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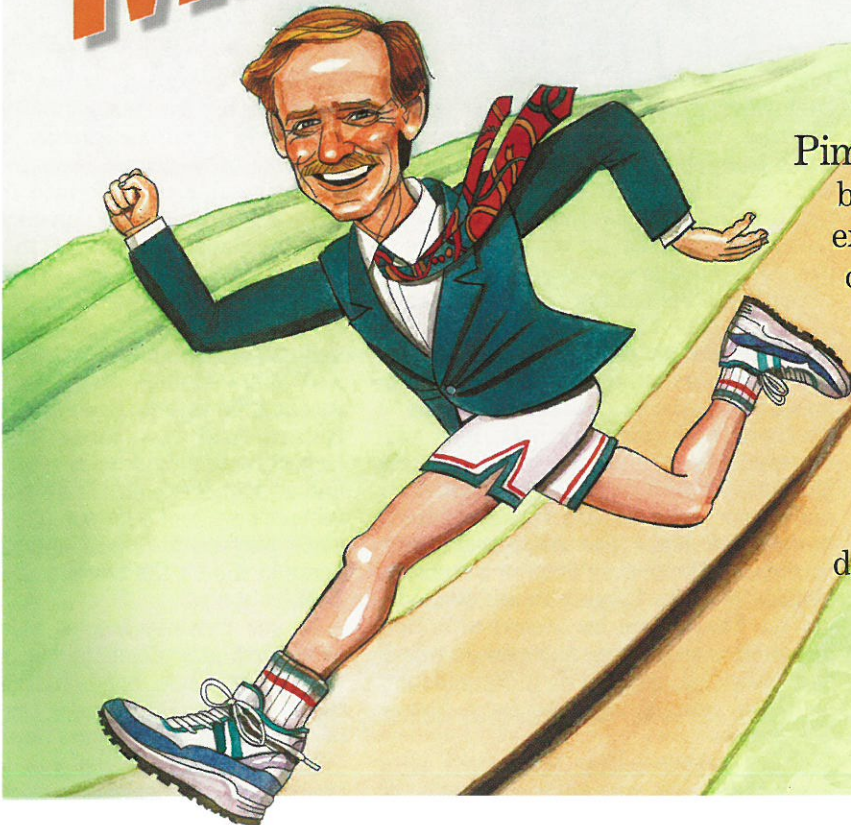
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BARRON'S

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MARATHON MAN



Pimco's Bill Gross, bond-fund manager extraordinaire, has outrun the markets for most of the past three decades. He's doing it again this year, but he sees big dangers ahead.

Randy Jones for Barron's

(over please)

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DOWJONES

A Truly Amazing Run

*But, with dangers ahead,
can Bill Gross keep outracing the market?*

By JONATHAN R. LAING



Randy Jones 2003...

PERHAPS IT WAS THE FREAK storm that sent sheets of rain scudding against the windows at Pimco's headquarters in normally sunny Newport Beach, Calif. Or maybe the press reports that North Korea was testing a missile capable of hitting the Golden State with a nuclear warhead. Whatever the cause, the king of the bond market was decidedly downbeat when *Barron's* visited him recently.

Bill Gross, who oversees \$300 billion in fixed-income investments at Pimco (Pacific Investment Management Co.) predicted that stocks are in for more tough sledding after nearly two decades of mostly fat returns, and that bonds won't turn in the kinds of gains they have over the past few years. The economy's growth prospects are sub-par, he warned, as much because of post-bubble overcapacity and poor profit growth as any geopolitical risk.

He is a study in contrasts. His pessimism is, if anything, only accentuated by his low-key manner and high-pitched voice. Gross can be distinctly New Age, talking, for example, about how his daily yoga sessions (with a personal trainer, naturally) "stretch and extend" him phys-

ically and spiritually. But he's not laid back when it comes to criticizing certain financial or political orthodoxies. In his latest monthly investment outlook, he ruminates darkly on Iraq: "I suspect that by invading 'evil-doer' nations, we may lessen our vulnerability but lose a piece of our soul in the process."

