeting, which would likely take place between late October and early December, any resulting asset outflows would likely occur between December and the first few months of 2015.

If a plan sponsor places the fund on watch, PIMCO's fate will likely hinge on short-term performance and manager retention. Subpar results or additional departures in the coming year could shake investors' confidence, causing more plan sponsors to replace the fund. Based on these scenarios, expect the bulk of immediate defined-contribution outflows to take place in 2015's first quarter. That said, PIMCO Total Return could be vulnerable to outflows throughout 2015 and into early 2016.

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Appendix 3
PIMCO Stewardship Grade

PIMCO

The year 2014 is proving to be among PIMCO's most eventful.

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Stewardship Grade Scorecard PIMCO

Corporate Culture:	**C**
Fund Board Quality:	**D**
Manager Incentives:	**C**
Fees:	**C**
Regulatory History:	**Neutral**
Overall Stewardship Grade:	**C**

PIMCO Stewardship Grade -- C

Summary

PIMCO's new normal, without founder and former chief investment officer William H. Gross, hinges on deft leadership from a relatively new multi-chief investment officer structure. Daniel Ivascyn, who was promoted to group CIO in September 2014 upon Gross' departure for competitor Janus JNS, is also leading the investment committee that shapes portfolios for the firm's fixed-income and multiasset funds. The firm named six deputy CIOs in 2014's first quarter after then-CEO and co-CIO Mohamed El-Erian unexpectedly announced his departure. The CIOs oversee broad swaths of the firm's investment operations. These changes to PIMCO's leadership and investment processes are significant, but the firm remains a leading global fixed-income manager with broad, deep resources.

PIMCO undoubtedly will face further redemptions that may further unsettle its staff and, in turn, investment returns. (Flagship PIMCO Total Return PTTRX was in net outflows for the 16 months prior to Gross' departure.) Other threats include high expenses on many noninstitutional share classes and an SEC investigation into securities pricing in the exchange-traded fund version of the Total Return strategy. Plus, there are only three independent directors overseeing the funds--too few voices representing fundholders.

These risks are not insurmountable, but they warrant caution and a continued Parent rating of Neutral.

Corporate Culture -- C

PIMCO's corporate culture will undoubtedly change now that founder and chief investment officer William H. Gross has departed. While the firm's success had a lot to do with the intense culture Gross created and oversaw, many strains had emerged in the past few years, diminishing PIMCO's corporate culture. Now that Gross has left abruptly for Janus JNS, new leaders and the deep well-resourced team will have to step up and create a workable environment that isn't centered so much around a single leader.

Daniel Ivascyn, previously a deputy CIO and 2013 Morningstar Fixed-Income Fund Manager of the Year for his charge PIMCO Income PIMIX, has replaced Gross as group CIO overseeing a new multiple-CIO structure. He now works with the firm's five new CIOs to shape investment policy and oversee the managers of the firm's strategies. This team of six, which also includes Mark Kiesel, Mihir Worah, Andrew Balls, Scott Mather, and Virginie Maisonneuve, was formed in 2014's first quarter after CEO and co-CIO Mohamed El-Erian unexpectedly left the firm.

Two top leadership-level departures in less than six months will test this relatively new structure.

