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Strategy Review

# City of Cincinnati

February 5, 2009

**Three-time Morningstar® Fixed-Income Fund Manager of the Year (2007, 2000, 1998)**

PIMCO

# Biographical Information

### Sapna Shah, CFA

Ms. Shah is an account manager in the Newport Beach office with a focus on institutional client servicing. Prior to joining PIMCO in 2007, she was with the equity research group of JPMorgan Asset Management as well as the finance department of SKS Microfinance. She has four years of investment experience and holds an MBA from the Wharton School of the University of Pennsylvania as well as an undergraduate degree from the University of Chicago.

### Susie Wilson

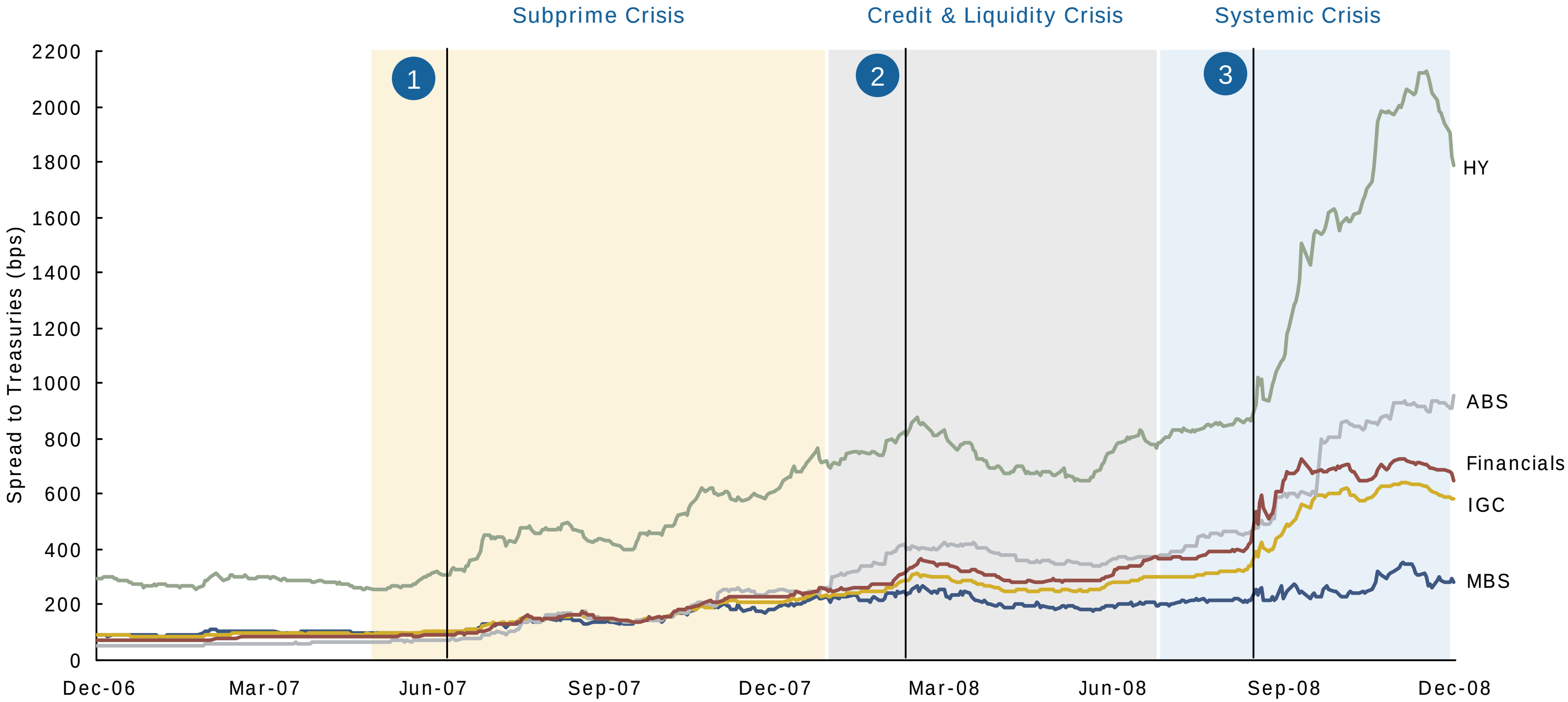
Ms. Wilson is an executive vice president and an account manager in the Newport Beach office focusing on client service. Prior to joining PIMCO in 1999, she was with the Frank Russell Company for 12 years as a senior research analyst, responsible for researching, evaluating, and formulating Russell rankings on bond managers. She also recommended fixed-income asset class structure, managers, and guidelines to institutional clients and Russell's internal funds. She has 21 years of investment experience and holds an undergraduate degree from University of Puget Sound.

