Since the financial crisis of 2008, holders of Auction Rate Preferred Shares (ARPS) issued by closed-end funds have been directly impacted by a lack of liquidity in the market. In simple terms, there is an overabundance of supply of ARPS, and little or no demand for ARPS. As a result, ARPS auctions have consistently “failed” and the ARPS market remains largely frozen.

Q: What are ARPS?
A: Many closed-end funds, including certain of those managed by Pacific Investment Management Company LLC (PIMCO Closed-End Funds), issued ARPS as a form of leverage, selling preferred shares and reinvesting the proceeds in an attempt to boost the distributions made to common shareholders. Because ARPS are senior to common shares in a fund’s capital structure, ARPS shareholders have priority when payments are made, either as dividends or in the case of liquidation.

Q: How does the auction process work?
A: Closed-end funds enlist the services of an underwriter (typically one of the major investment banks) for the initial public offering (IPO) of ARPS, and broker-dealers to facilitate the functioning of the auction process. ARPS trade in weekly or monthly auctions designed to attract at least one buyer for every seller of the outstanding ARPS offered for sale. The dividend rate payable on the ARPS is also reset during a successful auction and is influenced by supply/demand factors as well as the particular ARPS’ credit rating, typically issued by a national rating agency. Although the underwriter that led an ARPS’ IPO is under no obligation to participate in the auction for such ARPS, prior to 2008 such underwriters often stepped in as a market maker to provide additional liquidity for the ARPS by purchasing or selling any outstanding ARPS that did not otherwise receive bids or offers at auction.

Q: What is a “failed” auction?
A: A failed auction generally occurs when there is an overabundance of supply and insufficient demand (i.e., more ARPS are offered for sale than receive bids). If even a single outstanding preferred share offered for sale at an auction does not attract a bid, the auction fails. In February of 2008, most broker-dealers stopped purchasing outstanding ARPS that did not otherwise receive bids at auction, leading to a lack of bids and many failed auctions. It is important to note that a failed auction does not automatically result in a downgrade or default (changes in ratings agency standards, however, have caused ARPS of some closed-end funds,
including the PIMCO Closed-End Funds, to have their ratings downgraded by one or more ratings agencies. Even after a failed auction, funds are required to make dividend payments to preferred shareholders.

**Q: How does a failed auction affect ARPS shareholders?**

**A:** While ARPS dividend rates are influenced by the market in a successful auction, failed auctions cause the dividend rate to reset to a predetermined level called the Maximum Rate. This Maximum Rate typically represents a spread (or percentage) over a short-term interest rate such as the commercial paper rate or the London Interbank Offered Rate (LIBOR). Maximum Rate information for the PIMCO Closed-End Funds is posted daily on pimco.com/closedendfunds.

Failed auctions have also generally resulted in illiquidity for ARPS holders. Depending on the number of shares interested buyers are willing to purchase, it may be possible for ARPS shareholders to sell some but not all of their ARPS in a failed auction (sell orders get fulfilled pro-rata if there are buyers for a portion of the ARPS offered for sale). While any unsold ARPS may be offered at the next auction, there is no guarantee, and we have no current expectation, that future auctions will be successful. ARPS auctions have continued to fail on a regular basis since the initial collapse of the closed-end ARPS market in 2008.

**Q: How does a failed ARPS auction affect common shares?**

**A:** Failed ARPS auctions generally have no effect on the liquidity of common shares of a closed-end fund. However, the market price of a fund’s common shares may exhibit a degree of volatility as investors react to news about failed auctions or other negative press. There is no assurance that the net asset value or market price for a fund’s common shares will not be adversely impacted in the future due to failed ARPS auctions, related events or other market conditions. Additionally, failed ARPS auctions may result in higher leverage costs, which are passed along to common shareholders, because the Maximum Rate may be higher than the rate set by the market during a successful auction.

**Q: What are PIMCO’s views regarding the ARPS outstanding among select PIMCO Closed-End Funds?**

**A:** We recognize that a continued lack of liquidity remains a significant concern to holders of ARPS of the PIMCO Closed-End Funds. There are many factors that PIMCO must consider when reviewing potential financing alternatives to ARPS, including the maturity of such alternatives, the costs of financing such alternatives, other associated costs such as structuring or redemption fees, covenants or other restrictions carried by such alternatives, and the stability of the lenders in the space.

Because ARPS auctions have been failing since the financial crisis, the dividend rates paid on ARPS are currently set at the Maximum Rate (the dividend rate payable), which, as discussed above, is often a short-term interest rate plus a spread or multiplied by a percentage. This means that, in addition to the factors listed above, our economic outlook as it relates both to the interest rate forecast and the viability of alternative forms of financing, which often rely on the balance sheets of banks, also play a role in our assessment of financing alternatives.

In addition, each PIMCO Closed-End Fund’s ARPS have a different formula – set forth in the relevant fund’s by-laws – to calculate the Maximum Rate on its outstanding ARPS, meaning that a financing alternative may be more attractive than ARPS for one PIMCO Closed-End Fund while being less attractive than ARPS for other PIMCO Closed-End Funds. Currently, the ARPS for many of the PIMCO Closed-End Funds carry interest rates and terms that are more attractive than those of the financing alternatives currently available. Importantly, our overall analysis will vary by fund, as each PIMCO Closed-End Fund has a different Maximum Rate, a different set of financing alternatives available to it due to differences in its underlying portfolio, and other varying market dynamics.

Based on the considerations discussed above, PIMCO continues to monitor and evaluate financing alternatives on a fund-by-fund basis, searching for solutions that serve the interests of both common and preferred shareholders of PIMCO Closed-End Funds.
Closed-end funds, unlike open-end funds, are not continuously offered. After the initial public offering, shares are sold on the open market through a stock exchange. Closed-end funds may be leveraged and carry various risks depending upon the underlying assets owned by a fund. Investment policies, management fees and other matters of interest to prospective investors may be found in each closed-end fund annual and semi-annual report. For additional information, please contact your investment professional.

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