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The Bond King (Fortune, 2002)
By David Rynecki
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Bill Gross is in the feathered-peacock position. In a glass-walled room with a perfect view of the Pacific Ocean, the highest-paid money manager in the world is standing on his head–his legs split almost horizontally. His muscles are twitching under the strain. Sweat is trickling into his mustache. His face has turned beet red, yet he's able to hum along to Van Morrison's rhythmic "Back on Top." All the while, his personal yoga instructor, a former Marine turned guru named Geo Takoma, chants breathlessly: Free your mind of the outside world. Free your mind of work and responsibilities. Have no thoughts of the bond market.

Easier said than done. This is, after all, a man who oversees the investment of more than $350 billion in bonds–and whose words can spark rallies and ruptures in a $14 trillion market.

Minutes later, we're flying down the Pacific Coast Highway in a night-black Mercedes CL500 on our way to the Newport Beach offices of Pimco, the giant investment firm where Gross serves as chief investment officer and resident sage. Gross is at the wheel, his unknotted Ferragamo tie hanging like a scarf around his open-collared shirt, a glass of springwater in his free hand. As we wrap around curves, he speaks freely about his latest moves: a coup on eurodollars, a $250 million profit the firm made shorting Argentina bonds before anyone anticipated a credit default. And then there's The Bet, several hundred billion dollars spread across thousands of individual securities in a maze of futures, swaps, mortgages, and enough acronyms to fill a dictionary. The thesis driving Gross' current bond strategy is not comforting for those of us expecting a Nasdaq rebound anytime soon: Corporate profitability, the fulcrum that lifts stocks, is going to remain lousy, and economic growth will be stagnant. In such an environment the right mix of bonds could outperform all other financial instruments.

It's a bold call, but one undertaken with the measured steps of an investor who has survived longer than just about anyone else. Heading up to Pimco's trading floor from the parking lot, Gross sounds almost prophetic. "This is a time I've been waiting for," he declares. "This is when a lot of managers are going to realize that climbing to the top means very little. Getting there doesn't matter. The ultimate victory is staying there."

Warren Buffett, John Neff, Bill Miller, Peter Lynch–the stock market has always had dominant personalities whose long-term success becomes legend. In the bond market that dominant personality is Gross. At 57, he is the philosopher-king of bonds–combining big-picture wisdom with day-to-day performance. The chief architect and strategist for the world's biggest bond-management firm, his core portfolios have risen at an average annualized rate of 10.6% since 1973. Stop for a moment and think about that number. Bonds are supposed to be the tortoise of the investment race, not the hare. Yet not only has Gross beaten the benchmark Lehman Bros. bond index by 1.5 percentage points a year during the period, he's not all that far behind the main stock market barometer either: The S&P 500 has risen on average 13% a year since Gross began trading bonds. Equally impressive, Gross has had just three negative years during that stretch, with an average decline of 2.25%. By contrast, the S&P has suffered eight, averaging a 12.5% drop each.

Gross has an unusual combination of strengths. Like Buffett and Neff, he has mastered the craft of the value investor, and much of his stellar performance derives from his reliance on a clear set of mathematical formulas that determine value and reduce knee-jerk emotion. Like Lynch, he has become so closely identified with an organization that, to many, he is the organization. And like Miller, he is unmatched in exploiting weakness.

But unlike any of his peers in the stock market, Gross has compiled his record for brilliance in an area of the market that appears agonizingly dull, a haven for geriatric coupon clippers and math nerds. Whereas the rise and fall of a stock has a kind of inherent human drama–based on Wall Street's ever-changing "story" for a company–bond prices are driven by mathematical equations, tied to interest rates and inflation. Not exactly flashy stuff.

Then again, it ain't 1999 anymore; flash and drama are now decidedly unfashionable. In the two years since the equity bull market went bust, bonds have made a remarkable comeback among investors. Debt has replaced growth as the watchword of choice. The reason for that is obvious: Bonds have beaten stocks for two consecutive years, rising 21% over the period, vs. a 22% decline for the S&P 500. Such a winning streak has not been registered since the recession-plagued days of 1981 and 1982. Though forecasting a third year of outperformance–something that has never happened in the modern era–is a risky bet, one thing is clear: The momentum that was so heavily weighted on the side of stocks for so long has shifted. Stocks are no longer the only box to check in a 401(k) plan. In a market that is treacherous and uncertain, bonds play the role of the married man with children who wears a belt and suspenders–he might have nubby knees and thinning hair, but he's reliable.