In the years leading up to El-Erian and Gross' departures, the firm had experienced a number of other changes in its senior investment leadership. Two under-the-radar departures occurred in 2008 and 2009, for example, when Pasi Hamalainen retired and Zhu Changhong was recruited by the Chinese government to run its then-$2.5 trillion in foreign-exchange reserves, respectively. Neither Hamalainen nor Zhu's name was attached to high-profile mutual funds, but each had been a member of PIMCO's investment committee (then an even-smaller, more exclusive group than it has since become) and had been widely considered to be a valuable contributor to the firm's investment strength in his own right. Veteran generalist manager Bill Powers left the firm in 2010, and, although his focus on institutional accounts meant he wasn't well known to mutual fund investors either, he, too, had been a very senior member of the Investment Committee. Another former member of that group, Paul McCulley, held tremendous responsibility as a watcher-in-chief of the world's central banks, leader of the firm's cyclical economic forums, and head of PIMCO's short-term bond desk before he retired at the end of 2010. (McCulley returned to PIMCO in the months following El-Erian's departure and remains an economic advisor.) There were other notable departures of successful managers over the same years, including those of high-yield desk leaders Ray Kennedy (2007) and Mark Hudoff (2009), Treasury Inflation-Protected Securities luminary John Brynjolfsson (2008), global-bond specialist Sudi Mariappa (2011), and government-mortgage maven Scott Simon (2013).

The last very senior-level member of the Investment Committee other than El-Erian and Gross, long-tenured PIMCO veteran Chris Dialynas, made a November 2013 announcement that he would be taking a sabbatical beginning in early 2014. He is expected to return during the fourth quarter of 2014.

Morningstar had weighed the potential impact of each departure over the past six-plus years. And while some were more worrisome than others, PIMCO has always had a deep-enough bench to withstand the changes; that confidence in its staffing has historically proved to be well placed.

El-Erian's departure was clearly a game changer for several reasons, though. Most obviously, he was Gross' hand-picked and named successor, suggesting that he would likely take over as sole chief investment officer whenever Gross was to step down. Furthermore, his departure, coupled with the uncertainty surrounding Dialynas' return, meant that no single remaining member of the Investment Committee had the kind of senior-statesman profile of those who had departed in recent years. Meanwhile, El-Erian protege Marc Seidner, who had taken on increasingly greater responsibilities during his tenure at the firm, announced his own departure from PIMCO immediately after El-Erian's was made public.

Gross' subsequent departure, however, suggests his leadership did not go unchecked following El-Erian's exit. To be sure, the firm's investment professionals are some of the industry's brightest and best. The firm boasts more than 200 people in portfolio management roles around the globe, and among them at least 70 considered key contributors with a median average of roughly 17 years of experience. In addition, PIMCO's demonstrated history of picking leaders to fill in for those who have moved on suggests the firm has proved to have an uncanny ability to thrive in the wake of key personnel losses. In addition to moving to the co-CIO structure in 2014, PIMCO effectively filled in for Paul McCulley in 2010 with expanded roles for central-banking maven Tony Crescenzi and Saumil Parikh.

That new blood brings much more than fancy new titles to the table, and each member of the Investment Committee brings a resume of impressive accomplishments. Like Parikh's, Crescenzi's name became more well-known following McCulley's retirement, and he already had more than 30 years of experience and five books under his belt. Worah essentially built the firm's successful real assets strategies and team, with impressive results from PIMCO Real Return PRRIX and other inflation-protected offerings. Balls' reputation has revolved a great deal around his knowledge of and experience with global economics, while Mather has shone with excellent performance records at several, mostly global-bond-focused portfolios. Meanwhile, Mark Kiesel and Dan Ivascyn have each taken home a Morningstar Fund Manager of the Year Award: Kiesel for his work on PIMCO Investment Grade Corporate Bond PIGIX in 2012 and Ivascyn for his work on PIMCO Income in 2013 with comanager Alfred Murata.

It remains to be seen whether these managers together can smoothly steer PIMCO's massive asset base without Gross. Arguably, the firm's culture may be improved without Gross' at-times severe and reputed retaliatory temperament. But the firm's atmosphere has long been characterized as a pressure cooker, and any change to a firm's investment culture potentially upsets the mojo that made it successful in the first place. Remove the firm's founder and thought leader, and that risk could escalate. If other leaders jump ship, it would add to the strain.

