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Don't be complacent, take advantage of the illiquidity premium

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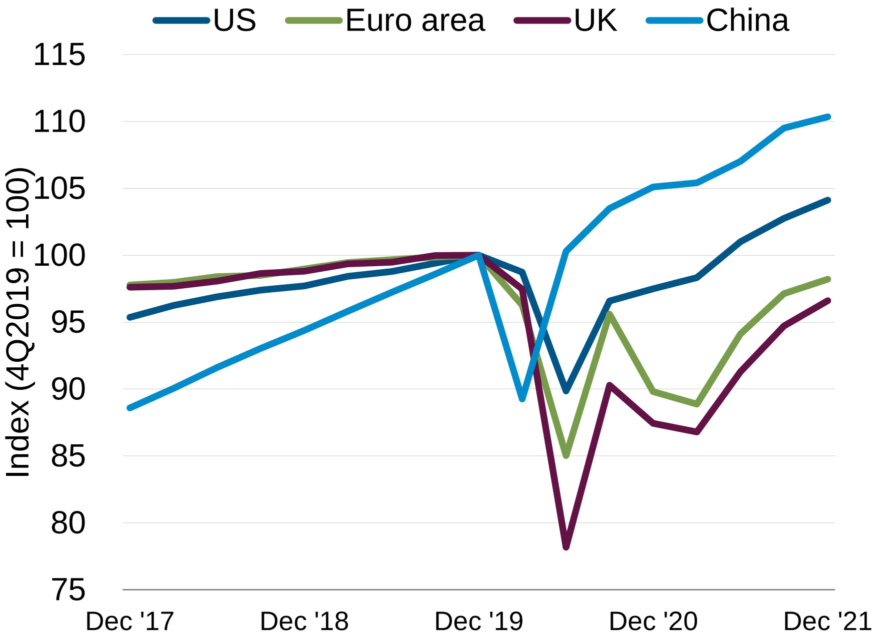
Portfolio Construction **Forum**

Cyclical outlook: Bounded Optimism on the Global Economy

Real GDP growth (4Q 2019 = 100)



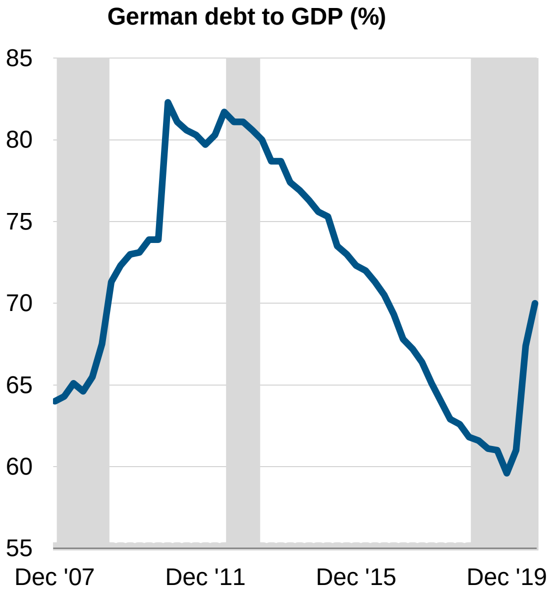
KEY HIGHLIGHTS

- **Global output and demand likely to rebound strongly in 2021**, driven by the rollout of vaccines and continued policy support.
- **Inflation should creep up only moderately** in 2021.
- **Central banks to remain supportive**, keeping policy rates low and continuing asset purchases through the year
- Key risks to baseline outlook include:
  - i. Fiscal fatigue or gridlock
  - ii. A negative credit impulse in China
  - iii. Pandemic-related economic scarring

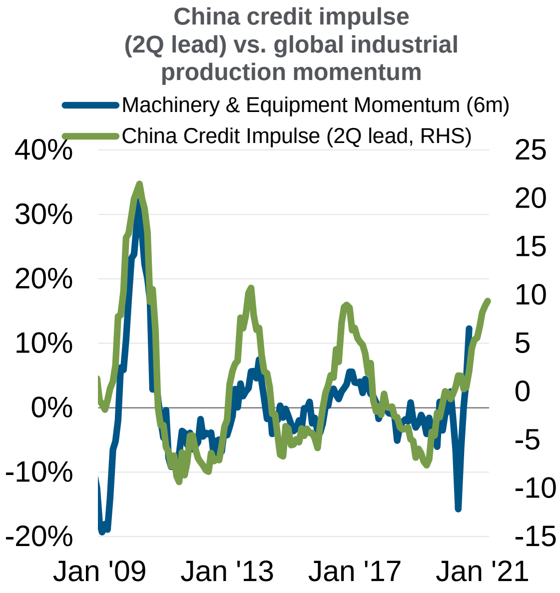
For illustrative purposes only
As of December 2020
Source: Haver Analytics, PIMCO