# Agenda

# Market Deleveraging Impacted All Sectors, as Contagion Spread

As of December 31, 2008

- Spreads and subsequent prices difficult to assess given bankruptcies, bailouts, and takeovers, leading to a virtual halt in trading
- Financials were worst performing area of investment grade market, as worldwide banking system seized up following Lehman collapse
- Fannie/Freddie conservatorship returned some stability to MBS, which had positive returns and was one of the best performing sectors for the quarter and year




SOURCE: Barclays Capital
Spreads for MBS, Investment Grade Corporate, ABS, HY, and Financials are nominal spreads over Treasuries. MBS spreads are represented by the Barclays Capital Agency Fixed Rate MBS Index; Investment Grade Corporate spreads are represented by Barclays Capital U.S. Corporate Investment Grade Index; ABS spreads are represented by the Barclays Capital Asset-Backed Securities Index; Financials spreads are represented by the Barclays Capital Investment Grade: Financial Institutions Index. HY Spreads are represented by the Barclays Capital U.S. Corporate High Yield Index.

[1] Bear Stearns hedge funds implode
[2] Bear Stearns takeover
[3] Lehman Brothers bankruptcy



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# 2008: What We Got Right and What We Got Wrong

## What We Got Right

### Lower Interest Rates

- Central Banks lowered rates, as inflation fears gave way to fighting recessions
- Portfolios were positioned for lower rates and steeper yield curves

### Housing and Agency MBS

- House prices continue to decline, consistent with PIMCO's outlook
- Portfolios overweighted agency MBS while avoiding subprime and riskier ABS
- Agency MBS were the best performing spread sector in 2008

### High Quality Bias

- Credit and high yield premiums spiked to record yield spreads as the crisis accelerated
- Portfolios substantially underweighted credit entering the crisis

## What We Got Wrong

### Liquidity Premium for LIBOR

- Systemic shock of Lehman bankruptcy sent LIBOR rates skyrocketing
- Implementation of interest rate strategies via swaps magnified effects of the dislocation

### Cash-equivalent Non-agency MBS

- Senior bonds suffered severe liquidity impairments during 4Q, as deleveraging drove prices down
- Portfolios holding these securities felt mark-to-market losses, even as top tranches continued to pay down principal

### Early Financial Sector Exposure

- Investment banks appeared to have implicit governmental support following the Bear Stearns rescue
- Uneven policy responses negatively impacted sector and portfolio holdings
- By year end, coordinated policy response stabilized and modestly improved holdings

# With Treasuries Rally Ending, Active Sector/Security Selection Is Key

As of December 31, 2008

- 2008 marked historic rally in Treasuries, which dominated benchmark returns

Barclays Capital Total Return 2008

| | U.S. Aggregate | BCAG Sector Returns | | |
|---|---|---|---|---|
| | | Treasuries | Corporates | Mortgages |
| YTD Total Return | 5.24% | 11.91% | -4.94% | 4.64% |

- Following tremendous Treasury rally, yield at year end was just over 2%

As of December 31, 2008

| | MV % | YTM |
|---|---|---|
| U.S. Aggregate | 100.00% | 4.04% |
| Treasuries | 38.61% | 2.06% |
| *U.S. Treasury* | *25.07%* | *1.60%* |
| *Government Related* | *13.54%* | *2.91%* |
| Corporates | 17.67% | 7.57% |
| Mortgages | 43.72% | 4.37% |

- Opportunities for attractive yields exist in corporates and mortgages
- While sector and out-of-benchmark opportunities are present, risks must be balanced

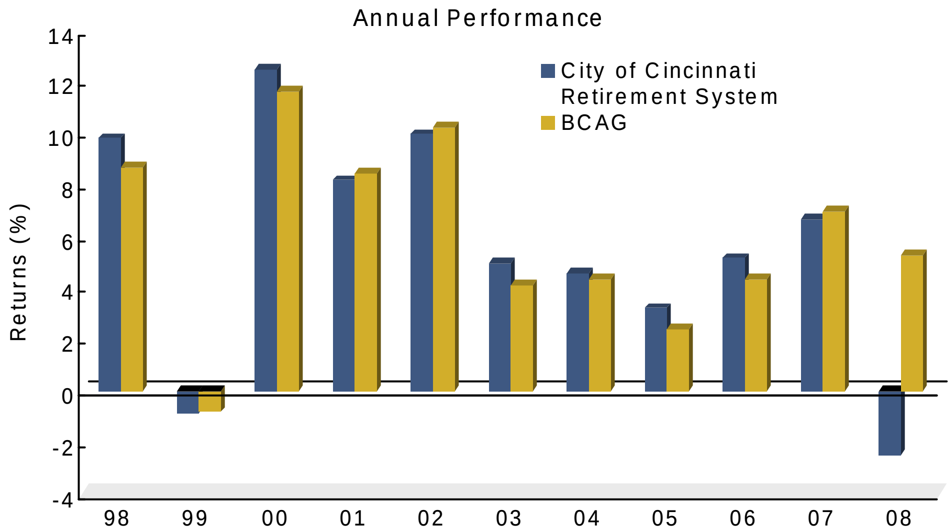
**Active decisions on sector allocation and security selection are vital to capture yield and avoid overvalued assets**

Refer to Appendix for additional index information.

