Eight months after Bill Gross’ abrupt departure from PIMCO on Sept. 26, 2014, the dust is finally starting to settle. Since September, Morningstar analysts have had more than three dozen conversations with senior PIMCO managers, business leaders, and investment staff, including a two-day due-diligence visit at the firm’s Newport Beach, California, offices held in March. In this commentary, we provide an update on the firm and the evolution of the investment team in recent months. In addition we address recent outflows and assess the impact of these flows on PIMCO’s business model and ability to attract and retain talent.

**Key Takeaways**

- We continue to have a cautiously optimistic outlook for PIMCO’s future. We’re encouraged at the progress the firm’s leaders have made in stabilizing the investment team, fortifying the firm’s culture, and continuing to invest in its research effort. Yet, the situation is fluid amid continued outflows and an investment team still in the formative stages of jelling and reforging its identity. Team stability continues to weigh heavily in our assessment of whether PIMCO can succeed in the future.
- Outflows since Gross’ departure have been worse than many had expected. While they have come down significantly so far into the second half of 2015 and we think that there are reasons they may ease later this year, we continue to watch this situation closely.
- PIMCO’s high profit margins should cushion it, and Allianz has proved to be a supportive parent, but continued outflows could spur cost-cutting and, with it, organizational instability.
- Year to date, Morningstar has updated ratings on a number of PIMCO strategies, with PIMCO Total Return PTRRX retaining its Bronze Analyst Rating; Morningstar has also affirmed PIMCO’s Neutral Parent Pillar score and “C” Stewardship Grade (attached as Appendix 2).

**Firm Update**

Reassuringly, fears that PIMCO would suffer mass defections following Gross’ departure have not materialized. There have been a few notable departures, among them Saumil Parikh, who led PIMCO Unconstrained Bond PFIUX after Gross left, and central-bank watcher Paul McCulley, who had returned to PIMCO in mid-2014 at Gross’ behest and whose departure was signaled well in advance. Overall, turnover in the firm’s investment staff has been close to historic levels in both the senior and more junior levels of the organization. As a result, PIMCO remains one of the best-resourced fixed-income managers in the business, with more than 250 portfolio managers with an average of two decades of experience. In the months since Gross’ departure, we’ve had the opportunity to meet with many of the firm’s
portfolio managers at both the CIO level and in more-junior positions and have been impressed by the experience and insights of investors across the organization.

The firm has also continued to invest in its research effort. The addition of several high-profile advisors and consultants—including former Federal Reserve chairman Ben Bernanke, former White House advisor Gene Sperling, and Nobel Laureate Michael Spence—provide added heft to the firm’s macro research effort, while Joachim Fels joined the firm as global economic advisor, after serving as chief economist at Morgan Stanley. Meanwhile, chief investment officer Dan Ivascyn has shored up the teams supporting Mihir Worah and Mark Kiesel, both of whom took on an expanded role as co-managers on PIMCO Total Return. Geraldine Sundstrom, who joined the firm’s multi-asset team and Investment Committee from Brevan Howard, is a key hire, while the promotions of Mohit Mittal and Jon Horne provide additional support for Kiesel. All in all, the firm has hired 11 new portfolio managers since October 2014.

The return of several high-level investment staff in the months after Gross’ departure has helped bolster the firm’s investment ranks and is a positive signal that the firm’s culture has improved in the post-Gross era. These include Investment Committee member and longtime PIMCO generalist portfolio manager Chris Dialynas, who returned from sabbatical shortly after Gross’ departure, and Marc Seidner, who had left PIMCO in January 2014 to head up GMO’s fixed-income effort. Seidner has quickly taken on a significant role within the firm as CIO for nontraditional strategies. He also heads up the firm’s New York office, leads PIMCO Unconstrained Bond PFIUX, serves as a full-time member of the firm’s Investment Committee, and will provide oversight to the firm’s equity effort upon Virginie Maisonneuve’s departure from the firm. Jeremie Banet’s return in late 2014 provides additional support to Worah on the firm’s real-return strategies. Finally, David Hammer rejoined PIMCO’s municipal-bond effort in New York in March.