Three risks to the baseline outlook

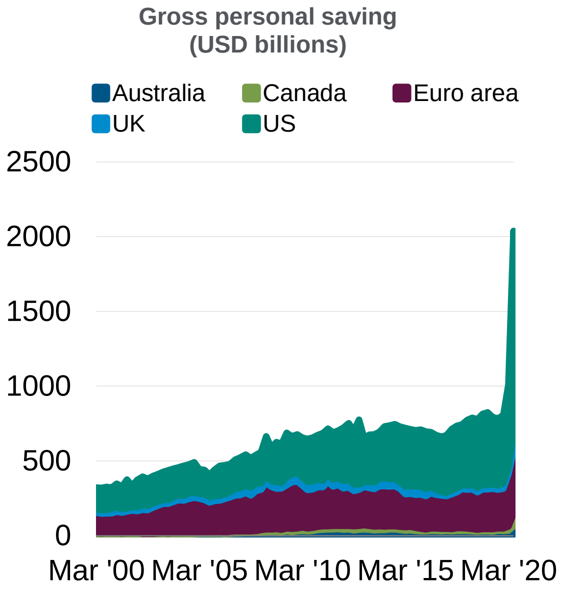
1 Fiscal fatigue



2 China deleveraging



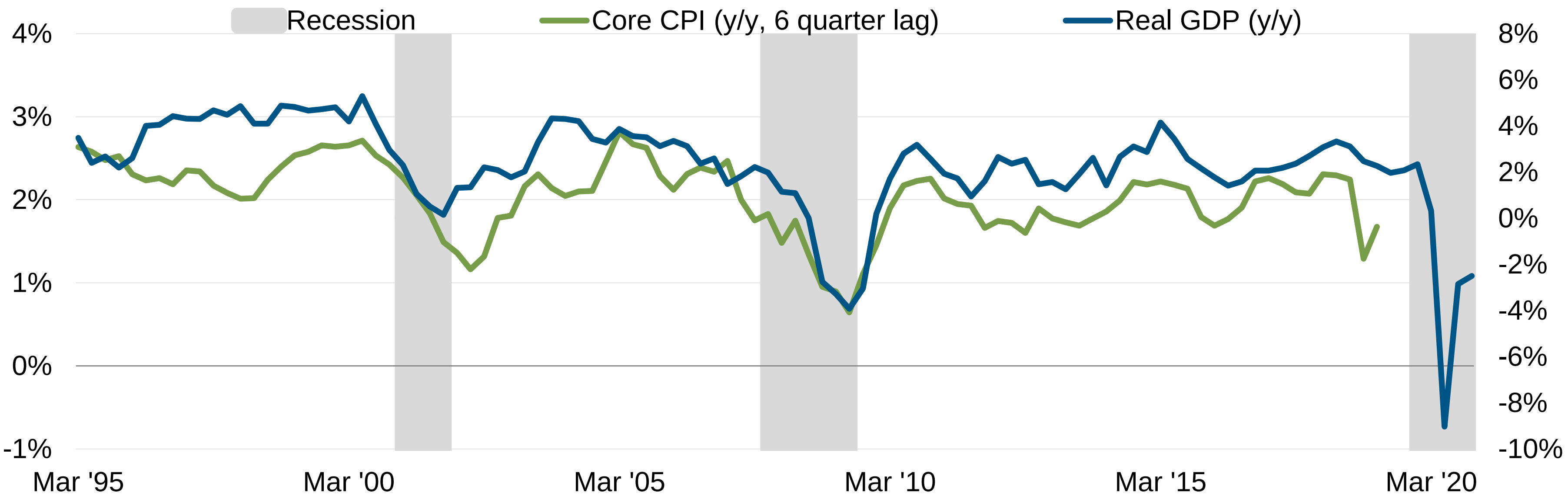
3 Economic scarring



As of December 2020. SOURCE: Haver, PIMCO. For illustrative purposes only.

