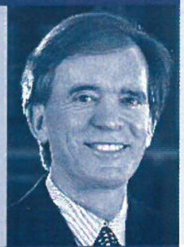
Bill
Gross

Investment Outlook

PIMCO

August 2009

Investment Potions

I took my troubles down to Madame Rue
You know that gypsy with the gold-capped tooth
She's got a pad down on 34th and Vine
Sellin' little bottles of – Love Potion #9

– Love Potion #9, Circa 1959

I've never known any gold-capped tooth money managers, but without squinting very hard there is undoubtedly a strong resemblance between all of us "managers" and the infamous Madame Rue selling Potion #9. Instead of love, though, we sell "hope," but very few are able to seal the deal with performance anywhere close to compensating for the generous fees we command. Hope has a legitimate price, of course, even if its promises are never fulfilled. It is the reason we put a five spot into the collection plate on Sunday mornings and why we risk a 25-dollar chip at the blackjack table. In the former case we usually rationalize it as "insurance," and with the latter as "entertainment." Whatever – I've already alienated all of you with strong faith in the hereafter or the ones who actually believe they're going to win on their next trip to Las Vegas. But my point is that those who sell investment "potions" must wrap their product with an extra large ribbon because history is not on their side. Common sense would dictate that the industry as a whole cannot outperform the market because they are the market, and long-term statistics revealing negative alpha for the class of active managers confirms it. Yet, what a price investors are willing to pay! A recent Barron's article pointed out that stock funds extract an average 99 basis points or virtually 1% a year in fees from an investor's portfolio. Bond managers are more benevolent (or less pretentious) at 75 basis points, and many money market funds manage to subsist at a miserly 38. Still, those 38 basis points are as deceptive as the pea that disappears beneath the shell of a street-side con game. Since money market funds barely earn 38 basis points these days, much of the return winds up in the hands of investment managers. A mighty expensive potion indeed. While some index and ETF proponents avoid this extreme absurdity with lower fees, roughly 90% of the $1.5 trillion in 401(k) and other defined contribution assets in mutual funds are in actively managed offerings with expenses close to 1%. Paying for those potions during an era of asset appreciation with double-digit returns may have been tolerable, but if investment returns gravitate close to 6% as envisaged in PIMCO's "new normal," then 15% of your income will be extracted based on the beguiling promise of Madame Rue. The solution, of course, is to compare long-