PIMCO

Marketing Communication

PIMCO'S SMART APPROACH TO PASSIVE INVESTING

Seeking to Deliver "Better Beta" in Fixed Income ETFs

PIMCO's "Smart Passive" approach is built with bonds in mind and designed to solve the challenges traditional passive fixed income ETFs face in index replication.

November 2024

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In bonds, passive ETFs face greater challenges than equities

Passive, index-tracking ETFs offer potential benefits to investors. A rules-based process helps to ensure a consistent investment management approach; transparency provides confidence that the manager will take on risk as represented; and lower turnover may help keep implementation costs down.

But passive ETFs face greater challenges when it comes to bonds than equities, because index replication is more complicated. Consider how equities work: They trade and are valued on price alone, which is fast, highly credible and freely available via well-known public exchanges. In contrast, bonds are mainly traded over the counter, lack a single public exchange, and split-second pricing on any individual bond may be hard to determine.

Instead, bonds are valued based on yield and spread, factors that may require specialized tools and skills to measure with precision, and then "matched" or mirrored in an index.

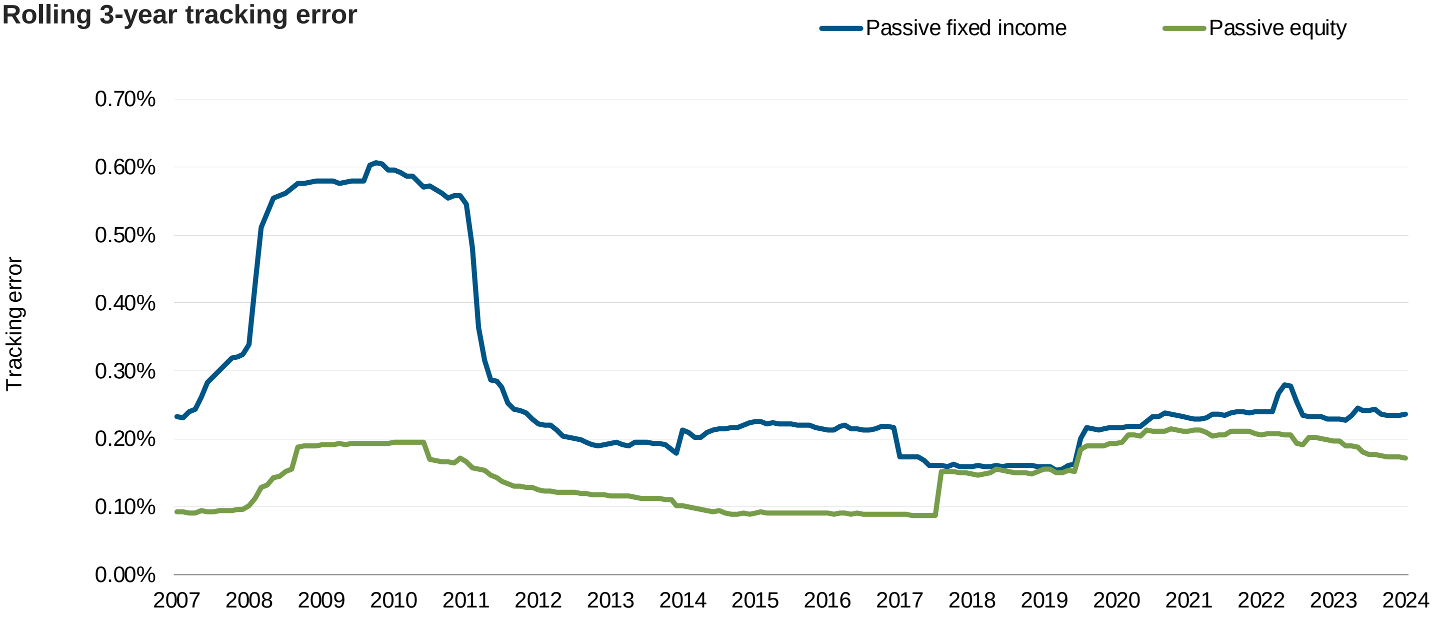
Bonds present other replication challenges too: Consider that the most commonly used bond index, the Bloomberg U.S. Aggregate, has over 13,000 individual securities, all of which are constantly "maturing," which results in much higher turnover in the index than in the S&P 500[1], for example, making bond indexes a constantly moving target. And finally, the cost to trade individual bonds can vary and be prohibitive at times, unlike the efficient trading of equities on an exchange.

Because of these challenges, index-tracking bond funds will often "sample" the index by including only the largest and most liquid constituents – and even then their tracking error tends to be far higher than their corresponding equity ETFs, as the chart below shows.

For investors seeking more efficient index-based replication, PIMCO's Smart Passive strategies can potentially offer an attractive alternative to traditional passive bond index strategies.