# Unprecedented Market Volatility, Driven by Deleveraging, Disrupted Performance

As of December 31, 2008

| City of Cincinnati Retirement System | |
|---|---|
| Market Value as of Dec. 2008 | $137,289,742 |
| Net Cash Flows 2008 | -$77,231,260 |



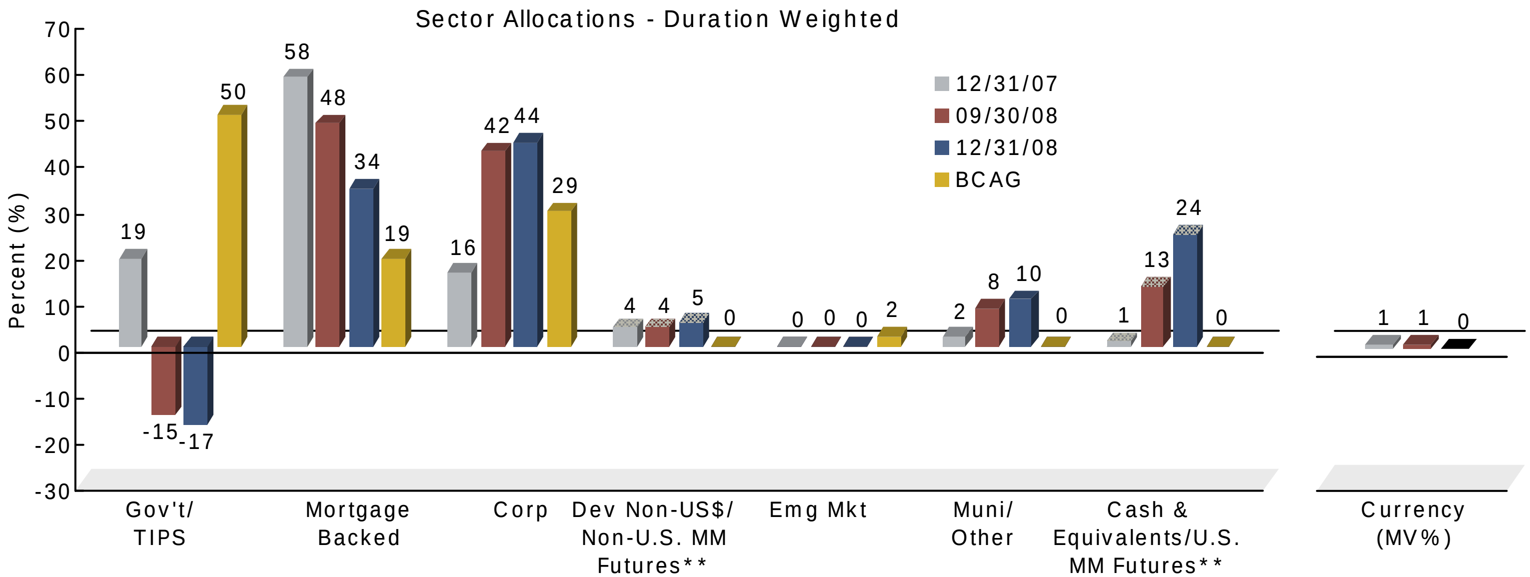

| | Since Inception 12/31/95 | 10 Yrs. | 5 Yrs. | 3 Yrs. | 1 Yr. | 6 Mos. | 3 Mos. |
|---|---|---|---|---|---|---|---|
| Before Fees (%) | 5.8 | 5.1 | 3.4 | 3.0 | -2.5 | -3.5 | 2.4 |
| Barclays Capital U.S. Aggregate Index (%) | 6.0 | 5.6 | 4.7 | 5.5 | 5.2 | 4.1 | 4.6 |

All periods longer than one year are annualized.

