Cashflow Orientated Investing

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PIMCO

Cashflow Orientated Investing (COI): a powerful tool for managing liquidity needs of maturing schemes

1 Negative Cashflows

Maturing schemes & peak liability cashflows expected in the next 10yrs

- **Drag on portfolio returns**
- **Liquidity needs**

2 Underfunding

Portfolios are typically allocated on (Growth +LDI) basis

- **Increased vulnerability to market downturns**
- **Forced selling**

3 Rising rates

Impact on levered LDI portfolios

- **Potentially exacerbating liquidity needs**

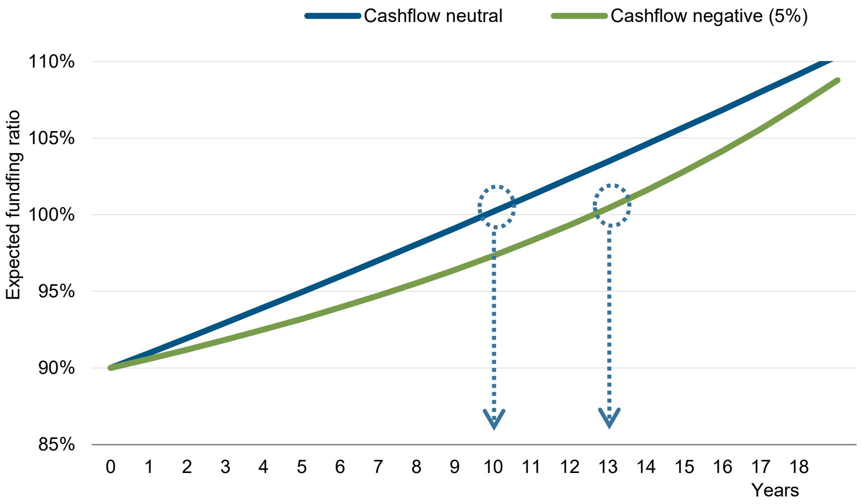
Timeframe to full-funding increased

SOURCE: PIMCO

For illustrative purposes only.

Impact of negative cashflow position on time to full funding

Illustration for a 90% funded scheme



Cashflow neutral

- Asset allocation designed to expect full funding in 10 years

Cashflow negative

- Scheme assumed to pay approx. 4.9% of cashflows annually in the first 10 years
- All else equal, expected time to full funding extends **by 3 years**

A Cashflow negative position can substantially extend the expected time to recovery: Assets need to work harder!

SOURCE: PIMCO.

For illustrative purposes only.

Illustration based on hypothetical asset portfolio expected excess return over liabilities of 1.1%

Underfunded & cashflow negative schemes: particularly vulnerable to market downturns

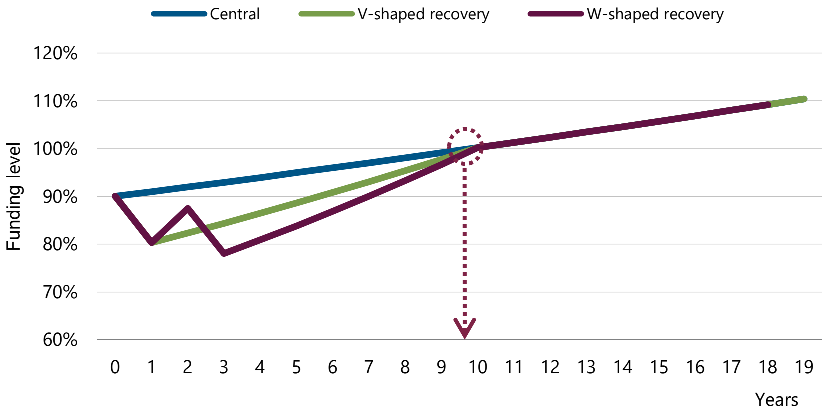
Cashflow neutral

- Scheme still recovers to reach full funding in 10 years independently of the recovery scenario