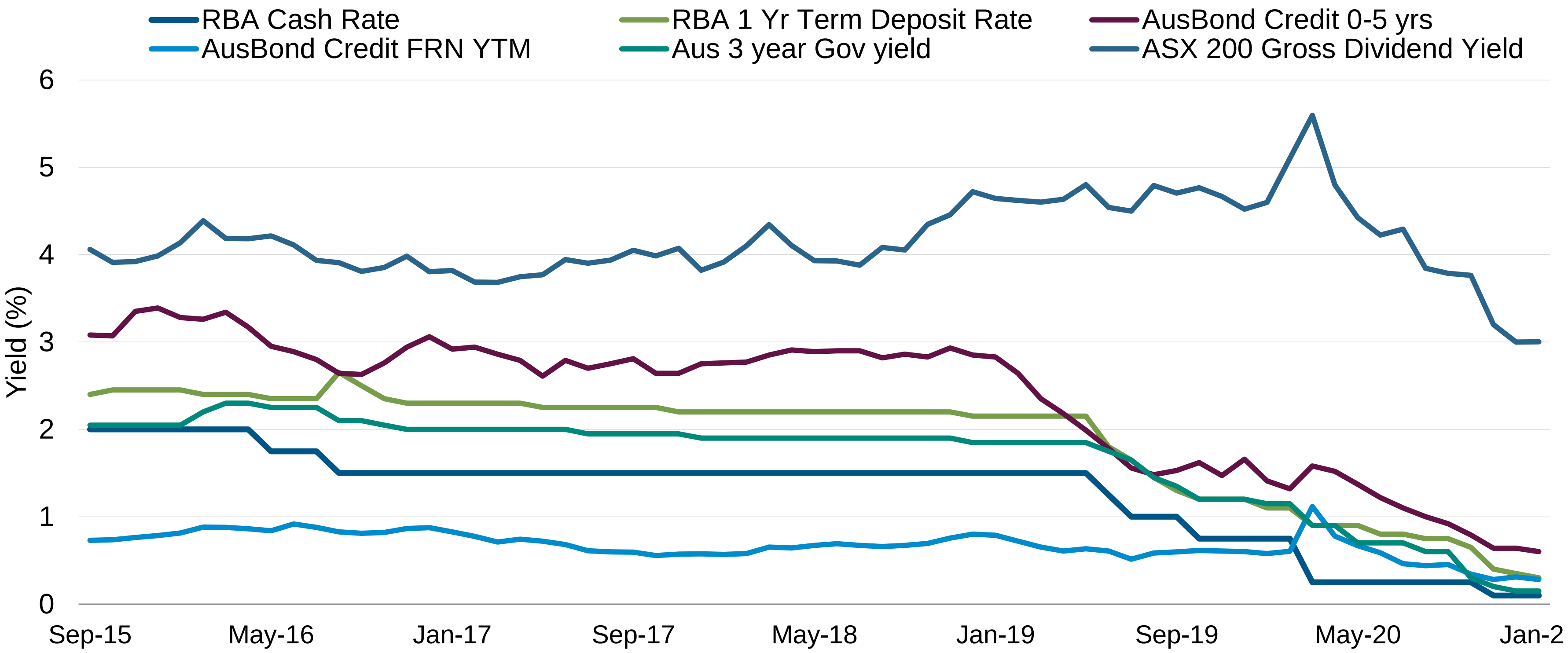
Despite strong growth rebound, inflation targets likely remain elusive for now

Growth leads inflation



As of December 2020. SOURCE: Haver

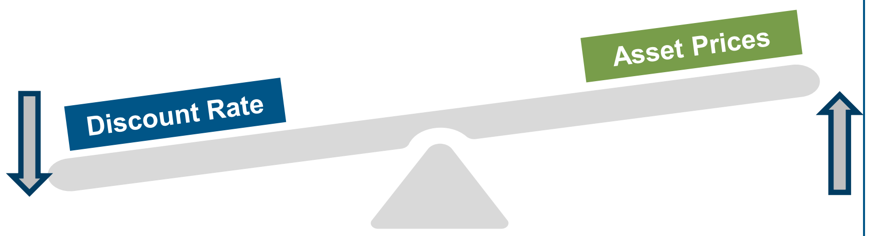
Yields have fallen! *Below 1% for Australian high-quality credit and 3% for shares*