And no one is more reliable than Gross, a man who compartmentalizes and analyzes every action so that it fits into a routine so damn monotonous that it would drive most people to distraction.

That routine starts promptly at 4:30 A.M., when the majority of big-brained, diurnal mammals are deep in slumber. Gross begins virtually every day in an enormous Mediterranean-style home built atop a Laguna Beach cliff, with a bowl of Post bran flakes, blueberries, and raspberries–not for the pure berry joy of it all, he admits, but because his wife, Sue, says they are rich in antioxidants. (Sue has also pushed him into the hourlong yoga sessions, which begin at 9 A.M.) During breakfast he checks on global markets from a Bloomberg machine. Then, after a 12-minute ride to Newport Beach, he enters Pimco's trading room. His shirt collar always unbuttoned, his tie always undone, he plops down in a chair and flicks on the four Bloombergs surrounding his desk–always in the same order. First, the one that tracks the ten-year Treasury; second, the global bond markets; third, world currencies; fourth, the general stock and bond indexes.

Finally, Gross checks to see that his lucky dice are in the same place he left them the night before.

Spend a week with the man, and against all instincts you come to understand that this might be the most exciting routine in the world. And on this particular Tuesday morning in December–minutes before the Federal Reserve is due to announce whether it will cut interest rates–the strange, sultry energy in Pimco's trading room is palpable.

Gross is nibbling his fingernails. He is seated in the middle of the oddly silent 4,200-square-foot trading floor, behind a horseshoe-shaped desk. He himself hasn't said a word in 15 minutes. He's staring intently, almost meditatively, at a computer screen flashing the number 96.25. The number represents the price of a eurodollar futures contract set to expire in December 2002. Despite their Continental name, eurodollars give a hint as to where the bond market believes U.S. short-term interest rates, specifically the Federal Funds rate, will lie a year from now. (A eurodollar trading at 100, or at par value, would reflect a 0% interest rate, for example.) The 96.25 figure means the market thinks rates will be at 3.75% come next December–something that could happen only if the economy took off like an Indy car and the Fed slammed on the brakes, raising interest rates two full points.

Hogwash, says Gross. The Fed hardly ever raises rates that soon after a stimulus program, he points out. And evidence suggests it won't this time either. Gross' track record is such that you don't want to bet against him. As early as May 2000, he was insisting that a recession was imminent. He and fellow Pimco managers concluded that two factors, the bursting of the tech bubble and the Fed's frantic rate-raising efforts to cool the economy, were setting the stage for a brutal slowdown. That's when Pimco began unloading $10 billion in corporate bonds and started purchasing an equal amount of government securities and federally backed mortgages. The move earned the firm $500 million in a matter of months. Then, in February 2001, Pimco stashed billions more in Treasuries, believing that the Fed would dramatically cut rates in an all-out drive to reinvigorate growth. One $20 billion stake in Treasury Inflation-Protected Securities, a way to play a drop in short-term rates, netted Pimco a nifty $1.5 billion profit.

Bill gross, managing director, chief investment officer, and founder of Pimco doing yoga in his gym in the Newport Beach Marriott Hotel and Spa. This is his gym which is directly across the street from his office. He works out every workday. 2006Photograph by Robyn Twomey

Sept. 11 was another pivot point. Sensing that the economy was finally near bottom, Pimco's maestro began quietly accumulating higher-yielding investment-grade corporates, including $5 billion worth of AT&T, Ford, and GMAC debt. When you're as big as Pimco, rivals take notice if you start buying bonds in such quantities. And when you're as good as Pimco, those same rivals usually rush to follow your moves. So when word began trickling out that "The Beach," as Pimco is known, was back into corporates, the market rallied and lifted the three new Pimco holdings by $200 million.

Now, in December 2001, Gross is again in Big Play territory, once more betting against the conventional wisdom. A recovery is in the works, he says, but it is hardly the robust rebound the stock market has been anticipating. Gross's sixth sense is telling him that 2002 will be a fine year for bonds, not equities. Inflation will remain tame, he is quite sure. In such an environment, therefore, high-grade corporates and mortgages are overly discounted, trading at a wide yield spread to Treasuries. So Pimco pounces, buying as many of these investment-grade bonds as it can get its hands on. And with rates going, if anything, lower, not higher, eurodollars–at 96.25–look like an all-out steal.

