Assessing Risk and Allocating Capital: A Framework for Clients

We anticipate a phased but bumpy recovery that plays to the strengths of active management.

Many asset classes have staged a strong rally from their March lows, but significant uncertainties remain. This is hardly surprising. We are, after all, dealing with the first-ever recession induced by shelter-at-home orders, an unprecedented response by fiscal and monetary policymakers, and a novel coronavirus that continues to spread around the world, often with tragic consequences.

In general, we believe the most resilient market sectors will stabilize well ahead of an economic recovery. Our base case remains a deep but short-lived recession and a U-shaped recovery. But if there’s a second wave of outbreaks, or if containment measures last for an extended period, we could face a longer, more uneven growth trajectory.

Figure 1: Valuations cheapened across asset classes during the drawdown

Source: Bloomberg as of 22 May 2020
Valuations based on data over last 20 years or relative to the period from index inception to 22 May 2020. Muni spread valuations from 2 January 2001 to 22 May 2020 and IG 1YR from 16 June 2009 to 22 May 2020.
Amid the uncertainty, we believe investors need sufficient resiliency in their portfolios. In our view, high quality segments of the bond market – including U.S. Treasuries, U.S. agency mortgage-backed securities, investment grade credit and municipal bonds – may provide this resiliency.

Yet a focus on selection – identifying bonds that best combine compelling valuations with solid fundamentals – will be critical. As Figure 1 shows, many market sectors have begun to rebound from their March lows. However, a focus on quality and seniority is likely to be essential going forward as lower-quality segments could face permanent capital loss.

**FRAMEWORK FOR ASSESSING RISK AND RETURN**

In times of crisis, it’s critical to have a strong framework for assessing risk and return. Since the financial crisis of 2008, PIMCO has benefited from a concept of concentric circles (see Figure 2). It places the most liquid, least-risky asset classes at the center, and populates outer rings with increasingly less liquid and riskier segments. Importantly, investors should earn greater risk premiums as they move out from the center.

Our view is that the Fed has been working hard to stabilize the “core,” the center of the circle – cash, and ultra-short bonds. The asset classes just beyond the center have also benefited from the Fed’s measures. These include mortgages, investment grade corporate bonds, municipal bonds and even select high yield securities. Risks are greatest, of course, in outer-perimeter assets.

**TWO-PRONGED APPROACH TO ALLOCATING CAPITAL**

At PIMCO, we’re taking a two-pronged approach to allocating capital in the current environment:

1. Stay focused on quality – Our main priority is to make sure our portfolios are sufficiently resilient; this means owning high quality fixed income assets, including agency mortgage-backed securities (MBS), investment grade credit and municipal bonds.
2. Be opportunistic – Some areas of the market have not yet recovered in price but have strong fundamentals, in our view; these include non-agency MBS, and select senior positions in securitized assets.

**Figure 2: PIMCO’s concentric circles**

Source: PIMCO

For illustrative purposes only.
ACTIVE MATTERS IN UNCERTAIN MARKETS

Nearly a half century of experience has taught us that active management is a responsible way to invest in the fixed income markets – and amid extreme uncertainty, that’s especially true today. Skilled active managers may help reduce drawdowns, preserve capital, and selectively take advantage of opportunities as markets recover. Our disciplined, time-tested investment process and extensive global resources have helped PIMCO successfully navigate past crises and difficult market environments – and enabled us to come out stronger on the other side.

As always, we’re committed and eager to support wealth management firms, advisors and their clients and to help them successfully navigate the challenges ahead.

Please see PIMCO’s “Market Volatility” page for our latest insights into market developments and the implications for the economy and investors.
Past performance is not a guarantee or a reliable indicator of future results.

All investments contain risk and may lose value. 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. 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. Inflation-linked bonds (ILBs) issued by a government are fixed income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. Treasury Inflation-Protected Securities (TIPS) are ILBs issued by the U.S. government. Mortgage- and asset-backed securities may be sensitive to changes in interest rates; subject to early repayment risk, and their value may fluctuate in response to the market’s perception of issuer creditworthiness; while generally supported by some form of government or private guarantee, there is no assurance that private guarantors will meet their obligations. U.S. agency mortgage-backed securities issued by Ginnie Mae (GNMA) are backed by the full faith and credit of the United States government. Securities issued by Freddie Mac (FHLMC) and Fannie Mae (FNMA) provide an agency guarantee of timely repayment of principal and interest but are not backed by the full faith and credit of the U.S. government.

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