# Portfolio Retains High Quality Bias Across Asset Classes

City of Cincinnati Retirement System

| Characteristics | | 12/31/07 | 09/30/08 | 12/31/08 |
|---|---|---|---|---|
| Effective Duration (yrs.) | Portfolio | 4.1 | 4.2 | 4.0 |
| | Index | 4.4 | 4.5 | 3.7 |
| Total Curve Duration* | | 0.1 | 1.2 | 1.4 |
| Average Portfolio Quality | | AA+ | AAA | AA |




* Measures a portfolio's price sensitivity relative to the benchmark to changes in the slope of the yield curve, measured between the 2-30 year Government yields, holding the 10 year yield constant. For every 1 basis point of steepening (flattening), a portfolio with curve duration of 1 year will rise (fall) in price by 1 basis point relative to the benchmark.

** Boxed portion represents Money Market Futures



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# Best Case for Aggressive Policy Response is Traction by 2010

As of December 31, 2008

2009

- Severe U.S. recession & worldwide downturn
- Rising unemployment and consumer pullback
- No inflation

Clarity of Policy Response

- U.S. uses its balance sheet to buy assets and reflate economy
- Financial system begins to heal

**U.S.**

- Massive problems / massive response
  - Nationalization / mergers
  - Troubled Asset Relief Program (TARP)
  - Direct mortgage and ABS purchases
  - Fed funds rate effectively zero
  - Massive fiscal stimulus

**Global**

- Underlying problems / swift policy response
  - Nationalization / mergers
  - Liquidity facilities
  - Expanded collateral
  - Aggressive rate cuts
  - Fiscal stimulus in emerging markets

SOURCE: Bloomberg, PIMCO

# Recessionary Economies and Tame Inflation Likely to Prevail in 2009

As of December 31, 2008

| | GDP | | Inflation* | |
|---|---|---|---|---|
| | Actual | Forecast** | Actual | Forecast** |
| U.S. | 0.7% | -2.25% – -1.75% | 2.1% | 0.5% – 1.0% |
| Euro | 0.7% | -1.0% – -0.5% | 2.1% | 1.25% – 1.75% |
| U.K. | 0.3% | -2.0% – -1.25% | 4.1% | 1.0% – 1.5% |
| Japan | -0.5% | -1.75% – -1.25% | 1.9% | -0.75% – -0.25% |
| China | 9.0% | 8.75% – 9.25% | 2.4% | 1.75% – 2.25% |

While 2009 economic headlines will likely disappoint,
the solvency and liquidity of the financial system should improve

SOURCE: Bloomberg, PIMCO

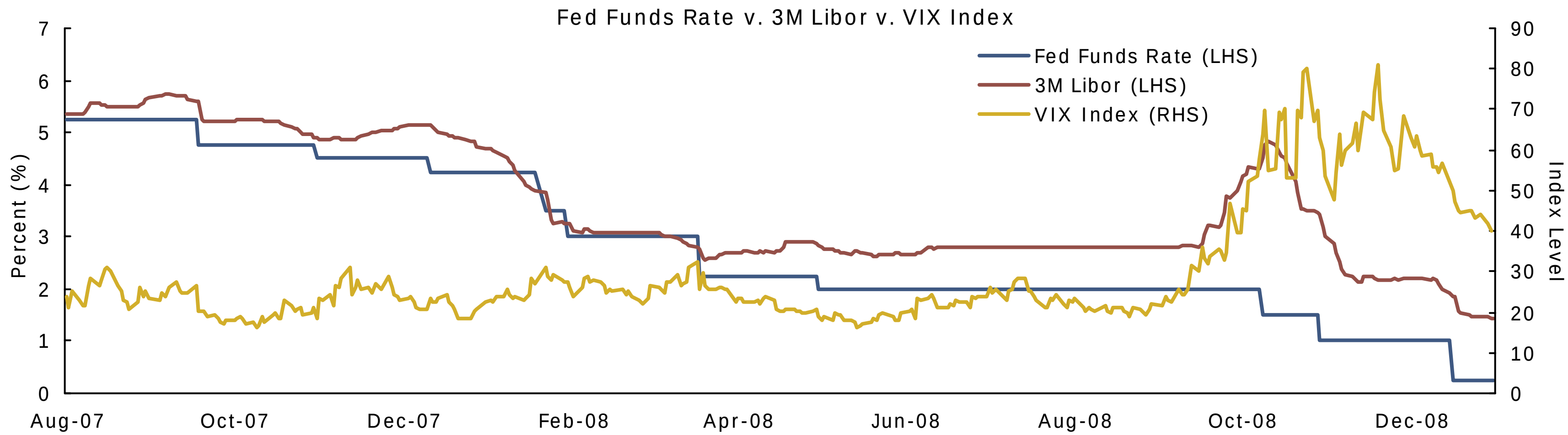
* Inflation YoY: U.S. Inflation is Core PCE (note Core PCE is usually about 50 bps lower than core CPI), Eurozone inflation is EuroArea 13 HICP (headline), U.K. inflation is the Consumer Price Index (headline), Japan inflation is CPI ex food; China inflation is Consumer Price Index.