Sure enough, on this day in December, Gross turns out to be right: For the 11th consecutive time, the Fed cuts rates. When the cut is announced, trading desks from London to New York explode with adrenaline. The bond market rallies, sending prices (including those of eurodollars) way up. Anxious, caffeine-stoked salesmen call orders into the Chicago pits. Much of the excitement is tied to a statement indicating that the economy remains shaky. And Bill

Gross? The 100,000 eurodollar contracts he bought–predicated on precisely this scenario–have just netted him $100 million.

Despite the triumph, none of Pimco's 60 portfolio managers, analysts, and trade assistants emit anything louder than a whisper. There's no backslapping, no whooping–just the clacking of computer keyboards. Gross long ago laid down the law that the trading floor should be quiet. He did so not in any verbal communication, but with his eyes: His is perhaps the most intense look you will ever see staring at you from across the room. "When he glares down at you, you'd better get out of the way," says John Hague, a longtime Pimco portfolio manager.

The only voices in the room are coming from the squawk box on Gross' desk, which is relaying the frenzy of excitement from the bond brokers in Chicago. It's so loud, in fact, that Gross, who has yet to mutter a syllable, turns down the volume. He takes a moment to adjust the pair of dice on his desk, positioning them at the perfect roll of five and six. In craps that's the roll when nearly everyone wins.

Finally, Paul McCulley, formerly the chief economist for UBS Warburg and now Pimco's designated Fed watcher, gets up from behind his desk and approaches the boss. McCulley, one of Gross' trusted lieutenants, has the job of translating Alan Greenspan into plain English. In his best "Southern Baptist preacher" drawl, he breaks the silence. "What the Fed just said," he offers, "is that the economy is not going to hell in a hand basket. It's just going to hell."

A bond investor's dream–slow growth and low inflation. Gross looks up and smiles, the spell seemingly broken. "This will be a billion-dollar day for us," he says aloud. "Not bad, eh?"

Bill Gross is so soft-spoken that his voice can barely be picked up by a tape recorder resting two feet below his chin. The voice, thin as a scallion, has an almost childlike quality, pitched high as though it were coming from his cheeks rather than his diaphragm. It is hardly the voice of a high-stakes gambler, at least not the Brett Maverick or Cincinnati Kid version. But that's exactly what Gross is. For the bond king, however, gambling is a team sport. In lieu of roulette and chemin de fer, Gross' handpicked seconds play TIPs, convertibles, and Peruvian debt. And the casino is massive. Pimco's 37 portfolio managers have stakes in more than 50,000 individual securities–and the firm has 14 Ph.D.s who do nothing but calibrate risk. The Beach–so-called because the office gazes upon the Pacific Ocean–manages $250 billion in pension money, private accounts, and a stable of mutual funds led by Gross' flagship $50 billion Total Return fund. It also controls another $100 billion for its parent, the German insurer Allianz.

The Munich-based conglomerate paid $3.3 billion for Pimco in 2000 and signed Gross–who also earned roughly $233 million from the sale of his shares in the company–to a five-year contract worth $40 million a year plus a regular salary and bonus. Assets have since poured into the firm, lifting its totals a stunning 30%. None of which seems to have made an impression on Gross. One imagines he wouldn't be able to find his firm's "back office" if he tried. Refusing to do any marketing, the bond king wants nothing more, it seems, than to play the market. Scratch that–beat the market.

This is how he does it. First, he preys on the element of certainty: Bond investing is built on mathematical precision, in which most of the variables, such as credit ratings, yields, maturities, and duration, are spelled out. Take the last of these terms. Combining the average maturity of all of a bond's cash flow (from its coupons and principal) into a mathematical formula, duration tells investors how the bond will react to interest rate fluctuations. As such, it is simply a measure of risk. The longer a bond's duration, the more wildly its price fluctuates when rates change. If the investor owns a five-year Treasury note, for example, and the Fed lifts rates by a full percentage point, the bond will lose 4% of its value, while a 30-year Treasury will drop 12%. So for cautious investors, the safest strategy is to limit price volatility by owning bonds with a shorter duration. If the outlook is for stable or lower rates, the exact opposite holds true. It will always be thus.