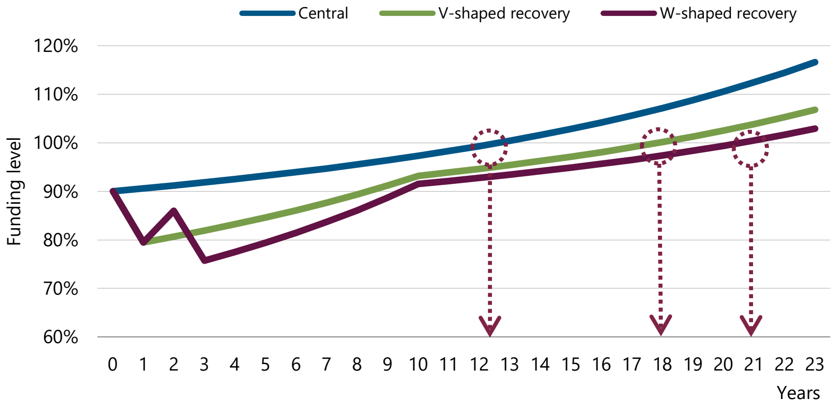
Cashflow negative

- Time to full funding extended by 5 or 8 years depending on the recovery scenario

Cashflow neutral - Funding Level Projection



Cashflow negative - Funding Level Projection



Cashflow Orientated Investing portfolios meet liability payments through coupons and maturing bonds, thereby avoiding need to “sell at a loss” during periods of market stress

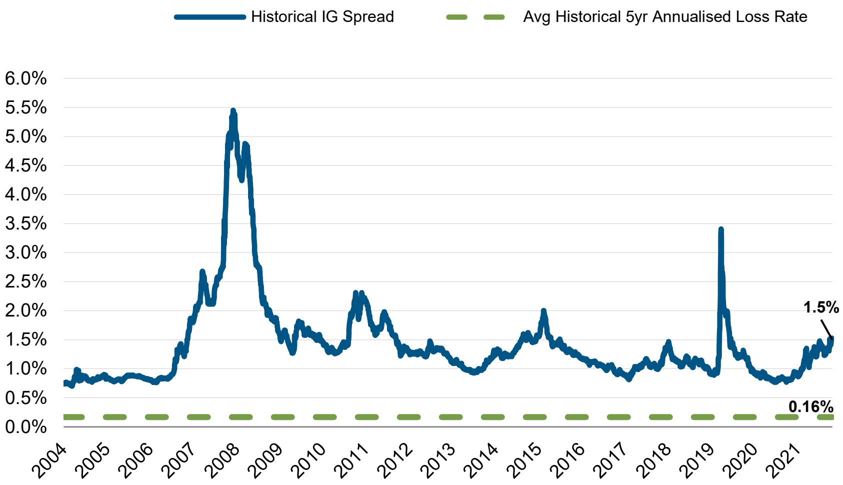
SOURCE: PIMCO.

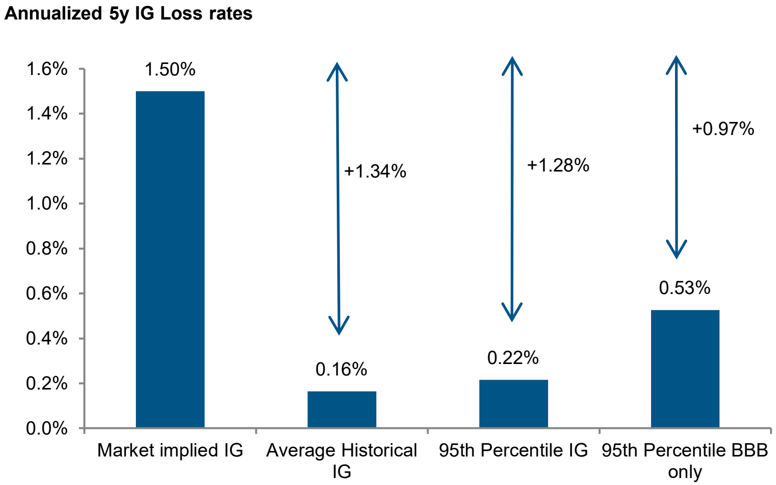
For illustrative purposes only.

Illustration based on hypothetical LDI /Growth portfolio (60%/40%) with annual re-balancing. Asset portfolio expected excess return of 1.1% over liabilities. Drawdowns are assumed to be 25% In the W-shaped case, we assume that the 25% drawdown Scenario assumes that the 25% equity drawdown is a strong recovery after the drawdown such that total expected excess return of the portfolio over 10years is recovered

Cashflow Orientated Investing in the current environment:
Favourable public credit valuations

- Current spreads imply losses much higher than the average historically observed value
- The spread also lies in the right tail of the distribution of historical annualized 5-year cumulative default rates





As of 18 Oct 2022. SOURCE: Bloomberg, Moody's investor Services.
US IG OAS is the option-adjusted spread of Bloomberg Barclays US Credit Index.
The historical 5yr annualized 5yr IG loss rates provided by Moody's cumulative default rates, assuming a recovery rate of 40%. Loss rates based on Moody's annual corporate default rates, data from 1920-2021, assuming a recovery rate of 40%, 5Y loss rate percentiles are based on data from 1970-2021.
Worst annual loss was experienced in 1938 at 93bps.