** Forecasts as of December 16, 2008.

Refer to Appendix for additional index information.

# Innovative Policy Responses Directed at Restoring Financial System

As of December 31, 2008




| Federal Reserve | Treasury / FDIC | Fiscal |
|---|---|---|
| Lowered Fed Funds to zero | TARP: $700 bn | Stimulus Program: $1 Trillion? |
| Agency MBS Program: $500 bn | Fannie/Freddie Conservatorship | ▪ Tax cuts<br>▪ Aid to States |
| CPFF: $334 bn (to date) | Money Market Funds Guarantee | ▪ Unemployment benefits |
| TALF: $200 bn | Deposit Insurance Increase | ▪ Infrastructure spending |

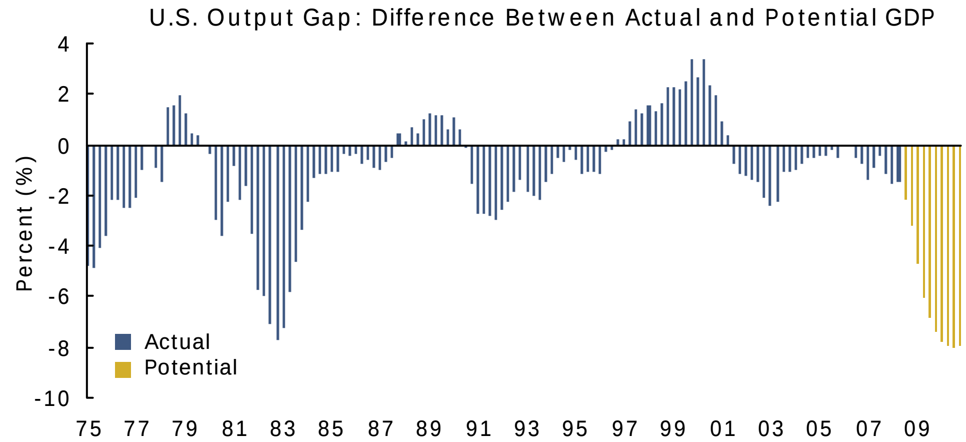
SOURCE: Federal Reserve, Bloomberg, ISI
Partial listing of policy responses and programs.
Refer to Appendix for additional index information.

# Cyclical Deflation, Secular Inflation

As of December 31, 2008

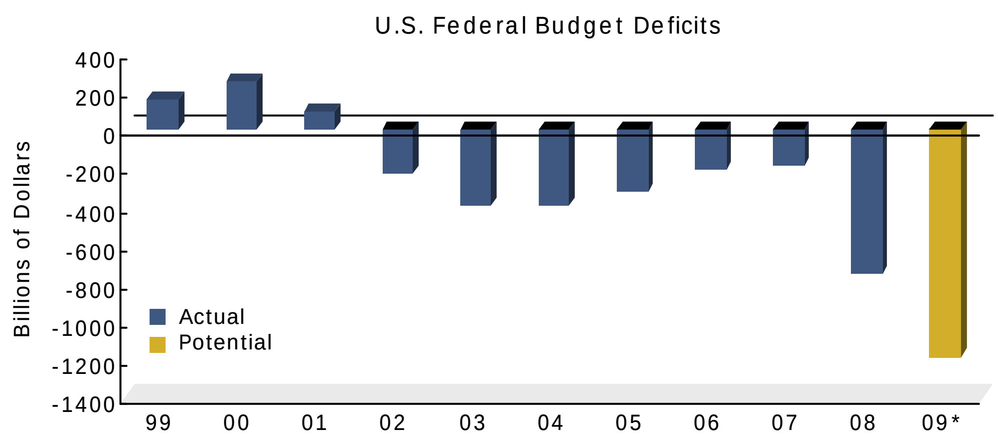
- Cyclical environment has witnessed growing output gap and demand destruction forcing economy to grow much slower than its potential

- Massive policy response is attempting to get traction




- Long-term consequences of various bailouts, quantitative easings and entitlements are uncertain

- If quantitative easing is successful, odds of a future inflationary wave increase

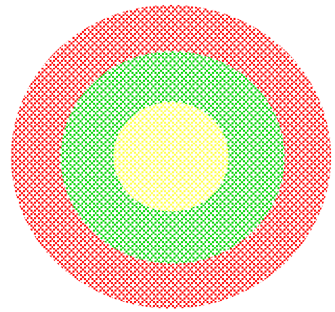



SOURCE: Congressional Budget Office
* Projected Budget Deficit.

