It’s hard to imagine a more challenging decade for income investors than the past 10 years. It was bookended by the great financial crisis and the surge in populist politics that led to the election of Donald Trump as U.S. President. Along the way, markets were roiled by the European debt crisis, the taper tantrum, concerns over a slowdown in China, the onset of interest rate normalization in the U.S., and Brexit. Through it all, interest rates and yields remained near historically low levels.

Nonetheless, PIMCO Income Fund's “bend but don’t break” strategy successfully navigated these dynamics, delivering consistent income. As the Income Fund reaches its 10th anniversary on 30 March, portfolio managers Daniel J. Ivascyn and Alfred T. Murata discuss how they turned volatility into opportunity and positioned the fund for a period of rising rates and elevated uncertainty.

Q: When you look back over the past decade – quite possibly one of the most tumultuous for markets – what aspects of the Income Strategy proved most important?

Ivascyn: First, I’d like to say how gratified Alfred and I are to have reached the Income Fund’s 10th anniversary. It was a team effort and we thank everyone involved, especially our clients who trusted us as stewards of their capital.

As changing demographic trends and a growing need for income among our clients became increasingly clear, we saw demand for a more systematic approach to deliver consistent income and capital appreciation.

This led to the Income Fund’s benchmark-agnostic approach and its flexibility to invest across a broad opportunity set, which have been crucial to navigating a challenging decade. Active management allowed us to manage duration and sector exposures to help keep the portfolio diversified across regions and sectors. We’ve seen periods when yields have fallen, periods when credit spreads have widened, and importantly, periods when yields actually rose as credit spreads widened. And throughout all these periods, this strategy has been able to use its flexibility in an effort to reduce downside risk and source opportunities from market dislocations.

Flexibility is necessary but not sufficient, however. Significant resources are required to seek
opportunities across the global opportunity set. That’s where PIMCO’s scale comes into play. With portfolio managers and trading desks around the world, we have the ability to invest across all sectors of the $100 trillion global fixed income markets. This can be especially valuable in an environment of low interest rates, where market mispricings may represent a more significant source of return potential.

Q: How does PIMCO’s investment process factor into the strategy?

Ivascyn: PIMCO’s investment process has played a central role in managing the strategy. Our Cyclical and Secular Forums, which bring together PIMCO investment professionals, along with outside experts including members of our Global Advisory Board led by former Federal Reserve Chairman Ben Bernanke, distill outlooks for economies and markets over the coming six to 12 months and three to five years, respectively. These top-down macro views are further informed by bottom-up insights from credit analysts, traders and portfolio managers focused on specific asset classes.

These insights help us calibrate the Income Fund’s “bend but don’t break” strategy, which is based on our view that the best way to generate consistent income and stable net asset values is to divide the portfolio into two components. The first is composed of higher-yielding assets that we expect will perform well if economic growth exceeds expectations. The second is invested in higher-quality assets that we believe will do well if economic growth disappoints. The Income Fund pursues a distinct strategy, but it’s fully integrated into PIMCO’s investment process.

Q: What’s the current outlook?

Murata: Over the coming year, we think the nearly eight-year-old global economic expansion will continue to strengthen. Growth will be fueled by supportive fiscal policies in most developed market economies, easier financial conditions since the start of this year, improved consumer and business confidence and a rebound in global trade. We expect two more Federal Reserve rate hikes in 2017, in addition to the one on March 15th. We forecast global GDP growth between 2.75% and 3.25% over the coming 12 months. (For details, see our current Cyclical Outlook, “Scaling It Back.”)

Over the three- to five-year period, we expect additional Fed rate hikes, although rates – and economic growth – are likely to peak at levels below historical norms because of demographics, the growth of public and private debt and slow productivity growth.

For these and other reasons, we foresee an investment landscape that will be as challenging as it is potentially rewarding. We see elevated volatility and uncertainty and an increased probability of both left-tail (downside) and right-tail (upside) outcomes.

Left-tail risks relate to central bank policies that are reaching their limits, stretched valuations, unsustainable debt levels, political uncertainty and the risk of trade wars. Right-tail risks include a rebound in global productivity – which would support higher investment, consumption and “animal spirits.”

While there are no guarantees, we believe this environment favors active strategies. Risk
management, including maintenance of sufficient liquidity and portfolio flexibility, is critical to navigating markets that will likely be volatile over the coming period.

