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# Morningstar's Current View on PIMCO

## Still Formidable, With Areas for Improvement and A Few Open Questions

On Jan. 21, 2014, PIMCO announced former CEO and co-CIO Mohamed El-Erian would be departing the firm by mid-March 2014. Those announcements took both PIMCO and PIMCO observers by surprise. The firm announced a number of additional changes to its leadership ranks on Jan. 29, 2014.

Since those announcements, a number of media articles have focused on the fractious interactions between CIO Bill Gross and El-Erian; short-term performance challenges and outflows at a few of the firm's funds; and Gross' at-times tempestuous behavior. Those articles generally did not directly address the question of whether El-Erian's departure, Gross' behavior, or the recent leadership changes have actually impaired or benefited PIMCO's investment process and investment culture.

Over the past six weeks, we've been delving into that question in a series of extensive conversations with PIMCO's leadership. Specifically, in this memo we weigh in on two main questions:

- What is the real impact of El-Erian's departure and the recent leadership changes on PIMCO's day-to-day investment process?
- Is PIMCO as formidable an investment firm now as it was prior to El-Erian's departure?

In addition, we detail the changes we are making to our Stewardship Grade and Parent Pillar rating for PIMCO.

We will follow up in coming weeks with fund analyses and in early April with a related piece to address questions we are receiving from investors regarding individual PIMCO funds.

### A Brief Synopsis of What Happened at PIMCO

In the wake of El-Erian's departure, PIMCO announced a number of changes to its leadership ranks, some on Jan. 21, 2014<sup>1</sup>, and the rest on Jan. 29, 2014<sup>2</sup>, including the following:

- Doug Hodge was named the firm's CEO, and Jay Jacobs was named president, assuming many of the noninvestment duties formerly handled by El-Erian.
- Six senior-level portfolio managers were named deputy CIOs—Mark Kiesel, Virginie Maisonneuve, Scott Mather, Andrew Balls, Mihir Worah, and Dan Ivascyn—to shoulder investment and personnel management duties formerly handled by El-Erian.
- Several of the deputy CIOs—Kiesel, Worah, and Ivascyn—as well as Tony Crescenzi, join Balls, Mather, Saumil Parikh, Christian Stracke, and Gross as permanent members of PIMCO's Investment Committee, the body charged with setting PIMCO's macroeconomic views.

<sup>1</sup> To review Allianz's Jan. 21, 2014 press release:

[https://www.allianz.com/v\\_1390337998000/media/investor\\_relations/en/announcements/140121\\_irrelease.pdf](https://www.allianz.com/v_1390337998000/media/investor_relations/en/announcements/140121_irrelease.pdf)

<sup>2</sup> To review Allianz's Jan. 29, 2014 press release:

<http://www.pimco.com/EN/PressReleases/Pages/PIMCO-Makes-Additional-Portfolio-Management-Leadership-Appointments.aspx>

- Deputy CIO Maisonneuve's primary focus will be to lead the Equity Portfolio Management Committee, and she will be immediately available to the Investment Committee to provide input for PIMCO's expanding investment platform.
- Equities portfolio manager Chuck Lahr and fixed-income generalist portfolio manager Marc Seidner left PIMCO—Lahr for personal reasons, while Seidner stepped into a new role overseeing fixed income at Grantham, Mayo & Van Otterloo.
- PIMCO alum Sudi Mariappa will be rejoining the firm as a generalist portfolio manager, from hedge fund GLG.

### **What Morningstar Has Done Thus Far to Assess the Situation**

Thus far, Morningstar has published a number of videos, articles, and fund analyses touching on the impact of these changes—a list of those pieces can be found in the Appendix to this memo.

Since the changes were announced, Morningstar analysts have been in frequent contact with PIMCO's senior leadership, including Gross, Worah, and other portfolio managers directly or indirectly affected by the changes. We've also had extensive conversations with other members of PIMCO's leadership, including CEO Hodge. These conversations culminated in an on-site visit to PIMCO on March 10, 2014.

Given our current view, we have lowered the Corporate Culture component of PIMCO's Morningstar Stewardship Grade for Mutual Fund Firms<sup>3</sup> to C from B. We have also lowered the firm's Manager Incentives component to C from B, reflecting a lower percentage of the firm's mutual fund assets in which at least one of the fund's managers invests in fund shares worth more than \$1 million, the highest ownership level reported to the SEC. As a result of those changes, PIMCO's overall Stewardship Grade falls to C from B, with an A grade being the highest possible and F the lowest. We have appended the full text and scoring for PIMCO's current Stewardship Grade to this memo.