Adding to the incongruity is that Gross, a Vietnam veteran, is the very picture of success, from his expensive silk designer ties to his tanned, whippet-thin physique honed by a rigorous exercise regimen, a Southern California granola diet and exercise. (An avid runner until his knees gave out, he once ran the equivalent of six marathons in six days, a feat that briefly hospitalized him.) The 58-year-old, self-proclaimed Republican lives on a stunning cliffside home in Laguna Beach overlooking the Pacific with his second wife, Sue, and their teenage son. A Japanese television crew that came to do a documentary on Gross mistook his wife for a former TV actress.

Gross acknowledges that, even after taxes and hefty charitable bequests, he has more money than he knows what to do with. When German insurer **Allianz** acquired 70% of Pimco in 2000 for \$3 billion, Gross received more than \$230 million for his stake. Allianz also ponied up a

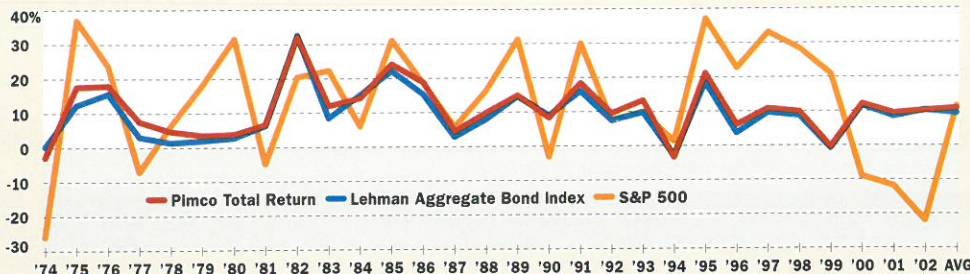
whopping retention bonus: \$40 million *annually* for five years.

Why so much? Gross boasts an extraordinary three-decade investment record, having handily outperformed the Lehman Bros. Aggregate Bond index—bond funds' key benchmark—in 23 of the 29 years since 1973. In that span, his portfolios delivered an average annual return of 10.83%, versus the Lehman index's 9.35%, and stayed within hailing distance of the S&P 500's 11.49% yearly return. Heavy recent inflows into Gross's **Pimco Total Return** fund have made it the world's largest mutual fund, with some \$70 billion under management. Moreover, his investors have had a lot smoother ride than stock players. He's had only three down years in the 29, the worst a 3.36% drop in 1994.

In our conversation, he reiterated his view, first articulated in December, that the government bond market's "salad days" are over, after more than 20 years of falling inflation and interest rates. While rate spreads can still tighten between, say, higher-risk corporate bonds and government debt, letting prices of the former rise somewhat, no sustained bull market in bonds can occur without government paper's participation. And with overnight rates at 1.25% and real yields

A Winning Performance

►Through three decades, Bill Gross usually has kept Pimco Total Return ahead of other bond funds and often in front of stock funds as well. He expects bonds to keep outstripping stocks over the next few years, but sees their returns getting slimmer.



Source: Pacific Investment Management



Bill Gross

on five year TIPs, or Treasury inflation-indexed bonds, under 1% before adjustment for inflation, there's little room for further price gains in intermediate and long-term Treasuries.

The best that bond buyers can hope for in the near future are total returns of 4% to 5%, he predicts. And, in 2004 or 2005, returns may be jeopardized by capital losses if inflation ramps up from its current level around 2% to perhaps 4%, as Gross expects, in response to soaring budget deficits and Federal Reserve efforts to "reflate" the economy. However, Gross doesn't expect an upward thrust in interest rates for many quarters and, when it comes, he says it will be muted. Plenty of folks appalled by money-market yields below 1% will keep cramming money into 10-year Treasuries yielding about 3½%, as they're now doing.