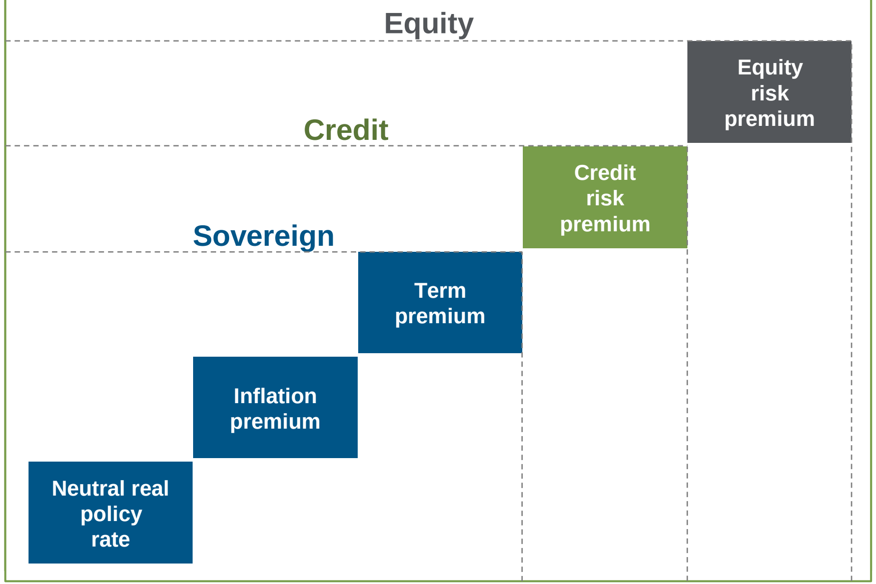
As of 31 January 2021.
Source: Bloomberg.

What low yields mean across asset classes

Lower discount rates led to higher valuations…

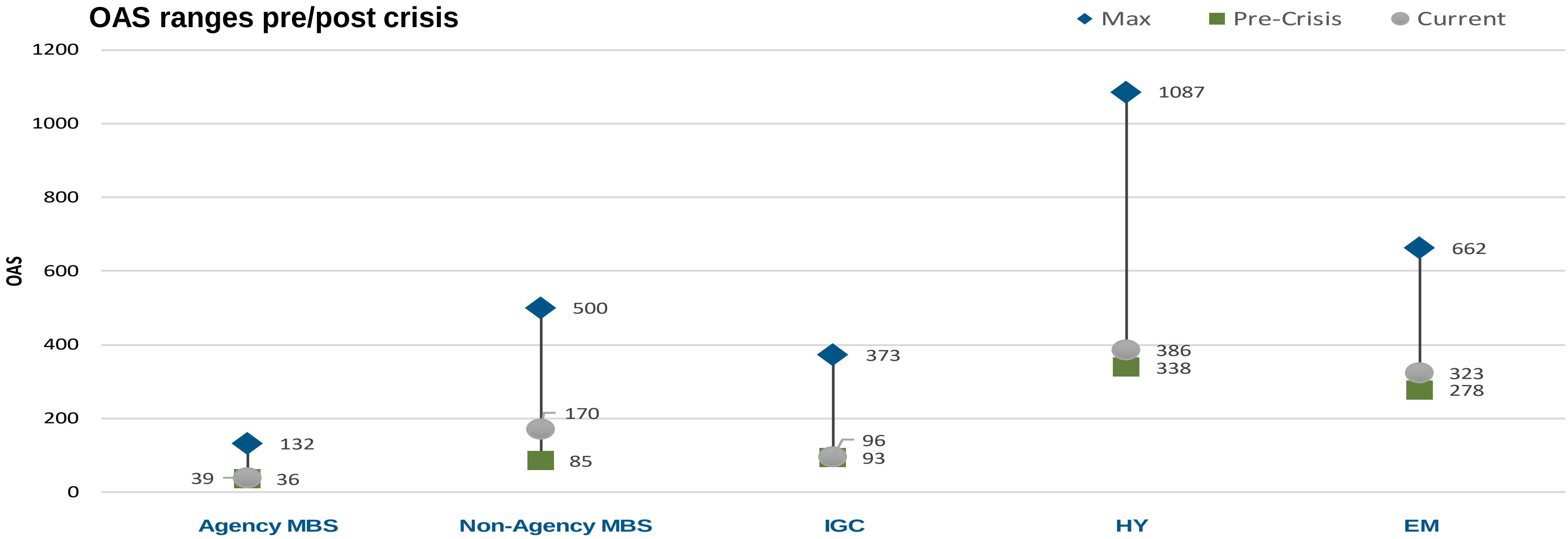


…across all major asset classes



For Illustrative Purposes Only
SOURCE: PIMCO

Generic valuations are rich – don't take lazy beta exposures



	Agency MBS	Non-Agency MBS	IGC	HY	EM
Percent Retracement	97%	80%	99%	94%	88%

Past performance is not a guarantee or a reliable indicator of future results.