PIMCO's approach to Core IG Cashflow Orientated Investing versus traditional Buy & Maintain

	Traditional B&M	PIMCO's COI	Comments
Liability payments met through coupons and maturing bonds	✓	✓	
Transparent performance measurement	X	✓	• Bespoke liability index designed on the basis of desired cashflow liability profile • Provides transparency in Manager short term performance and risk taking, and visibility on ability to deliver excess cashflows
Exploits IGC markets Inefficiencies	Typically not / partially	✓	• IGC markets offer numerous opportunities to enhance returns without additional risk. PIMCO's COI approach exploits these opportunities (many of which are unique to PIMCO) without compromising cashflow certainty
Target Alpha	X	✓	• In its simplest form, PIMCO's COI portfolio seeks to generate 25-50bps of alpha over and above the bespoke benchmark • PIMCO's track record in IG credit has experienced <0.5x defaults vs. market • In HY and EM we have experienced <0.2x defaults vs. market

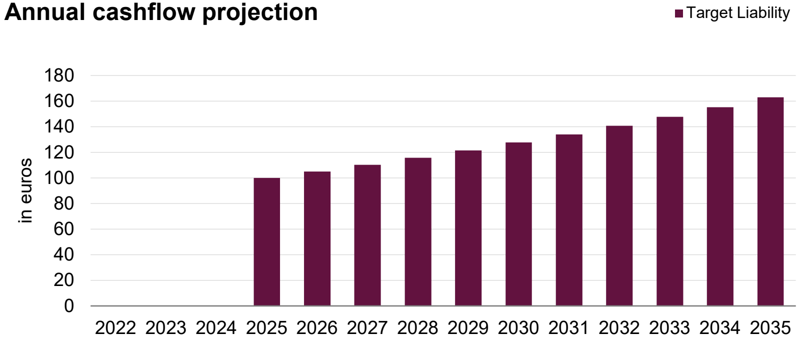
SOURCE: PIMCO.
For illustrative purposes only.

Liability Cashflow Index

Design process

1 Start from a desired cashflow profile

Annual cashflow projection



2 Define EUR and USD sub-indices by maturity buckets

	2022	…	2024	…	…	2032	…	2035
ICE ML EMU Broad Index excl TSY, LCA & Securitized			✓	✓	✓	✓	✓	✓
ICE ML US CORP			✓	✓	✓	✓	✓	✓

3 Find the benchmark allocation which fits the liability cashflows subject to issuer and sector concentration limits

% MV allocation to sub-maturity indices at inception

Sub indices	Eur	USD
2025	4.0%	4.0%
2026	4.1%	4.1%
2027	4.2%	4.2%
2028	4.4%	4.4%
2029	4.4%	4.4%
2030	4.6%	4.6%
2031	4.7%	4.7%
2032	4.8%	4.8%
2033	5.0%	5.0%
2034	5.0%	5.0%
2035	0.4%	0.4%
Total	**45.6%**	**45.6%**

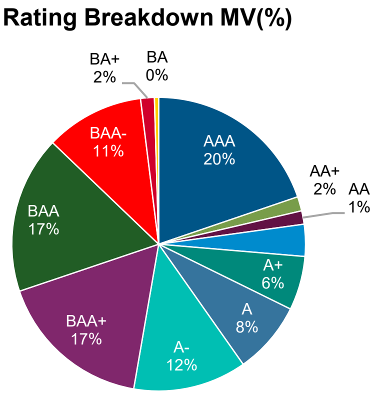
Concentration at ultimate parent	
AAA	1.50%
AA-A	1.0%
BBB	0.5%