And powerful deflationary forces could frustrate the Fed's easy-money, reflationist efforts, he adds. Without pricing power for finished goods, companies may suffer severe profit-margin pressure from rising commodity costs and other factors. Huge debt loads might induce many to cut staff further, sell assets and curb expansion. Likewise, U.S. households, laboring under record debt levels to GDP, may retrench.

As for stocks, Gross sees their agony enduring, even after a three-year bear market in which the S&P 500 and Nasdaq are down by more than 45% and 75%, respectively. He finds equities markedly overvalued, on a price-to-earnings or dividend-yield basis, when real earnings—rather than those often used by analysts—are taken into account.

Gross drew a firestorm of criticism last fall, arguing in his monthly Investment Outlook that "stocks stink and will continue to do so until they are priced appropriately probably somewhere around Dow 5000, S&P 650, or Nasdaq God knows where." The equity crowd huffed at the bond geek's impudence.

Now he says he threw out the Dow 5000 number as a counterpoint to the now-infamous bubble prediction of Dow 36,000. But even if the Dow never reaches his target (it was 8300 when he made

his prediction and traded as low as 7200 a month later), he insists that it could meander around current levels for a decade or so, until earnings grow enough to properly undergird value. "Double-digit returns for stocks will become a distant memory and corporate bonds should offer returns comparable to stocks over the next few years with a lot less risk," he contends.

Dire Warnings

Part muckraker and part philosopher, Gross has used his monthly market letters to flail companies and take strong positions. Last month's letter claimed that the U.S. is in the early stages of hegemonic decline. His screeds and his 1997 book ("Bill Gross on Investing") are peppered with literary, poetic and rock-tune allusions. His latest letter, bemoaning the U.S.'s pell-mell rush into Iraq, has quotations from Virginia Woolf and Lord Tennyson.

To Gross, the 'Nineties bubble economy both fostered and papered over "imbalances" that could have grave consequences in the future. The surge in corporate and household debt, for example, is bad enough because of its absolute size. But even worse is its composition, he argues. Many borrowers have bulked up on short-term debt to save money on interest costs, rather than prudently locking in a somewhat higher long-term rate. Consumers have embraced three-to-five-year adjustable-rate mortgages and home-equity loans whose monthly tab eventually could move far higher or that are pure floating-rate obligations. Gross says companies have been playing a similar game.

Some companies used off-balance-sheet derivatives to trim their cost of funds from, say, 6% or 7%, to 2%. The preferred means: interest-rate swaps, in which holders of short- and long-term obligations switch positions by taking over the periodic payments for the other one—a ploy almost impossible to track in company financials.

Borrowing short and investing long in residential real estate, plants, equipment or corporate acquisitions is a dangerous

game. Substantial spikes in short-term rates—and they often occur in the normal course of a credit cycle—could cripple households and corporations alike. Gross also fears that Alan Greenspan & Co. are now hostage to the huge buildup in short-term debt. Thus, they may not boost short-term rates as aggressively as necessary to, say, bolster a sinking dollar.

Disinflation Danger

Gross also worries about the annual U.S. trade deficit, now approaching 5% of GDP. "How much longer will the world be willing to devote some 80% of its savings to finance our overconsumption?" he asks. "We've only gotten away with it because we're the globe's primary reserve currency, but fairly soon we're going to be regarded as the emperor with no clothes."

If we're fortunate, he says, the dollar's slide will continue at a measured pace. A panic out of the greenback could batter U.S. financial markets, what with foreigners owning 35% of U.S. Treasuries, 23% of corporate bonds, 14% direct interest in U.S. companies and 13% of U.S. stocks.

Although he won't admit it, stock investors' recent woes have to fill Gross with a bit of *Schadenfreude*. To him, stock investing is a somewhat ignoble calling compared with bond trading. Stocks move more on raw emotion and storytelling than the bond market, which he thinks can be beaten with steely detachment and rigorous mathematical analysis. Then, too, equity investors often have the deck stacked in their favor. In the post-1982 stock bull market, greedy corporate managements were forever trashing bondholders by leveraging up their balance sheets to boost their personal holdings of restricted shares and stock options.