As of 31 December 2020

Source: Bloomberg, BofAML, PIMCO. Pre Crisis Spread Date: Agency MBS: 1/13/2020, Non-Agency MBS: 2/28/2020, IGC: 1/22/2020, HY: 1/20/2020, EM: 1/17/2020

Agency MBS: Bloomberg Barclays Fixed Rate MBS OAS; IGC: Bloomberg Barclays Credit Aggregate; HY: Bofaml US HY Credit Index; NAMBS: BofAML Current Pay Subprime; EM: JPM EMBI Global External OAS

The Illiquidity Premium

Why do you get paid to lock up your investment

- Market modelling can quantify the illiquidity discount associated with long-term capital lockups. The outcomes show that the economic justification for a liquidity discount is the return opportunity one forgoes when they commit capital.

- Investors with a reasonable ability and willingness to take advantage of alpha opportunities should command liquidity premiums of 1.5% to 2.5% per year over and above other available risk premiums

- Capital needs to be locked up, so that a private fund's investment nature is aligned with investor expectations

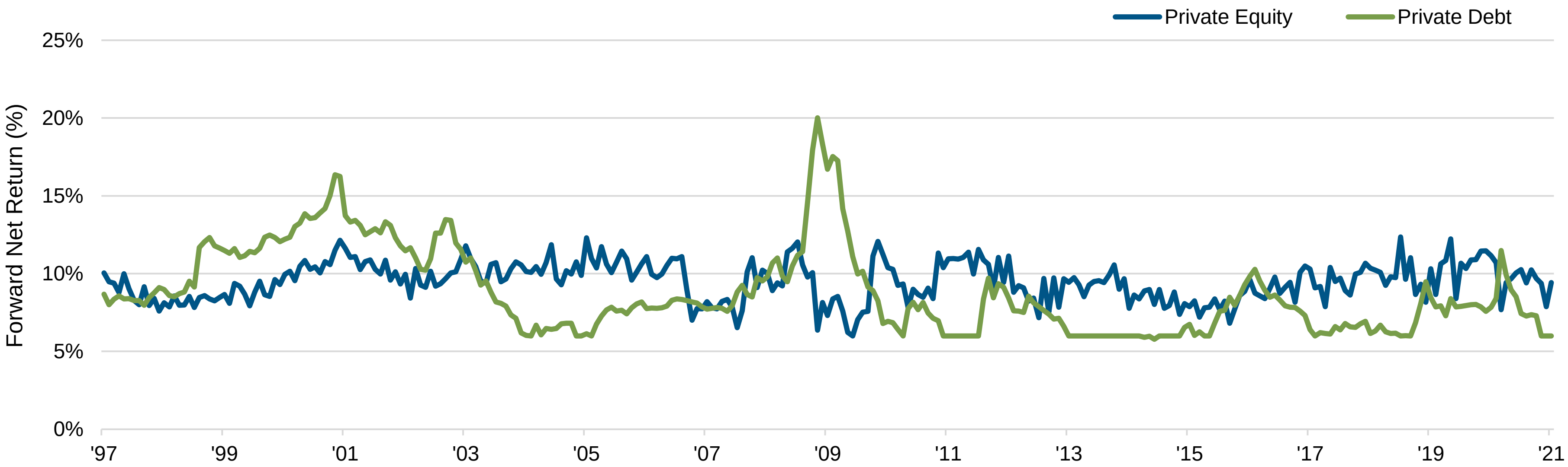
- Depending upon market conditions and investor skill, effective liquidity premiums can be significantly higher.

As of 30 June 2020. SOURCE: PIMCO

** See "Valuing a Lost Opportunity: An Alternative Perspective on the Illiquidity Discount" Jamil Baz, Christian Stracke, and Steve Sapra. PIMCO (2019)