Passive index replication has historically been more difficult for fixed income

Rolling 3-year tracking error



[1]Source: Bloomberg.

As of 30 September 2024. Source: Morningstar Direct. **For illustrative purposes only.**

There is no guarantee that the trends mentioned above will continue. Statements concerning financial market trends are based on current market conditions which will fluctuate. Passive equity includes all passive funds in the US Large Blend category benchmarked to the S&P 500. Passive fixed income includes all passive funds in the Intermediate Core Bond category benchmarked to the Bloomberg U.S. Aggregate index. **Refer to important information at the end for additional chart, index, outlook and risk information.**

PIMCO's Quant-Based Smart Passive Methodology

For 10+ years, our dedicated team of senior portfolio managers and quantitative analysts have been building passive portfolio replication strategies that offer risk factor exposure to select fixed income markets while managing for tracking error.

Our "Smart Passive" approach has three key elements:

1

Isolate "Better" Beta: We construct indexes to be representative but also relevant, seeking bonds that best capture distinct aspects of a particular fixed income market beta. For example, to deliver a more direct translation of CPI increases with less potential interest rate risk, we might isolate on short-term TIPS. Or we might target lower duration high yield credit, for a portfolio with a similar yield but lower rate risk than full maturity high yield. Or we might develop or choose an index that allows a larger number of smaller issuers for greater diversification potential.

2

Optimize Risk Factor Exposures: Our extensive credit research capabilities allow us to construct portfolios with attractive performance profiles while limiting tracking error to the index. To implement this, we seek to match key risk factor exposures in portfolios, such as duration, credit spread, sector, liquidity and convexity, to their respective indexes on a forward-looking basis – not just simply "sampling" the largest and most liquid bonds in a fixed income index. This optimization helps us to replicate index performance while harvesting fixed income specific risk premia like carry and value.

3

Minimize Trading Cost: Bonds are generally less liquid than equities, may carry higher transaction costs and can present cross-border tax-inefficiencies when trading. To address this we apply real-time screening criteria to filter out bonds with lower liquidity profiles or which may appear relatively over-valued.
We optimize for new securities (often fairly valued securities with better liquidity characteristics) in our rebalancing methodology to minimize turnover costs. And we also seek to reduce friction costs and optimize trade execution through our scale and trading relationships across the global fixed income universe.

If you go passive, consider going Smart Passive

PIMCO's 50 years of experience as a leading active fixed income manager has provided a wealth of expertise and a robust set of tools that allow us to optimize traditional approaches to passive management. Our index replication process starts from the perspective of a skilled active bond manager, with time-tested risk analytics and industry-leading execution capabilities in bond funds.

Source: PIMCO. **For illustrative purposes only** and not an offer or a recommendation to invest in any PIMCO managed fund or strategy.

Refer to appendix for additional investment strategy, PIMCO ETF's Plc and risk information.

To learn more about our smart passive approach and fixed income ETFs, visit **pimco.com/etfs**

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Investing in the **bond market** is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and low interest rate environments increase this risk. Reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. **Equities** may decline in value due to both real and perceived general market, economic and industry conditions. Investing in foreign-denominated and/or –domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. **Investing in foreign denominated and/or domiciled securities** may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. **Currency rates** may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. **High-yield, lower-rated, securities** involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. **Sovereign securities** are generally backed by the issuing government, obligations of U.S. Government agencies and authorities are supported by varying degrees but are generally not backed by the full faith of the U.S. Government; portfolios that invest in such securities are not guaranteed and will fluctuate in value. **Mortgage and asset-backed securities** may be sensitive to changes in interest rates, subject to early repayment risk, and while generally supported by a government, government-agency or private guarantor there is no assurance that the guarantor will meet its obligations. Entering into **short sales** includes the potential for loss of more money than the actual cost of the investment, and the risk that the third party to the short sale may fail to honor its contract terms, causing a loss to the portfolio. **Derivatives** may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. **Diversification** does not ensure against loss.

INVESTMENT STRATEGY

There is no guarantee that any investment strategies discussed will work under all market conditions or are appropriate for all investors and each investor should evaluate their ability to invest for a long-term especially during periods of downturn in the market.

Outlook

Statements concerning financial market trends or portfolio strategies are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions or are appropriate for all investors and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market. Outlook and strategies are subject to change without notice.

CHART

Performance results for certain charts and graphs may be limited by date ranges specified on those charts and graphs; different time periods may produce different results.

CREDIT QUALITY

The credit quality of a particular security or group of securities does not ensure the stability or safety of an overall portfolio. The Quality ratings of individual issues/issuers are provided to indicate the credit worthiness of such issues/issuer and generally range from AAA, Aaa, or AAA (highest) to D, C, or D (lowest) for S&P, Moody's, and Fitch respectively

INDEX DESCRIPTIONS

The Bloomberg U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. It is not possible to invest directly in an unmanaged index.

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