Then, somehow, Gross masters the element of uncertainty. There are a nearly infinite number of variables driven by the human condition (Sept. 11 and Enron, to name two) that are impossible to quantify in a neat formula. Given those imponderables, mathematical models are about as useful at predicting the direction of interest rates, the rate of inflation, and the outlook for corporate profitability as a Magic 8-ball. That's where Gross' surprisingly accurate gut comes in. For a belt-and-suspenders guy, he has a remarkable inclination–and talent–for guessing. Educated guesses, for sure. The philosopher-king will spend hours alone in his office, blinds shut, reading everything from analyst reports to Balzac. There is no TV. He takes no phone calls. It works.

As the record shows, the uncertain world appears more certain to Gross than to virtually all his competitors. And right now his uncanny clairvoyance sees the overall bond market returning between 7% and 8% this year, vs. a stock market that has come dangerously close to meltdown. So Gross is doing what bond guys do when they believe that economic growth is mediocre, stocks are lukewarm, and inflation is minimal. He's going long.

The story goes that in his senior year at Duke University, 22-year-old Gross was involved in a near-fatal car accident when his Nash Rambler skidded head-on into traffic on an icy road. He was thrown through the windshield, and three-quarters of his scalp was sliced off. He spent the rest of the semester in and out of the hospital, receiving multiple skin grafts and treatment for a collapsed lung. To pass the time during recovery, the mathematically inclined Gross started reading a book called Beat the Dealer that purported to have a new system for blackjack players. Gross liked the argument that minimizing risks would lead to maximum returns.

After he'd recovered, he camped out at a $5-a-night motel off the Vegas Strip, and spent upwards of 16 hours a day at blackjack tables at the Fremont and Four Queens. He soon developed his own system, based on the mistakes he saw other players make. Rather than be swayed by emotion or momentum into placing large bets, he used incremental bets to probe the dealer–never risking more than 2% of his stake–putting down more money only as his card counting showed that the odds were improving. Within six months, just in time for his enlistment in the Navy, he had turned the initial $200 stake into $10,000. After he finished a tour of duty on a gunboat in Vietnam, the winnings paid his way through UCLA's MBA program.

Gambling had another effect: It taught him about money management. Though most Wall Streeters cringe at the association, Gross reckons that gambling and money management are one and the same. In each the goal should be to spread risk, avoid becoming emotional, and focus on the odds. An investor succeeds by hitting singles and doubles–not by going for the fences. In fact, a home run is a sign of a mistake, because it deviates too far from the mean. “Vegas taught me that I could beat the system with a combination of hard work, ideas that no one has thought of yet, and the ability to tolerate a constant routine that to many people seems monotonous,” says Gross. “But to me, it’s the most exciting thing in the world.”

By the early 1970s, Gross was working as a junior bond analyst for Pimco, then an obscure distribution arm of Newport Beach-based insurer Pacific Mutual. At the time, bond investing was no more complicated than buying a bond for its duration and literally mailing in the interest coupons that accompanied it. Soaring inflation and a sluggish economy, however, had already diminished the value of such investments, which were entering their worst phase in decades.

Gross had a solution. He approached his bosses with a proposal: Let him take over a modest bond portfolio and see whether he could do better by trading the darn things. By anticipating broad swings in inflation, which has a huge impact on interest rates, he insisted that he could profit from volatility without risking capital. Gross argued that while trading sounded risky, it actually allowed portfolio managers to hedge the risk of holding on to sinking bonds while missing out on higher yields. Pacific Mutual started him off with $15 million. Four years later Gross was managing $40 million out of a cramped office he shared with another Pimco grunt. The strategy paid off. In 1975, a year in which passive bondholders struggled, Gross turned in a 17.6% gain, followed by nearly 18% in 1976.

Over the next three decades he continued to goose the stodgy fixed-income world with an array of weird-sounding strategies. He proved that newfangled instruments like Treasury bond futures, mortgage-backed securities, TIPS, convertibles, and emerging-markets debt could actually be used to diversify a portfolio and thereby minimize risk. But more than that, Gross created the modern bond firm. Debt securities trading had long been a solo endeavor; he turned it into a thriving collaboration of intellectual capital.