# Portfolio Strategy: Focus on Sectors That Benefit From Government Actions

**2009 Opportunity Set**

**In:** High Quality Spread



**Out:** Treasuries & Long Dated Swaps

**Out:** Default & Earnings Risk

## Green Zone

- Portfolios to focus on higher yielding assets that have governmental support
- Bank Debt: Supported by TARP, FDIC and Fed Liquidity
- Agency MBS: Supported by Fed/Treasury buying program and conservatorship
- TIPS: Explicit governmental guarantee with high real yields
- Municipals: High credit quality assets at yields double Treasuries

## Treasuries

- Historic rally in stampede to safety
- Safest assets are too expensive and provide little or no return

## Riskier Assets

- High yield, equities, real estate
  - Recession poses real risk to these assets
  - No governmental support

# Investing in Resources to Achieve Your Investment Goals

As of December 31, 2008

## Depth of Resources Supports Long-Term Investment Philosophy

- Total of 406 Investment Professionals worldwide in 10 global offices
- Broad participation in forecasting and investment committees promotes innovation while ensuring continuity
- Credit research team includes 29 analysts worldwide
- Deep capabilities and research in asset allocation, analytics and strategy

## Breadth of Resources Enhances Investment Services

- Assets Under Management: $747.0B

| | |
|---|---|
| U.S. | $ 532.8 |
| Europe | 151.6 |
| Japan | 34.7 |
| Asia | 14.0 |
| Australia | 10.8 |
| Canada | 2.7 |

- Market Segment Focus

| | |
|---|---|
| Foundations | Corporations |
| Endowments | Central Banks |
| Public Entities | Taft-Hartley |
| Insurance | Subadvised |
| Healthcare | Variable Annuity |
| Independent Financial Advisors | |

- 38 Product Managers

| | |
|---|---|
| Real Assets | Equity |
| Emerging Markets | Mortgages |
| Global | Absolute Return |
| Credit | Tax-Sensitive |
| Long Duration | Structured Products |
| Cash Management | Asset Allocation |

## PIMCO Institute Offers Educational Opportunities

- Client education seminars in Newport Beach
- Topical visiting seminars and custom programs
- Gain insight into market trends and investment strategies
- Opportunity for interaction with PIMCO professionals and industry peers



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# Assets Under Management by Strategy

## PIMCO's expertise spans all asset classes to provide effective solutions to meet investor needs

| | | | |
|---|---|---|---|
| **Alternative Investments:** | Absolute Return Strategies | LIBOR based vehicles: enhanced cash or pure alpha | $11,546 |
| | Commodities | Commodity-linked exposures enhanced with active bond portfolios | 7,029 |
| | Real Estate | Real Estate-linked exposure backed by inflation index bonds | 109 |
| | Real Return | TIPS and other inflation-hedging strategies | 49,023 |
| | Tactical Allocation | Tactical allocation among PIMCO strategies, All Asset, All Asset All Authority* | 14,787 |
| | Diversified Income | Global credit combining corporate and emerging markets debt | 9,274 |
| | CBO/CLO | Collateralized bonds/loan obligations | 5,384 |
| **Equities:** | U.S. Market | Combines derivatives-based equity exposure with active bond management | 17,139 |
| | Large Cap | StocksPLUS® | |
| | Small Cap | StocksPLUS® Total Return | |
| | International: | StocksPLUS® PARS | |
| | Japan, Europe | StocksPLUS® Long Duration | |
| | Global, International | Fundamental IndexPLUS™ / Fundamental Advantage | |
| **Fixed Income:** | Long Duration | Focus on long-term bonds; asset liability management | 57,111 |
| | Intermediate** | Total Return, Moderate Duration | 327,258 |
| | Cash Management** | Low Duration, Enhanced Cash, Money Market | 49,428 |
| | Credit | Investment Grade Corporates, High Yield | 34,861 |
| | Mortgages | Emphasis on management of mortgage pass-throughs | 62,378 |
| | Global | Non-U.S. and global multiple currency formats | 70,709 |
| | Emerging Markets | Focus on solid credits with improving economic fundamentals | 15,374 |
| | Municipals | Tax-efficient total return management | 9,462 |
| | Other | | 6,127 |
| | | **Total Assets Under Management:** | **$ 747,009 M** |

Assets as of December 31, 2008. PIMCO now includes the assets that it manages for third-party clients of its German affiliate, Allianz Dresdner Global Investors Germany. Potential differences in asset totals are due to rounding.

* All Asset strategies are invested in PIMCO Funds; these assets are not included in the individual strategies.

