



PACIFIC INVESTMENT MANAGEMENT COMPANY

INVESTMENT

OUTLOOK

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Selling the Noise

President and Mrs. Coolidge, visiting a government farm, were taken around on separate tours. At the chicken pens Mrs. Coolidge paused to inquire of the overseer whether the rooster copulated more than once a day. "Dozens of times," said the man. "Tell that to the President," requested Mrs. Coolidge. The President came past the pens and was told about the rooster and Mrs. Coolidge's question. "Same hen every time?" he asked. "Oh no, a different one each time." Coolidge nodded. "Tell that to Mrs. Coolidge," he said.

Well, "Silent Cal", our 30th president, may not have had much to say, but he was certainly successful in pointing out that there are two different ways to looking at a chicken coop or a rooster, as the case may be. This story, which actually led to the formulation of a scientific principle on human sexual behavior called the "Coolidge Effect" (contact your PIMCO account manager for a more thorough explanation) reminded me of some recent differences of opinion on, of all things, bond and stock market volatility. (Right now I feel like the investment manager counterpart of a used car salesman practicing bait and switch. I've grabbed you with the sexy intro, now I'm about to shift gears to the more expensive model.) At Pacific Investment, as most of our readers know, we place a high degree of emphasis on volatility analysis because buying or selling volatility at the right price can make a lot of money. With embedded options attached to almost every bond in the marketplace, the proper stand on market volatility is critical. Corporate bonds with call options, for instance, or mortgage pass-through pools with prepayment provisions, or even noncallable Government bonds with "convexity" characteristics, all have options which vary in price when the financial markets become more or less volatile. Because this is so, yield spreads between corporate, mortgage and Government issues move back and forth like an arrhythmic pendulum. Although some of the movement is due to economic