Thursday, two days after the December Fed meeting, some 50 Pimco veterans–most of whom had been rising stars on Wall Street before joining The Beach–are proving the point in living color. They have crowded around a 100-foot cherrywood table to spar over how Pimco should play the conflicted economy. It is the mildly termed “Portfolio Manager’s Strategy Meeting,” a full-on brainiac shoving match that takes place every quarter in the domed stadium that is Pimco’s conference room. Gross acts as moderator, only rarely interrupting the intellectual brawl. When he does venture a question, it can seem to come out of left field. To one manager, he asks, “What’s the worldwide implication of a recession in the U.K.?” He gently scolds another who raises the possibility of a private placement in a utility: “We’re not a bank,” he says. Risk is the everpresent theme, no matter what the individual topic. Gross freely admits he’s nervous about more Enrons. “We’re going to see a lot of Enron-type accidents,” he predicts. For the most part, however, he silently watches the debate, rocking back and forth in his chair, twisting his gold wedding band between his fingers.

“You still haven’t made a case,” complains one portfolio manager. He’s targeted a recommendation by Pimco’s emerging-markets guru, Mohamed El-Erian, that the firm go long–meaning buy and hold–on the South African rand as well as Croatian debt. In 2001, El-Erian and partner Curtis Mewbourne compiled the single best record in the sector. The 28% return of their fund, Pimco Emerging Markets, is attributable in part to a decision to short Argentina debt long before the current crisis. When the collapse became more apparent and investors began dumping bonds across Latin America, the Pimco duo swept in and purchased $1.5 billion worth of debt in Mexico and Brazil.

El-Erian is not intimidated by the badgering. A former deputy director of the International Monetary Fund, he turns to Gross to finish his point: “I see this whole cycle leading to a Moody’s upgrade. At some point, we’ll be in a virtuous cycle.”

If the debt is upgraded, bond prices rise, Pimco makes a boatload of money. In other words, a five-and-six roll.

Several weeks after the portfolio managers’ meeting, Gross is standing in thick rough along the 16th hole at Pebble Beach, anxiously clutching an eight-iron. It’s the final day of the AT&T Pro-Am, and he’s playing in a foursome with Tiger Woods. More than 1,000 people have been following the group since they teed off hours earlier. Gross swipes at the ball. For an instant, he pictures it flying toward the flagstick, then watches it head in a line drive toward Woods, who had walked far to the side. “Fore!” he shouts as the shot comes within 18 inches of hitting Tiger in the head. The pro doesn’t flinch.

Had the scene been in the bond market, Gross would have been the calm one. His fund managers have been deploying billions of dollars to support his thesis about the limping economy, buying up investment-grade corporates and emerging-markets debt while also shorting the Japanese yen. At the same time, the firm has been culling its holdings for any potential Enrons (on which the firm lost close to $100 million). It has sold $3 billion worth of triple-A-rated asset-backed securities–credit card receivables and home equity loans–in anticipation of a Moody’s downgrade.

Gross is at peace with his strategy. The turbulence in the financial markets is validation enough. There isn’t a hint of worry, though he does predict that the parade of bankruptcies is just getting started. Which, in many respects, is exciting for him. Bankruptcies are part of the game. And he’s very much enjoying the confusion. Pimco’s higher-quality holdings are benefiting from a flight by investors into safer issues. “When the garbage gets taken to the dump, our portfolio does better than most,” he says.

He’s having fun. As much as walking the links with Tiger Woods is thrilling, it can’t compare with bonds.

Years ago Gross appeared as a guest on Wall Street Week with another young portfolio manager who was beginning to make a name for himself. The manager was Peter Lynch, then the head of Fidelity's Magellan fund and in the middle of a 13-year streak during which his total return topped 2,500%. Then, in 1990, Lynch stepped down. "That was sort of a chicken-shit way out," Gross mutters. "The guy was in his 40s and had lots of years left."

He's often asked whether he should do the same–get out when he's still on top. Would he rather be remembered as a 50-year-old Frank Sinatra at the peak of his vocal excellence or Sinatra at 80 trying to remember the words to "My Way"? For now, Gross might prefer the tune "All the Way," because that's his plan. "I've wondered whether I should do what Lynch did," he says. "But I can't. My desire isn't to make money. I have more money than I know what to do with. My desire is to win–and win forever."