Another complicating factor is outflows from PIMCO's investment strategies. The firm's flagship Total Return fund has faced 16 straight months of outflows. One way to view those outflows is as a vote against Gross and the turmoil at PIMCO, but it's safe to assume that PIMCO's investor base--individuals, advisors, retirement plans, and institutions--will be re-examining its holdings in the coming months and not all will stick around. That scrutiny will be time-consuming and potentially distracting for PIMCO, and it may ultimately lead to earnings pressure on the firm and its parent company, Allianz AZSEY, that could result in a smaller staff or higher fund fees.

Those risks are significant but not insurmountable. The firm has strong and capable corporate leaders in the form of CEO Doug Hodge and president Jay Jacobs. Ivascyn, the new CIO, has been on the ascent at PIMCO for years and was largely viewed as the insiders' choice for the firm's next investment leader. He and the deputy CIOs have been leading committee meetings on a rotating basis since early 2014, and each has been overseeing several portfolio managers and, by extension, all of the specialist desks and the assets for which each skipper is responsible. (Most of these personnel management duties had previously fallen on El-Erian.) Those developments arguably lessen the impact of Gross' departure.

It's crucial to note that PIMCO's essential investment process remains at the core of everything the firm does. The tone was set early on by Gross, who favored a total-return approach to bond investing, which has since become de rigueur but that was novel as recently as the early 1990s. Those investing with Gross have often found themselves looking at comparatively modest income payouts but total returns that have almost always been much better than average.

Although the complexity of PIMCO's strategies, tactics, and favored investing tools often lends an aggressive flavor, a fierce attention to risk is built into the firm's investment and operational processes. The workings of PIMCO's Investment Committee illustrate the relationship between its approaches to performance and risk control. The committee typically meets four times per week, for hours at a time, to debate matters of the market and economics. Other colleagues are invited to come to present ideas, while some rotate through for stints on the committee in order to encourage a diversity of views. PIMCO outsiders are also brought in to make presentations, and managers are given incentives to second-guess the Investment Committee.

One risk that the firm has addressed is liquidity. Total Return has easily met redemptions thus far because it traditionally focused plenty of fund assets in very, very liquid securities, including Treasuries, agency-backed mortgages, and even cash. Between bond interest payments, mortgage principal flows, bond maturities, and calls, so much cash comes in every day that meeting even the sizable redemptions from 2013 was a relatively easy exercise. (Total Return's fund assets shrunk by 17% in the 12 months through August 2014.) As such, Total Return fundholders should not be overly concerned that the fund will be compromised in its ability to meet near-term redemptions.

There are, of course, plenty of other issues relevant to PIMCO's culture. The firm has been more prolific in its rollout of new funds in the past few years, for example, and, despite its very anemic record with new equity-focused offerings in particular, the deliberate style with which the firm has done so has been, and continues to be, indicative of a mostly investor-friendly culture. PIMCO does not have a record of rolling out niche funds simply to take advantage of popular trends. Rather, most have been driven by ideas and developments in institutional management or, in some cases, developments in financial markets that have made one strategy or another newly feasible.

Morningstar continues to harbor some concern about size. Even in the wake of recent redemptions, PIMCO Total Return still comprised more than $220 billion in investor assets as of the end of August 2014 and remains the world's largest actively managed mutual fund. Gross had said that Total Return’s girth makes managing it more challenging, but it has been among the largest bond funds in existence for a long, long time, and its long-term risk-adjusted record has remained strong. The firm’s ability to build on that record under its new managers Scott Mather, Mark Kiesel, and Mihir Worah will likely depend on whether it can retain command of big-picture macroeconomic and sector themes that had been at the root of that success under Gross.

Even at its reduced asset base, however, the impact of Total Return's size remains a question that Morningstar continues to study and examine.