**Q: How is the portfolio positioned given our outlook?**

Ivascyn: As always, our top priority is to provide consistent income and long-term capital appreciation. The higher-yielding part of the portfolio focuses on defensive, high quality, short-dated and default-remote corporate and structured credit. For example, we continue to see value in non-agency mortgage-backed securities (MBS), which have attractive yields and may be resilient even during slower economic periods.

In the higher-quality bucket, we’ve recently added U.S. interest rate duration, especially after the U.S. election, as a way to be more defensive against potential left-tail scenarios. We also find it attractive to invest in Australian interest rate duration. If there’s a slowdown in Chinese growth, we think commodity prices would weaken, reducing growth and interest rates in Australia. We continue to see value in diversifying exposures globally. Almost 30% of the portfolio is invested overseas, in both emerging and developed markets.

**Q: Alfred, what’s the outlook for non-agency MBS?**

Murata: Non-agency MBS are backed by mortgage loans in the U.S. but don’t have a guarantee from government agencies such as Fannie Mae or Freddie Mac. Investors depend on borrowers to pay them back. So we look carefully at two main performance drivers – home prices and borrower quality – and we see value.

What the market may not fully appreciate is that for legacy securities issued before the financial crisis, many of the borrowers have been making payments for 10 years or more, which improves credit quality. In addition, we are looking to buy these bonds at around 75-85 cents on the dollar, so we don’t need to get back to par to get an attractive return.

**Q: The Income Fund has attracted more investors. Should they be concerned about capacity constraints?**

Murata: We don’t see this as an issue anytime soon. The $100 trillion global fixed income investment universe is immense and we believe we have ample room to find attractive opportunities. We strive to maintain a diversified portfolio with securities across the liquidity spectrum.

It’s true that some sectors are smaller or shrinking. But the strategy has been able to find attractive opportunities from diversified sources over the years. This is why the strategy’s benchmark-agnostic approach and its flexibility to invest across a broad opportunity set are so important to navigating the current market environment and seeking consistent income and attractive risk-adjusted returns.

**Q: Finally, no one could have predicted all the shocks of the past decade. What do you say to investors worried that the coming decade will bring even more surprises?**
Ivascyn: Market volatility is a given but also an opportunity, particularly in an era of low interest rates. When the market overreacts, it's often a good time to seize opportunities.

Another way to say this is that we're willing to accept mark-to-market volatility, but we look to protect the portfolio against permanent capital loss. Our emphasis on structural seniority and an allocation to higher-quality assets is an important way of seeking stability in the fund's income distribution and net asset value.

We've come through a tumultuous decade. And we're confident about our ability to weather whatever comes next.

The Fund has issued a dividend distribution for each month since inception. No guarantee is being made that a future dividend will be issued.

Guarantee is based on agency corporate health, and is not explicitly guaranteed by the U.S. government. During the recent financial crisis, the U.S. government affirmed its implicit backing through the conservatorship of the agencies.

DISCLOSURES

Investors should consider the investment objectives, risks, charges and expenses of the funds carefully before investing. This and other information are contained in the fund's prospectus and summary prospectus, if available, which may be obtained by contacting your investment professional or PIMCO representative or by visiting www.pimco.com. Please read them carefully before you invest or send money.

It is important to note that differences exist between the fund's daily internal accounting records, the fund's financial statements prepared in accordance with U.S. GAAP, and recordkeeping practices under income tax regulations. It is possible that the fund may not issue a Section 19 Notice in situations where the fund's financial statements prepared later and in accordance with U.S. GAAP or the final tax character of those distributions might later report that the sources of those distributions included capital gains and/or a return of capital. Please see the fund's most recent shareholder report for more details.

Although the Fund may seek to maintain stable distributions, the Fund’s distribution rates may be affected by numerous factors, including but not limited to changes in realized and projected market returns, fluctuations in market interest rates, Fund performance, and other factors. There can be no assurance that a change in market conditions or other factors will not result in a change in the Fund’s distribution rate or that the rate will be sustainable in the future.

For instance, during periods of low or declining interest rates, the Fund’s distributable income and dividend levels may decline for many reasons. For example, the Fund may have to deploy uninvested
assets (whether from purchases of Fund shares, proceeds from matured, traded or called debt obligations or other sources) in new, lower yielding instruments. Additionally, payments from certain instruments that may be held by the Fund (such as variable and floating rate securities) may be negatively impacted by declining interest rates, which may also lead to a decline in the Fund’s distributable income and dividend levels.

A word about risk:

Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Mortgage and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market’s perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. High-yield, lower-rated, securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. Diversification does not ensure against loss.

There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.

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