On a related note, PIMCO's Parent Pillar score—one of the five pillars of the Morningstar Analyst Rating for Funds<sup>4</sup>—falls to Neutral from Positive.

### **What Morningstar Is Doing Next**

The changes to PIMCO's Stewardship Grade and Parent Pillar score do not automatically affect PIMCO funds' overall Morningstar Analyst Ratings for Funds, yet it is logical to assume that Morningstar analysts would move quickly from here to reassess those ratings on a fund-by-fund basis. We are preparing a follow-up piece for early April 2014 that will summarize our current opinions on individual PIMCO funds. In that piece we'll also answer a number of PIMCO-related questions that we have been receiving most frequently from investors.

3 To review the Morningstar Stewardship Grade for Mutual Fund Firms methodology:  
<http://corporate.morningstar.com/US/documents/MethodologyDocuments/MethodologyPapers/StewardshipGradeMutualFundFirmsMethodology.pdf>

4 To review the Morningstar Analyst Rating for Funds fact sheet:  
<http://corporate.morningstar.com/US/documents/MethodologyDocuments/FactSheets/AnalystRatingforFundsFactSheet.pdf>

## Appendix

### Morningstar's Pieces on PIMCO Leadership Changes

PIMCO Aims to Ease Succession Worries, Video Report, Eric Jacobson, Jan. 29, 2014:

<http://www.morningstar.com/cover/videocenter.aspx?id=632401>

More Questions About PIMCO in the Post El-Erian Era, Fund Spy, Eric Jacobson, Feb. 6, 2014:

<http://news.morningstar.com/articlenet/article.aspx?id=633964>

This Fund's Latest Manager Change Is Cause for Concern, Fund Analysis, Michael Herbst, Feb. 18, 2014:

<http://analysisreport.morningstar.com/fund/research?t=PGAIX&region=usa&culture=en-US>

PIMCO's Perils, Rekenhaller Report, John Rekenhaller, March 5, 2014:

<http://news.morningstar.com/articlenet/article.aspx?id=638166>

PIMCO Total Return: Not Fussing, Rekenhaller Report, John Rekenhaller, March 17, 2014:

<http://news.morningstar.com/articlenet/article.aspx?id=639426>

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**Appendix – Morningstar's Stewardship Grade for PIMCO****PIMCO Stewardship Grade -- C****Eric Jacobson, Senior Analyst**

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**Stewardship Grade Scorecard  
PIMCO**

<b>Corporate Culture:</b>	<b>C</b>
<b>Fund Board Quality:</b>	<b>C</b>
<b>Fund Manager Incentives:</b>	<b>C</b>
<b>Fees:</b>	<b>C</b>
<b>Regulatory History:</b>	<b>Neutral</b>

The investment community was taken by surprise in January 2014 by CEO and co-CIO Mohamed El-Erian's decision to leave PIMCO. The firm quickly named longtime employees Doug Hodge as CEO and Jay Jacobs as president. Concurrently, it designated two deputy CIOs (naming four more within about a week), made additions to its Investment Committee, and reassigned El-Erian's investment and personnel management duties. Those adjustments were designed to help ensure a degree of continuity for the investment approach that has proved to be successful for many investors in the past.

There's reason to believe PIMCO can thrive going forward given the qualifications of its new deputy CIOs and its deep research resources. Yet it will take time to assess whether recent changes prove beneficial for investors. It's also an open question how effectively the firm will navigate a tougher environment for fixed income. Despite PIMCO's prowess, relatively high expenses on many of its funds' noninstitutional share classes have historically kept it from garnering Morningstar's highest marks. Arguably, its funds' boards have not done all they could do to aggressively negotiate for better economies of scale. In addition, the firm no longer stands out versus rivals in terms of its managers' investment in the funds they run.

These issues, plus the uncertainty associated with the recent disruptions, result in a Neutral rating.

**Corporate Culture – C**

In many ways, PIMCO has long had a standout corporate culture. Chief investment officer Bill Gross is the founder around whom PIMCO was built, and his essential nature as an investor, above all else, has been a critical foundation for the firm.

The firm's public reputation was shaken in January 2014 following the announcement that CEO and co-CIO Mohamed El-Erian would be leaving PIMCO in March. Much of what was publicized after El-Erian's announcement can arguably be viewed as tabloid fodder, but his resignation, combined with other departures in recent years, has helped drive material changes in PIMCO's corporate culture.