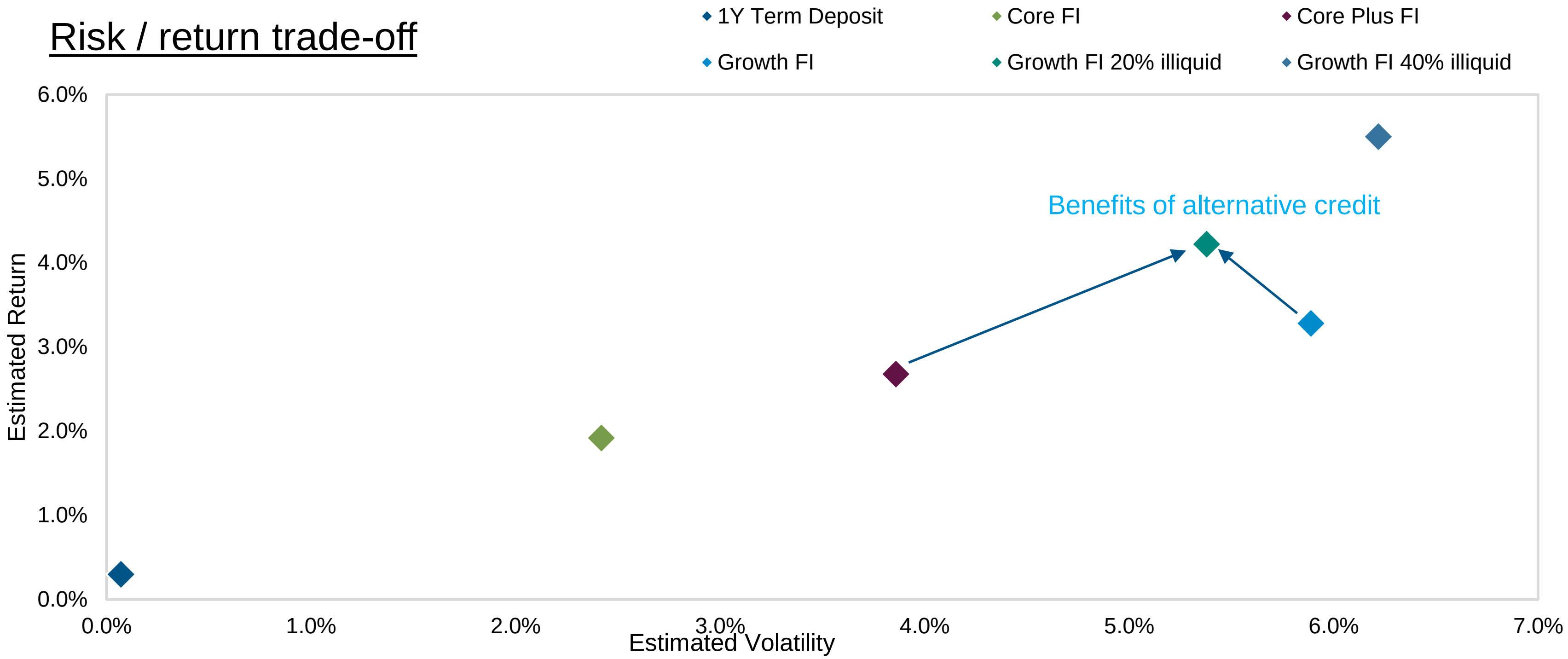
What looks cheap today? Illiquidity.

Comparing forward expected returns for private equity and private debt given current market conditions



As of 29 January 2021. SOURCE: Bloomberg, PIMCO modelling. **Hypothetical example for illustrative purposes only.**
*The private equity and private debt expected return shown is the average of the alpha added to the beta component.

How to get 5% expected return with half the risk of shares



For illustrative purposes only. As of 31 January 2021. Estimated return and volatility are sourced from PIMCO's proprietary system - PIMCO Risk Analytics and Hedging Application

* Calculated in a mean-variance optimization under consideration that at least 60% of the portfolio need to be highly liquid at any time with a probability of success of 90%.

Investment implications

Portfolio Implications

1)	Avoid rich sectors of the bond market that have rallied disproportionally due to QE
2)	Don’t be lazy - Allow active management to harvest the dispersion in valuation across bond sectors and securities
3)	A combination of interest rate, credit, and illiquidity risks provide diversified FI exposures with attractive return potential
4)	A private asset allocation of 10% - 23% is optimal for a representative 60/40 portfolio
5)	Don’t be complacent, take advantage of the illiquidity premium

Items for you to investigate further

1)	Inflation should creep up only moderately in 2021
2)	Central banks will remain supportive, keeping policy rates low and continuing asset purchases over the cyclical horizon
3)	Lower discount rates have elevated valuations with generic beta seen as rich
4)	An ability and willingness to lock-up a fraction of your capital should command a 1.5% to 2.5% additional premium per year for most investors. Investors that are highly skilled can generate significantly more
5)	Go back to your desk and ask - Is my asset allocation aligned with my macro view?

SOURCE: PIMCO

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