There are additional signs that PIMCO’s corporate culture might be healthier now than it was under Gross. It’s still early to judge how effective the firm’s retooled Investment Committee is in Gross’ absence, but it’s clear that Ivascyn has succeeded in bringing a broader range of voices to the table. Judging from our due-diligence visit and a number of related conversations, we were encouraged by the apparently vigorous debate around the key macro views that are ultimately formulated within the Investment Committee and then expressed across the PIMCO portfolios. In recent months, that debate encompassed views on: inflation and the outlook for Treasury Inflation-Protected Securities; currency movements within developed and emerging markets; how soon the Fed is likely to raise interest rates; and how to position portfolios along the yield curve. Meanwhile, Ivascyn is placing an emphasis on increasing communication within and across investment teams and making sure that conflicting views are heard. This effort is clearly designed to mitigate the risk of groupthink and to support assessments of relative value across the fixed-income investment universe—it also lessens key-person risk.

Other efforts to strengthen the Investment Committee have also been encouraging. Since early 2014, the firm’s top bottom-up thinkers, including Kiesel and Ivascyn, have been permanent members. And, although macro positioning will continue to drive PIMCO Total Return’s strategy, it’s clear that there are more opportunities to infuse bottom-up thinking into the firm’s macro outlook. Ivascyn has also clearly been focused on increasing the rigor of the firm’s macroeconomic analysis, as evidenced by significant
additions to the firm’s macroeconomist ranks and by investment in quantitative tools to support that analysis.

Finally, the May 2015 announcement that PIMCO will shutter several of its equity funds and that equity CIO Maisonneuve would be leaving the firm is not a red flag in terms of the broader investment team’s stability. While PIMCO’s initial foray into fundamental equities initially has been disappointing, the funds affected by the most recent announcement accounted for less than 0.1% of the firm’s assets under management, and their liquidation will have a greater impact on lowering the firm’s costs than its revenues. Also, the firm is not abandoning its $50 billion equity business. Three dividend-oriented funds under Brad Kinkelaar and PIMCO’s global long-short strategy under Geoffrey Johnson remain intact. Going forward, PIMCO will focus on physical stock versions of the RAFI-index-related strategic-beta offerings crafted by Research Affiliates under Rob Arnott and on its “portable alpha” capabilities (PIMCO StocksPLUS PSTKX, for example), where it gains equity market exposure through derivatives and actively manages the fixed-income collateral backing those positions to eke out gains versus the funds’ equity-index benchmarks.

After a tumultuous year and a half, the relative stability of PIMCO’s senior fixed-income team and the steps taken under CIO Dan Ivascyn to shore up communication and collaboration around the firm are reassuring signs of the continued strength of PIMCO’s investment culture. They’re also a key reason for our cautious optimism regarding the firm’s future.

**Update on Firmwide Flows**

Outflows following Gross’ departure have been staggering. PIMCO Total Return alone shed an estimated $180 billion in net assets between mid-2013 and May 2015, with the bulk of redemptions coming since September 2014. Outflows peaked in October 2014 and continued at a heavy, if slowing, pace through the first part of 2015. While PIMCO management notes redemptions from individual investors came quickly, it has seen a much longer tail of outflows from institutional accounts, including defined-contribution plans. Exhibit 1 compares estimated net outflows from PIMCO Total Return versus firmwide U.S.-domiciled funds since 2013:
Redemptions from PIMCO Total Return, taken together with other hard-hit strategies, including PIMCO Unconstrained Bond, PIMCO Low Duration PTLDX, and PIMCO High Yield PHIYX, have led to a total of more than $250 billion in estimated outflows from PIMCO funds through April 2015. Meanwhile, total firm assets under management fell from $1.88 trillion as of September 2014 to $1.59 trillion as of March 2015, a decline of roughly 15%.

Outflows from PIMCO Total Return finally started to slow meaningfully in April and May, dropping to $7.6 billion and approximately $2.7 billion, respectively. (Note: There are modest timing differences in the outflows reported by PIMCO and those estimated by Morningstar, so monthly flow data cited by each firm will vary slightly.) Although slowing outflows are a positive sign, they remain significant, so we continue to watch this situation closely.

There are reasons to believe that flows might continue to decline, barring a major departure from the investment team or a period of significant underperformance. It’s likely that outflows from defined-contribution plans, which appear to be driving the continued redemptions through May 2015, will continue to diminish as decisions made in late 2014 and early 2015 have now been implemented. Indeed, earlier this spring, PIMCO’s management team noted that it was seeing a decline in this activity, and Allianz also suggested in May that it expected PIMCO flows to turn positive by the end of 2015. That’s consistent with what we’ve heard from other large fixed-income money managers who say the bulk of manager searches for defined-contribution plans are now complete.