In the years leading up to El-Erian's departure, 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 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. 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. Whether temporary or not, Dialynas' loss is especially notable given his reputation as something of a "glass-half-empty" kind of guy in contrast to--and as an important foil to--Gross, who sees himself as more of an optimist when looking at economic and investing landscapes.

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, and in Gross, 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.

That litany of defections may look alarming when assembled in a single narrative, but it is arguably less of a worry than it might seem. PIMCO's case for depth is compelling, boasting 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 the wake of El-Erian's resignation, the firm appointed six deputy chief investment officers, three of whom--Mark Kiesel, Dan Ivascyn, and Mihir Worah--were concurrently added to the Investment Committee. New deputy CIOs Andrew Balls and Scott Mather were already on the committee, while equity-group leader and newly named deputy CIO Virginie Maisonneuve effectively became an adjunct member. At the same time, central-banking maven Tony Crescenzi, who like colleague Saumil Parikh, took over important roles following Paul McCulley's retirement, also joined Parikh and the others as a full-time member of the committee. PIMCO has said that the appointment of new deputies was actually an idea developed and championed by El-Erian before he stepped down.

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's star had already been shining as well, 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 PIMIX in 2013 with comanager Alfred Murata.

From the perspective of PIMCO's culture, the biggest question about this chain of events is whether the atmosphere within which the firm's current Investment Committee and broader investment team work will remain conducive to its success. That atmosphere has long been characterized as a pressure cooker, yet it remains an open question whether the current Investment Committee members--several of whom are a bit less seasoned than their predecessors--will consistently voice their opinions and fuel the debate that has been crucial to PIMCO's past success. That may prove daunting, given Gross' at-times severe and reputed retaliatory temperament.

Even so, PIMCO's power structure looks very different in the wake of El-Erian's resignation. The firm has strong and capable corporate leaders in the form of CEO Doug Hodge, president Jay Jacobs, and six very capable deputy CIOs. In addition, by his own account, Gross has acknowledged that he understands the risk an unhealthy culture can pose to the organization and concedes that PIMCO has room to improve. He has thus taken concrete steps to encourage greater dialogue and debate within the Investment Committee: In a break from the past, each of the deputy CIOs is charged with leading committee meetings on a rotating basis, so Gross heads only one out of every seven meetings. In addition, each of the new deputy CIOs now oversees several portfolio managers and, by extension, all of the specialist desks and the assets for which each skipper is responsible, thus taking on most of the personnel management duties that had previously fallen on El-Erian.

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 rigeur 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.

In theory, dialogue within the Investment Committee may be more open than it had been prior to El-Erian's departure, but it will take time to determine whether PIMCO's recent leadership changes and Gross' apparent change of heart will truly produce better investing outcomes.

Meanwhile, there remains a process in place to replace Gross as CIO when the time comes, and he believes that the most likely candidates are now those filling PIMCO's deputy CIO roles. The firm isn't likely to name anyone as an intended successor, however, before the need actually arises to appoint one, and it seems in the realm of possibility that competition for the slot could prove contentious. Other important questions, of course, are whether any of those newly appointed folks would even be a good fit for the role and whether any would be ready to take over from Gross should that need arise much sooner rather than later.

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.

One area with which Morningstar continues to harbor some concern is size. Even in the wake of notable redemptions in 2013, PIMCO Total Return PTRX still comprised more than \$235 billion in investor assets as of February 2014 and remains the world's largest actively managed mutual fund. Meanwhile, Gross himself manages approximately \$470 billion. That girth has by Gross' own admission made managing Total Return more challenging, though the redemptions appear to have neutralized some of the past focus on its size, and he points to long-term performance as the ultimate measure of that question. That's a credible claim despite the fund's size given that it has been the largest, or among the largest bond funds in existence for a long, long time, and its long-term risk-adjusted record has remained strong.

Even despite PIMCO's 2011 and 2013 stumbles, it's clear that Gross has adapted better than almost any other manager ever has to massive asset growth, certainly among bond funds, and there's scant evidence to suggest that those years' setbacks had anything to do with limitations from the firm's size. Gross' command of big-picture macroeconomic and sector themes has been at the root of that success, especially as PIMCO's size has expanded. Whatever the image that his latest personality tribulations have projected in the wake of El-Erian's departure, there remains good reason to believe he can persevere and his success persist.