In a Fortune magazine profile last year, Gross criticized Peter Lynch, the storied ex-manager of Fidelity's **Magellan Fund**, for retiring in his 40s in 1990. Neither does Bill Miller, the celebrated Legg Mason stock-fund manager, earn much praise for beating the S&P 12 years in a row. "Anyone can theoretically roll 12 sevens in a row," Gross snarls, mindful of

his own record of generally topping Mr. Market over three decades.

This is Gross's darker side again. In keeping with that is the often-told tale of how he turned \$200 into \$10,000 by card-counting at the Las Vegas blackjack tables following his 1966 graduation from Duke. Gross says the tawdriness of the 16-hour stretches at the table, cheap motels and 75-cent breakfasts combined "to lower my view of humanity." Then it was on to Vietnam, where he served as a Navy gunboat officer ferrying Marines and Seals on special operations. "I came away very conflicted about war, even though my assignment wasn't nearly as dangerous as what the Marine grunts in the country" faced, he explains. "That's one reason I'm speaking out on Iraq now."

Much of Pimco's success in recent years stems from his realization in the mid-'Nineties that forces at work in the U.S. and abroad were squelching inflation. Perhaps the most important: the globalization unleashed by the Cold War's end, which opened low-wage areas such as China and India to international commerce. At the same time, aging populations in the U.S. and other key developed lands such as Japan and Germany promised lower levels of inflation from reduced consumption.

Another weight on economic growth and inflation has been the build-up of corporate and household debt. The refinable mortgage has saved the day for consumers by letting them slash monthly payments and suck equity out of their dwellings. But, Gross says, that game is about over, now that interest rates' decline and home prices' ascent have slowed.

Disinflation is a wonderful tonic for markets, until it turns malignant, as Gross argues it did last year. Now, he contends, the U.S. is staring into the same deflationary abyss that has swallowed Japan. Pricing power for goods and wage growth are evaporating. Stocks have continued to slump. Debt contracted on the assumption that it would be paid off through rising income streams could become back-breaking. Liquidity is drying up. Debt defaults are soaring. And forced asset sales will only exacerbate the collapse in prices of, say, telecom gear.

To be sure, Gross also cites a number of inflationary tailwinds, including rising energy and medical-care prices. The Bush administration's tariffs on foreign steel and Canadian lumber fan inflation, too, Gross says. In addition, U.S. fiscal and monetary policy are in pedal-to-the-metal mode, attested to by interest rates at four-decade lows and the shift from budget surplus to deficit. And a war or new tax cuts will only worsen the situation, he asserts.

Ultimately, employing cheap credit to

Gross says he won't keep playing the bond game if he isn't a winner: "If I have two or three years of losing out to the index and my peers, then I will hang it up."

reflate an economy sends out false price signals and creates capacity and supply bubbles, the Pimco manager maintains. "It seems quite possible that our reflation attempts will...leave us at best with stagflation and at worst with an economy characterized by heavy job losses and continued debt liquidation."

Gross's bleak view of stocks' prospects rests on his gut feelings and research by the likes of consultant Peter Bernstein and Pasadena money manager Rob Arnott. Yes, they say, the stock market has indeed provided a real (inflation-adjusted) annual return of nearly 7% over the past century—about five percentage points more than less-risky Treasury bonds. But, they contend, the outperformance was more an accident than proof of the inherent superiority of stocks.

Bond returns were savaged by an inflationary shock in the 'Sixties and 'Seventies unprecedented in the U.S. And stocks' P/E ratios tripled during the century, while shares became valued at about 20 times to 60 times their dividend yield. "Some observers argue that P/E ratios deserve to be at today's elevated levels because of cheaper stock transaction costs, more favorable tax treatment of stock gains and enhanced stock-market liquidity, but I feel that the possibility of some post-Sept. 11 calamity has ratcheted the risk level of the stock market high enough to militate for much lower valuation levels," Gross declares.