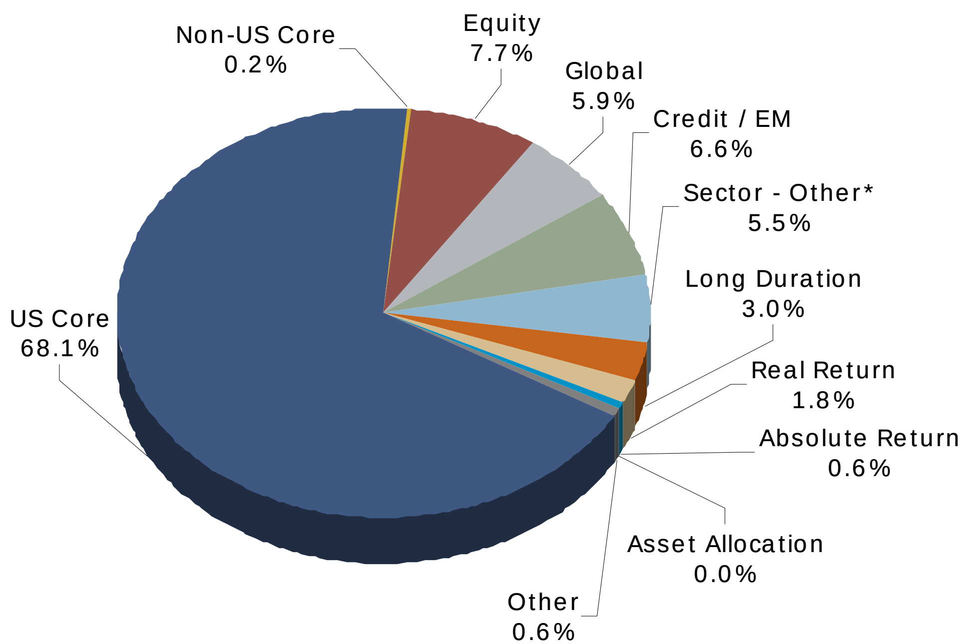
** Stable Value assets have not been netted from US Total Return, US Moderate Duration and US Low Duration assets. As of December 31, 2008, total Stable Value assets equal $22,493MM.

# Client Diversification Trends Reflected in PIMCO AUM

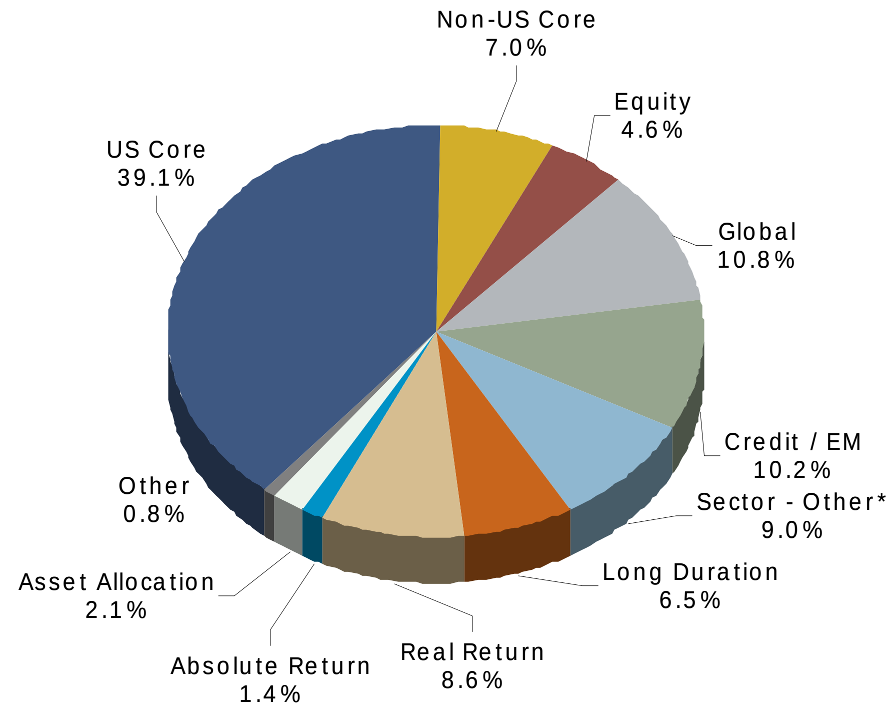
As of December 31, 2007

Product innovation capitalizes on global capabilities across asset classes to meet client objectives