Even at its modestly reduced asset base, however, the impact of Total Return's size remains a question that Morningstar continues to study and examine. Meanwhile, many investors have raised the question of how that fund would fare should redemptions spike back up to their 2013 pace or worse. Given the way that Gross has managed the portfolio in recent years, though, investors have good reason for confidence. He has traditionally focused plenty of fund assets in very, very liquid securities, including Treasuries, agency-backed mortgages, and even cash. Gross notes, in fact, that 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 an easy exercise.

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 \$15 billion in assets as of February 2014, is the second-largest chunk of fund assets in the category if combined with \$3.3 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. 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, particularly given Gross' occasional public comments about the headwind of high fund costs--in a 2009 column he referred to 0.75% bond fund expense ratios as an "extreme absurdity."

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 El-Erian 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 or turn out to be malignant for PIMCO's rising stars; 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, push down PIMCO's Corporate Culture grade to Neutral.

### **Fund Board Quality -- C**

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 the firm's seven equity offerings. The PIMCO Funds Trust encompasses everything else, about 160 funds. (There are also two separate Variable Insurance Trusts and an ETF Trust.)

The equity trust recently experienced some disruption, as two of its independent trustees resigned in mid-2013 and had not been replaced as of February 2014. Vern Curtis stepped off the equity trust at the end of June 2013 but remains a director on the larger PIMCO Funds Trust. On Aug. 14, 2013, Allan Hubbard resigned, though he hadn't served on PIMCO's other open-end trust. That leaves the equity board with just three members, including interested chairman Brent Harris, who also chairs the PIMCO Funds Trust. A three-person board is quite small for such a large organization and for the industry more generally, even considering there are only seven funds currently included in this trust.

PIMCO's equity-series trustees, meanwhile, have been busy. They've not only had to contend with changes to the board but also a steady trickle of new funds--PIMCO Balanced Income is the latest entry, offered under a prospectus dated Jan. 27, 2014. PIMCO has also recently lost two of the portfolio managers it hired to launch two of the funds. Performance has been mixed. On the plus side, the equity funds are generally competitively priced.

The PIMCO Funds board has a much longer history and governs over a much larger operation, including PIMCO's flagship offering PIMCO Total Return PTTX. This board is made up of seven trustees, five of which have been on the board for more than 14 years. Two are interested; five are independent. The good news is that, some recent performance stumbles notwithstanding, the board has overseen an extended period of excellent portfolio management and strong results for most shareholders.

Although 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 PIMCO likely embarks on a more challenging interest-rate environment that could have implications for performance and fund flows. At the same time, the loss of Mohamed El-Erian brings succession issues back to the forefront, though PIMCO quickly rejiggered its investment committee in the wake of El-Erian's departure announcement, perhaps signaling the candidates for Bill Gross' next heir-apparent.

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 2013, Total Return's advisory fees totaled more than \$685 million, while its supervisory and administrative fees clocked in at \$656 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 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--even in just the past year--and several are 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.

### **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 has just more than half of its assets, 58%, in funds in which at least one manager has more than \$1 million invested, thus earning it a C for Manager Incentives. That's a drop from its last grade, when it barely eked into above-average territory with 60% of assets in funds in which at least one manager had more than \$1 million invested.

Mohamed El-Erian's recent departure from the firm affects this figure, as his more-than-\$1 million investments are now excluded from this calculation. El-Erian's old charges have new managers as of the end of January 2014; an amendment to the most recent Statement of Additional Information reports they have no investment in those funds as of the end of February 2014.

Otherwise, PIMCO's manager-investment story is a mixed bag.

Of course, that Bill Gross has more than \$1 million invested in PIMCO Total Return, which represents just under half of the firm's open-end fund assets, goes a long way in explaining its Manager Incentive figure. Gross is listed on more than a dozen funds but, according to the funds' most-recent Statements of Additional Information, invests in only PIMCO Total Return.

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, several of PIMCO's funds, representing just under 20% of assets, have no manager investment at all, though those do include some of El-Erian's old charges on which there are now new managers. One standout, though, is Vineer Bhansali, who invests \$100,001-\$500,000 in four of the target-date funds that he runs. A handful of other managers do have investments above the \$1 million mark.

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 or 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 49 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. 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 largest fund with more than \$235 billion in assets as of the end of February 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 has not had any material regulatory infractions in the recent past, so it gets full credit for Regulatory History.