In the meantime, there are other in-house examples of PIMCO funds whose size does raise even stronger questions about the firm's unwillingness to close large funds. Even with a smaller portfolio than it boasted a couple of years ago, PIMCO High Yield PHIYX, with more than $11 billion in assets as of September 2014, is the second-largest chunk of fund assets in the category if combined with $2.1 billion sibling PIMCO High Yield Spectrum PHSAX, and PIMCO manages additional high-yield assets in other funds and institutional accounts. Unlike Total Return, whose fortunes are more tied to macroeconomic and sector calls, these two funds are arguably much more dependent on bottom-up research and bond-picking--the kind that becomes more and more difficult to execute at a high level when a fund's size minimizes the impact of the smaller deals that dominate the at-times illiquid high-yield sector. On a somewhat different note, PIMCO All Asset PAAIX and PIMCO All Asset All Authority PAUIX, both led by Rob Arnott, are the biggest single investor in a number of underlying PIMCO funds, exposing those funds' other investors to the risk of substantial or sudden inflows or outflows. The question for such funds is whether PIMCO sacrifices the interests of existing shareholders in favor of its own growth of assets under management.

If there is one element of the size question that does give reason for pause, though, it's the question of what might happen should PIMCO's overall business shrink, whether as a result of a loss of confidence in the firm or even simply a trend of investor rotation away from the fixed-income markets that dominate its business. That's a much more difficult puzzle to assemble given the many possible paths the situation could take and the variety of potential responses from the leadership of PIMCO or even Allianz. It's a near certainty, however, that a sustained reduction in the firm's assets under management could trigger staff reductions and potentially make it much more difficult to retain talent. It's another element of the story that Morningstar will certainly continue to monitor.

Arguably just as important to PIMCO's Corporate Culture grade is the cost picture for investors in PIMCO's noninstitutional share classes in particular. Several are priced high relative to similarly structured peers and sometimes emphatically so relative to the economies of scale that the firm enjoys. It's difficult to pin down why this issue has failed to gain more attention within PIMCO or the funds' boards, but it may catch on if investors are not as willing to pay the higher fees, especially without Gross at the helm.

Other PIMCO representatives have offered that the world-class caliber of its management is ample justification for its fees. There is some merit to that argument, but PIMCO's noninstitutional share classes sometimes carry fees that are simply too high to recommend, no matter how good the management. And even then, while the funds' institutional shares are competitive on a relative basis with their various cohorts, they tend to lack fee breakpoints--Total Return is a glaring example--and charge a lot more than one might expect given their size. Of all the funds in the marketplace, this enormous portfolio should by all rights boast a truly low expense ratio in its peer group. And that's really the ultimate issue, especially for a fund group that has some of the best economies of scale of any in the world.

There's no question that PIMCO's overall culture and what it has produced for investors deserve significant recognition. On some levels, this firm still approaches or achieves best-in-class status. The aforementioned cost and asset size issues, however, have been enough to keep it from earning Morningstar's highest grade for some time. And despite all of the reasons for optimism, there is a heightened level of uncertainty in the post-Gross era surrounding the questions of whether PIMCO's latest senior staffing transitions will prove beneficial to investors; whether recent and future senior-level departures indicate a persistent side effect of the firm's pressure-cooker culture; whether that culture will improve under new leadership; and even whether the prospect of rockier bond markets or anemic performance could cause the temperature to rise even further. Those areas of uncertainty, combined with the aforementioned cost and size issues, cause us to maintain PIMCO's Corporate Culture grade at C.

Fund Board Quality -- D

A mutual fund board's sole purpose is to act as an advocate for fundholders, helping to ensure they are treated fairly and honorably. Only mutual fund directors have a seat at the negotiating table when it comes to hiring mutual fund advisors and setting fees, for example. Most boards of directors take their responsibility seriously, but those that stand out have established a track record of independence and shareholder-friendly practices.

For the purposes of governance, PIMCO's open-end funds are divided into two groups. The PIMCO Equity Series Trust includes three of the firm's international-equity offerings, one alternative offering, and three allocation funds. The PIMCO Funds Trust encompasses the firm’s other, nearly 90 open-end funds. (There are also two separate Variable Insurance Trusts and an ETF Trust.) All told, PIMCO offers more than 160 funds among its five trusts.