He also notes that real dividend growth—a proxy for earnings gains—contributed about one percentage point to annual stock returns over the century. In fact, Gross points out, the main component of the roughly 7% annual stock-market return was the starting dividend return of 4.2% in 1900. But with an average dividend yield around 1.7% or 2.0%, 21st-century stock investors are starting the next hundred years at a much higher valuation level. This will blight annual returns for years.

Idiosyncratic Bets

Gross sees annual real stock returns hovering around 4%—not any better than what he expects a diversified portfolio of government, mortgage and corporate bonds to generate. To beat bonds, Gross says, stocks must slip at least to Dow

7000, so they'd have a starting yield of 2.7%. At Dow 5000, this yield hits a respectable 3.5%. But that's not something stock investors would savor.

Through Thursday, just 2½ months into the year, Pimco Total Return was up 1.55%, again laying waste to the Lehman benchmark, which had advanced by 1.27%.

Gross is outpacing the market by, as usual, making idiosyncratic bets. For example, while Treasury securities account for about one-third of the Lehman weighting, they make up only about 10% of his holdings. He's overweighted by roughly 10 percentage points in mortgages, which account for about one-third of the index. But he's opted for shorter, 15-year maturities to guard against any major rise in rates, which could hurt his holdings.

Gross is also reaching for yield via a 4% position in debt from emerging markets—Mexico, South Korea and Brazil—a sector not in the Lehman index. These bonds boast 8%-15% yields, and Gross thinks there's little chance of default because their issuers rely heavily on commodity sales to fuel their economies, and he sees commodities staying strong.

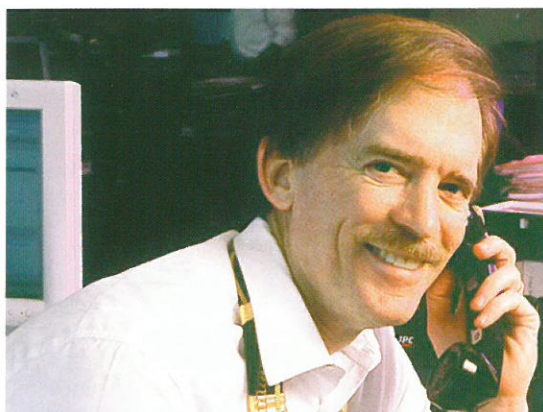
He also has a 15% weighting in the bonds of developed countries, with a heavy exposure to the German *bund*. A large portion of this position is hedged for currency risk and costs him 1.5 percentage points. That vigorish absorbs the gain he'd get from the yield spread between short-term issues from Europe (2.5%) and the U.S. (1.25%), so Gross is rooting for the European Central Bank to cut rates more.

His 5% position in TIPs, another sector not in the Lehman index, has also paid off nicely, as after-inflation Treasury yields have fallen sharply. A lighter-than-Lehman weighting in corporate bonds helped Gross finish in the top quartile of his peers last year, according to Morningstar. A huge plus: He largely avoided the WorldCom and Enron debacles.

Now corporates have a weight in his portfolios nearly equal to their 35%-40% representation in the Lehman index. Despite concerns about the U.S. economy, he finds the issues tempting, given their two- to three- percentage- point yield advantage over Treasuries. And he expects investment-grade corporates to outpace their issuers' stocks.

Yet his innate caution is keeping him from any grandstand plays. His aim is to outstrip the Lehman index without taking on more risk than it does.

For Gross, trying to beat the market remains exhilarating—as long as he's at the top of his game. "If I have two or three years of losing out to the index and my peers, then I will hang it up," he says. But at least for the time being, that's not a worry. The king of bonds still sits securely on his throne. ■



New-Age Man *Jonathan R. Laing*

COVER STORY • “Bond King” Bill Gross has an extraordinary investment record and a bleak view of what lies ahead for the economy. The end of Treasuries’ “salad days.” The dangers of disinflation. Dow 5000?