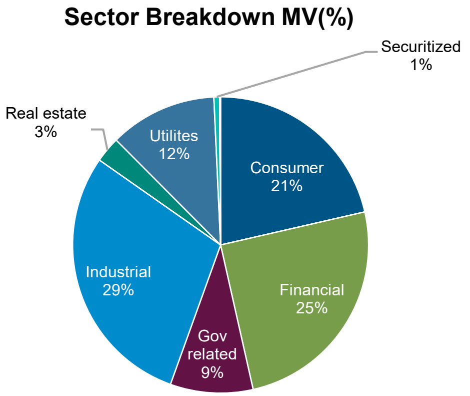
4 The resulting portfolio is by definition *the Index*, which is subsequently maintained independently from PIMCO by ICE

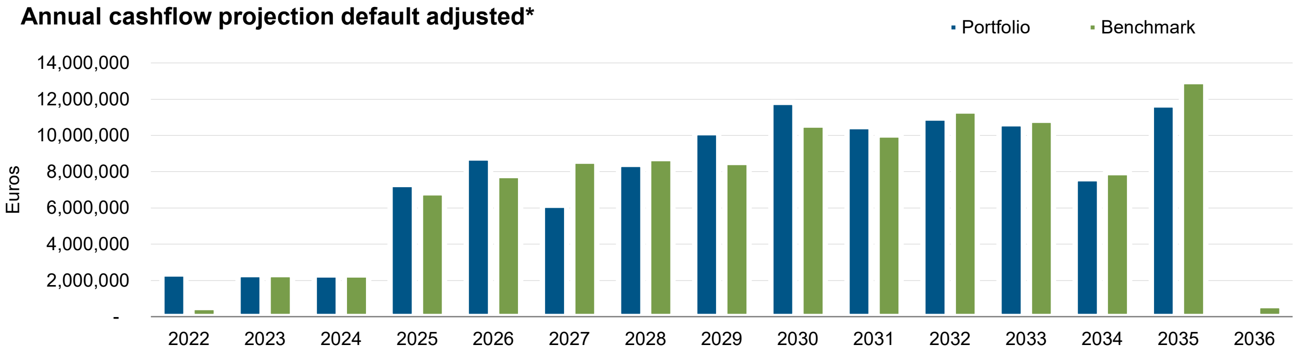
SOURCE: PIMCO. **For illustrative purposes only.**

Sample Cashflow Orientated Investing portfolio

	Portfolio	Benchmark
Yield to maturity € hedged (%)	3.87%	3.51%
Duration (yrs)	6.7	6.8
Average Quality	A	A







As of 30 September 2022. SOURCE: PIMCO

A flexible framework that can adapt to client's desired cashflow and return objectives

Overview	Core IG COI	Integrated COI – LDI	Forward Starting COI	Public-Private COI
Desired Outcome	• Immediate cashflow requirements	• Combined COI + LDI portfolio covering entire liability profile	• No immediate cashflow requirement • Active returns in first 5 years	• Higher yielding portfolio whilst maintaining stable cashflow coverage
Return Target (over rolling 3-5 years)	25-50 bps alpha	20-40 bps alpha	75 bps alpha	A function of allocation to Private Assets
Index Characteristics	• 100% EUR IG, ESG Exclusions	• COI Index targets liability cashflows net of LDI portfolio cashflows	• No maturity redemption in first 5 years • Global IG	• COI index targets liability cashflows net of Private Assets expected cashflows
Portfolio Investment Universe	• Global multi-sector credit • Max 5% HY, EM • Max 30% non-EUR	• LDI: Gilts, linkers and inflation swaps • COI: global IG credit	• Global multi-sector credit • Max 10% HY, EM • Derivatives permitted for risk taking	• Global multi-sector credit • Private credit allocation through Evergreen structure

Source: PIMCO. **For illustrative purposes only**.

Key Takeaways

1 Reduce sensitivity to market drawdowns

- COI portfolios meet liability payments through coupons and maturing bonds, thereby avoiding transaction costs or cristalising portfolio mark-to-market losses during periods of market stress

2 Seek to offset drag on returns

- Negative cashflows can translate into a meaningful extension of time to reach full funding
- Active management can potentially improve outcome by making assets work harder

3 Require transparent measurement of portfolio returns and expected cashflow

- Incorporate a bespoke Index customised to your liability cashflows to allowing for performance measurement & monitoring of portfolio quality and credit risk sizing relative to Index

4 Access a global opportunity set

- Maximise value, Diversification & liquidity

SOURCE: PIMCO. **For illustrative purposes only.**