When there is turmoil at a fund company, it is especially important to have an effective board in place. Yet the PIMCO boards themselves are in some turmoil. Continued disruption among PIMCO’s independent trustees raises significant concern about the board’s independence as well as its long-established setup. More specifically, two of the PIMCO Funds Trust’s five independent trustees, William Popejoy and Vern Curtis, recently left the board (as well as the Variable Insurance Trusts and ETF Trust), leaving its composition at just three independent trustees and two interested trustees and at just 60% independent. This level falls short of industry norms; most fund boards are at least 75% independent.

These unexplained departures come in the wake of losses on the newer PIMCO Equity Trust, which also lost two independent trustees in mid-2013, including Davis, who stepped down in June 2013, and Allan Hubbard, who left in mid-August 2013. These seats had not been refilled as of August 2014. Those changes left the equity board with just three members, including interested chairman Brent Harris, who also chairs the PIMCO Funds Trust.

Although PIMCO says that board is seeking trustee replacements, most board members report it can take easily more than a year or even two to come fully up to speed as a new director. That learning curve at PIMCO seems particularly steep considering the firm's large fund lineup and complex portfolios.

These partings highlight the smallness of PIMCO's boards and--especially combined with the complexity apparent at PIMCO--argue for a larger board that can withstand change and provide fundholders with a deeper level of expertise, particularly as the firm moves into newer areas for it, including equities, ETFs, and alternatives.

It's also concerning to see the funds' boards shrink during a time of change and stress for the fund company. Bill Gross' sudden departure has implications for the firm and its funds. Although Mohamed El-Erian's exit in March 2014 caused PIMCO to address and plan for Gross' eventual succession, the firm has still lost one of the savviest fixed-income investors out there. And while the board's job is to oversee the funds' operations and not to manage the firm on a day-to-day basis, the board may be in for more of a test, as Gross' departure, as well as what is likely to be a more challenging interest-rate environment, could have implications for performance and fund flows.

Another elusive issue that falls under the board's domain is the way in which PIMCO accounts for and reports the expenses of its funds. In essence, the firm breaks down the bulk of its funds' costs into the two large line items of "investment advisory fees" and "supervisory and administrative fees." What's especially noteworthy about that construct is the parity between those two line items. The firm's flagship Total Return fund places the issue into sharp focus.

For the fiscal year ended March 2014, Total Return's advisory fees totaled more than $641 million, while its supervisory and administrative fees clocked in at $608 million. The proximity of those numbers is perplexing simply because the first number should represent what shareholders are paying for the expert, value-added services of an active money manager, while the second should account for the relatively commodified costs that are otherwise associated with operating a fund and servicing shareholder accounts. Even if one were to argue that some providers of "supervisory and administrative" services warrant more compensation than others, it doesn't make sense that the true cost of servicing one of the best-run mutual funds in the history of the business is anywhere remotely close to the fair value of its investment advisory services. Ultimately, though, it's a matter of transparency and allowing shareholders to understand whether the board is doing enough to make sure that investors aren't overpaying for commodified services, and while the annual report does describe what kinds of expenses are included in the "supervisory and administrative fees" line item, it does not break down those costs, as other competitors do.

That said, PIMCO and the board both argue that investors should look past the technical nature of these breakdowns and simply evaluate fund costs as they appear in total. That's not an entirely problematic suggestion for the firm's institutional share classes, whose price tags are generally reasonable. But it doesn't quite address the issue with regard to many of the firm's other share classes, which carry fairly high total expense ratios. By and large, fees for PIMCO some of the share classes sold through advisors or directly to investors (as opposed to institutional classes) are not competitive. PIMCO argues that the high returns generally produced by management justify the premium prices charged by PIMCO funds. The firm's assets under management and the funds overseen by this board have grown tremendously, though, and even despite recent outflows, have significant scale. Several remain among the largest in their respective categories.