2001 AUM: $227 Billion




2007 AUM: $746 Billion




* MBS, Short-Term, and Munis



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# Financials: Uneven Policy Responses Eventually Assisted Debtholders

| Firm | Action | Debt | | Equity | | Comments |
|---|---|---|---|---|---|---|
| | | Senior | Subord. | Preferred | Common | |
| Bear Stearns | JPM Takeover | | | | | NY Fed absorbed BSC's troubled assets and facilitated "shotgun" wedding with JPM |
| Fannie/Freddie | Conservatorship | | | | | Treasury seized both institutions, made implicit guarantee explicit, but wiped out all equity (including preferred) |
| Lehman Brothers | Bankruptcy | | | | | Lehman filed for bankruptcy after failing to find a buyer, but Barclays bought all the best assets cheaply with court approval |
| Merrill Lynch | BoA Takeover | | | | | Merrill dove into the arms of BoA, though the deal was a surprisingly good one for Merrill shareholders |
| AIG | Government Loan | | | | | AIG forced to accept government bailout on onerous terms; future remains unclear |
| Washington Mutual | Receivership | | | | | FDIC seized WAMU and sold its assets to JPM, stripping creditors of just about all asset cover |
| Wachovia | Wells Fargo Takeover | | | | | Wells bettered Citigroup's FDIC-backed deal to buy Wachovia's bank assets |

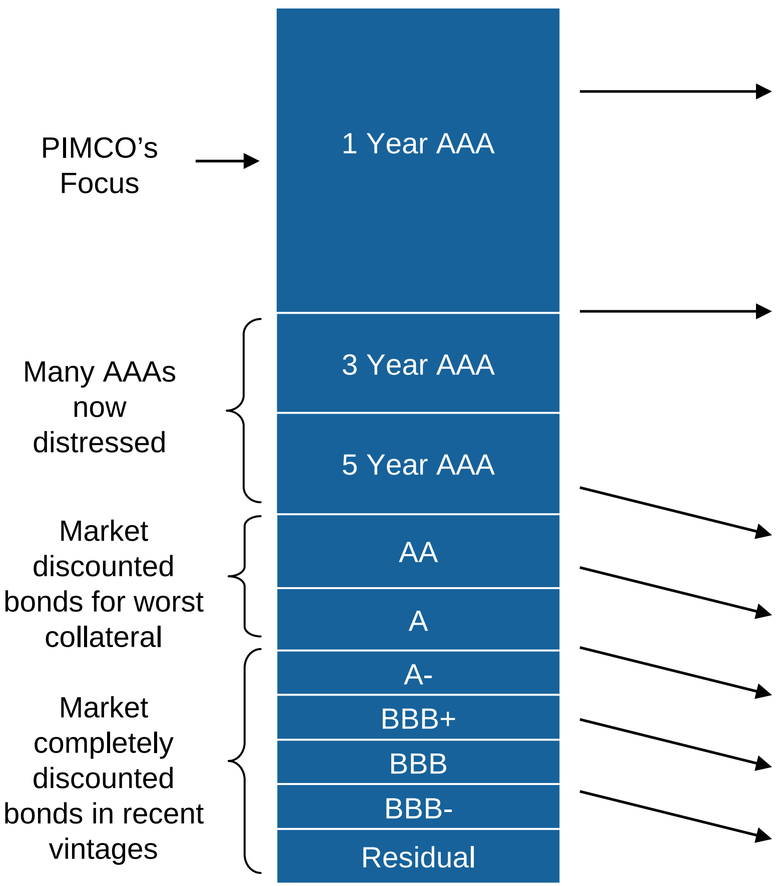
Positive impact
Moderately negative impact
Negative impact

- Each institutional crisis has been met with a different response, leaving investors uncertain as to the rules of the game, or even the nature of the playing field
- Policy response has shifted from piecemeal, reactive approach to a more holistic one

SOURCE: PIMCO

# Systemic Debt Reduction Impacted Prices of All Non-Agency MBS

- Technical price pressures on senior bonds should improve as liquidity returns to the market, whereas subordinated debt is unlikely to recover
- Seniority of cash flow is critical to price recovery
- ABS spreads reached historic levels due to systemic deleveraging




### Senior Bond Price Changes

| 12/31/07 | | Price | | Change |
|---|---|---|---|---|
| Tranche | Price | 9/30/08 | 12/31/08 | YTD (%) |
| Front Pay/ Super Senior | 96 | 92 | 87 | -9% |
| Prime AAA Pass-Through | 94 | 83 | 75 | -20% |
| AAA Super Senior MTA Floater* | 92 | 63 | 42 | -54% |

### Subordinated Bond Price Changes**

| 12/31/07 | | Price | | Change |
|---|---|---|---|---|
| Tranche | Price | 9/30/08 | 12/31/08 | YTD (%) |
| AAA | 76 | 52 | 40 | -47% |
| AA | 46 | 12 | 5 | -89% |
| A | 26 | 8 | 4 | -85% |
| BBB | 20 | 5 | 3 | -85% |
| BBB- | 19 | 5 | 3 | -84% |

SOURCE: JPMorgan, Amherst Securities
* Monthly Treasury Average (flexible payment option)
** ABX 07-1