The ultimate problem, however, is that it really doesn't, and shouldn't, matter how PIMCO would like to position its fund costs. It's up to the funds' board to oversee such issues in a way that best serves shareholders. The opacity of these data, combined with its girth, suggests that the board has not done all that it can to aggressively negotiate for better economies of scale or to at least help investors better understand why the fees they pay are appropriate. That includes not only making sure that cost data are transparent but also that shareholders are getting the best deal possible for the services that are being provided.

These long-standing issues surrounding fee disclosure and economies of scale--PIMCO Total Return doesn't have any management-fee breakpoints, for example--combined with newer concerns about the disruption to the funds' boards and their independence are enough to consider the current quality of the boards inferior and thus earn PIMCO a lowered Board Quality grade of D.

Fund Manager Incentives -- C

Portfolio managers who invest alongside their fundholders not only show a conviction in their investment approach and portfolios but also are better able to share in a true fundholder experience as they endure the same tax and cost consequences as their shareholders. Further, Morningstar's research has found that portfolio managers who invest significantly in their funds simply perform better on average, particularly on a risk-adjusted basis. For these reasons, Morningstar's Manager Incentives grade is determined primarily by how heavily and predominantly a fund family's managers own the funds they oversee. Specifically, Morningstar considers what percentage of assets are in funds in which at least one portfolio manager has at least $1 million invested (the highest ownership range reported to the SEC).

PIMCO's Manager Incentives score has been carried largely by the manager-ownership level in PIMCO Total Return, which today comprises roughly 40% of the fund company's open-end mutual fund assets even after significant redemptions from that offering. Bill Gross had long maintained a more-than-$1 million investment in the fund.

With Gross' investment out of the Manager Incentives calculation and without a significant investment from PIMCO Total Return's new management team, which includes lead manager Scott Mather, Mark Kiesel, and Mihir Worah, PIMCO's portfolio managers' financial alignment with their fundholders would look very weak overall. The level of assets in funds in which at least one manager has more than $1 million invested would drop to less than 20% of total firm assets. In part, Mohamed El-Erian's departure from the firm in early 2014 brought the firm's Manager Incentives grade to a C from a B. Gross' departure could work to lower the grade further.

Morningstar is maintaining PIMCO's Manager Incentives grade at a C for now, because it's likely at least one of the portfolio managers will have (or already has) a significant investment in the firm's flagship fund. However, investors should expect the investment and disclosure to come sooner rather than later and should monitor any communication from PIMCO in the coming days and weeks.

Meanwhile, PIMCO otherwise has work to do on the manager-ownership front. New group CIO Dan Ivascyn's investment in one of his charges, PIMCO Income, recently moved to the more-than-$1 million mark, and Worah, who also remains a deputy CIO and head of global multiasset and real return investments, has shown conviction in his investment processes, with a cumulative investment in the range of $850,000 to more than $2.5 million in the six offerings he oversees. However, other senior investment leaders should do more to align their financial interests with fundholders'. Kiesel, who is a deputy CIO and leads PIMCO's corporate investing efforts, has less than $20,000 collectively in his three charges, while Mather, deputy CIO and member of PIMCO's investment committee, is not invested in his four other funds.

To some extent, a smaller manager investment may be expected at a predominantly fixed-income shop. It's not unreasonable to expect limited investment in municipal-bond funds, for example, or other narrowly focused fixed-income funds. Nonetheless, too many of PIMCO's funds, representing about 30% of assets, have no manager investment at all, though those include several previously headed by Gross that will now pass to new managers, as well as other funds that had previously been assigned to El-Erian. It would be encouraging to see a broader representation of PIMCO managers with a substantive level of investment in their funds as a sign of conviction in those strategies and their fee structures.

Morningstar also considers a firm's manager-compensation plan in its manager-incentives assessment and may factor in particularly strong or deficient characteristics of such setups. PIMCO's plan, however, neither boosts nor detracts from its Manager Incentives score.
As is common in the fund industry, PIMCO's manager compensation can be broken down into three pieces: base salary, a bonus, and equity or long-term incentive compensation. Although a series of positive factors may be considered when determining managers' earnings, they may also receive compensation tied to the performance of the firm, which can be seen as a potential conflict of interest, insofar as the interests of firm stockholders and fund shareholders may be misaligned. Furthermore, compensation for portfolio managers can also be linked to the amount and nature of assets managed by the portfolio manager, which can act as incentive for managers to take shortcuts to chase performance or overgrow assets.

PIMCO's compensation plan can also be linked to performance, which is a plus for shareholders. Specifically, it's based on one-, two-, and three-year dollar- and account-weighted pretax investment performance versus predetermined appropriate benchmarks. That said, a compensation structure that stresses longer-term investment performance would better align managements' interests well with those of fund shareholders, and Morningstar notes a trend toward including five-year results in portfolio-manager bonus schemes. On the whole, PIMCO's manager-compensation structure has its pluses, but its potential focus on size of assets and short-term performance are notable shortcomings.

Fees -- C

Morningstar calculates a fund family's Fees grade based on the average Morningstar Fee Level percentile for all the family's funds. These percentiles compare each fund share class with similar share classes of funds in the same fee-level group, ranging from 1 (for the cheapest funds in each group) to 100 (for the most expensive). To find a family's overall fee-level percentile, Morningstar takes the straight average of the fee-level percentiles for all the funds in the family, counting each share class separately.

Morningstar's research indicates that a fund's price tag is among the best predictors of its future relative performance. Funds with below-average price tags are likely to outperform typical rivals; those with above-average expense ratios are more likely to underperform.

PIMCO's Average Fee Level is 48 and thus earns the firm a C for Fees overall. The firm has a fairly even distribution of share-class fee levels, with roughly 20% of share classes populating each of Morningstar's five groupings--Low, Below Average, Average, Above Average, and High.

For the most part, PIMCO's institutional share class expense ratios are low or below average; however, they require a $1 million minimum investment, though investors may find them in their 401(k) plans. Many of PIMCO's A share classes are also low or below average. In many cases, the Institutional and A share classes together represent each fund's largest portion of assets, so PIMCO is giving the majority of its fundholders a good deal, relative to competitors.

Meanwhile, PIMCO's "PLUS" series of funds, such as its StocksPLUS funds, tend to run with expense ratios that are Low or Below Average (though even there, there are some more-expensive vehicles). These funds are essentially index funds backed by actively managed collateral, so it stands to reason that they would be cheaper than their category peers. Also, PIMCO's small suite of fairly young equity funds is competitively priced, as PIMCO looks to break into the crowded field of active-equity managers.

However, the firm's no-load D shares tend to be Above Average or High. Furthermore, the firm's target-date series, which, granted, is quite small, is not competitively priced compared with other target-date series.

Of particular note, though, is the curious case of PIMCO Total Return, the industry's second-largest fund with more than $220 billion in assets as of the end of August 2014. As suggested above, that fund's Institutional and A share classes both carry Below Average expense ratios; its other share classes, though, are Average to High. However, a fund so large might have further economies of scale to pass on to fundholders of all share classes. There appear to be no management-fee breakpoints, according to the fund's most recent Statement of Additional Information. At the fund's level of assets, such breakpoints could have a meaningful impact on its expense ratio.

Regulatory History -- Neutral

Because investors should expect fund companies to comply with laws and regulations, the highest Regulatory History rating a firm can receive is Neutral. PIMCO confirmed in September 2014 that the Securities and Exchange Commission is investigating securities pricing within the exchange-traded fund version of its Total Return strategy. The findings of the investigation have not yet been made public, and firm has not been accused of wrongdoing, so it gets full credit for Regulatory History.