Regarding flows, there have been a few bright spots in the PIMCO lineup. According to PIMCO’s management, the firm has seen more stability in its business outside of the United States, where assets were less concentrated in Gross-run strategies. Even in the U.S. there have been several strategies enjoying sizable inflows, including PIMCO Income PIMIX, which is run by Morningstar 2013 Fixed-Income Fund Managers of the Year Dan Ivascyn and Alfred Murata, as well as the firm’s long-duration accounts run for institutional investors. Several newer alternative strategies have also been quick to gather assets. Exhibits 2 and 3 outline the funds with the most significant inflows and outflows since mid-2013:
Impact of Flows on PIMCO’s Profitability

In Morningstar’s November 2014 PIMCO update, we estimated that PIMCO could take a roughly $300 billion to $350 billion hit to its $1.88 trillion assets under management over a three-year period before suffering an impact on its profit margins sufficient enough to affect its ability to invest in its business. With the firm’s assets down roughly $290 billion between September and March 2015, the firm is getting close to that point—and more quickly than we had expected or modeled. The decline in assets over the course of 2014 and the corresponding fall in revenue have already led to a marked decline in PIMCO’s profitability in 2014. From 2013 to 2014, PIMCO’s operating margins fell from an estimated 37% to 33%, worse than we expected but still within the range we think the company could withstand without having to make drastic changes to its cost structure. However, even assuming that the firm’s assets under management have stabilized now, we expect PIMCO’s overall profitability would continue to decline in 2015.

Prior to Gross’ departure, PIMCO was among the world’s most profitable money managers, so even with the decline, its profitability is still within a range of other well-run asset managers of comparable size. However, most investment organizations, including PIMCO, have significant operating leverage in their business models because of a high-fixed cost structure. For these reasons, we think that a near-term stabilization of flows is critical to the firm maintaining its current structure. Exhibit 4 highlights estimated operating margins for PIMCO and other select asset management firms:

*PIMCO revenue and operating income are in euros. Estimates based on Allianz’s asset-management segment data.

We are comforted by PIMCO’s long-standing and supportive relationship with its corporate parent Allianz and PIMCO’s importance to Allianz, which should buy PIMCO time to withstand outflows. Allianz is...
clearly keeping a close eye on outflows and has also recently raised its dividend to shareholders, which increases pressure on the firm to maintain its profitability. However, Allianz has thus far been supportive of PIMCO’s decisions to continue to invest in its business. Allianz has publicly stated that it is willing to give PIMCO adequate time to right its ship and backed a deferred compensation program introduced in late 2014 that committed to deferred cash payments through 2017 to executives in addition to increased 2014 bonuses to certain senior portfolio managers and non-managing-director-level staff. PIMCO also continues to retain a significant amount of independence from Allianz, which gives it control over hiring and compensation. Finally, despite its recent struggles, PIMCO has been a driver of Allianz’s growth since the German insurer purchased PIMCO in 2000; PIMCO accounted for a quarter of Allianz’s operating profit in 2014. As a result, Allianz has a strong incentive to maintain PIMCO’s competitive appeal.

In all, continued outflows and their potential impact on the firm’s ability to attract and retain investment staff remain the biggest unknowns for the firm as it emerges into the post-Gross world. The good news is that management teams at Allianz and PIMCO clearly understand that PIMCO must continue to invest in its investment operations to be successful, and they appear ready to take some pain to make these investments. We continue to watch this situation closely.

**PIMCO Fund Ratings Recap**

Following Gross’ September departure from PIMCO, we updated the Morningstar Analyst Ratings on all PIMCO funds under coverage. Since the beginning of 2015, we have revisited our ratings on a number of funds, and all ratings reflect our cautious optimism on the firm’s prospects. We reconfirmed our Analyst Rating of Bronze on PIMCO Total Return, as detailed below. The highest ratings go to funds we’ve long thought highly of and whose management teams and strategies have remained consistent since Gross’ departure, including PIMCO Income (run by Ivascyn and Murata), PIMCO Investment Grade Corporate Bond PIGIX (Kiesel), and PIMCO Real Return PRRIX and other related strategies managed by Worah’s real-return team. Rob Arnott’s PIMCO All Asset PAAIX and PIMCO All Asset All Authority PAUIX, which have relied only sparingly on the formerly Gross-run funds, earn Gold and Silver ratings, respectively.

We summarize our view on several strategies with recently revised ratings below. A full list of Morningstar Analyst Ratings for PIMCO funds is attached in Appendix 1.

**PIMCO Total Return and PIMCO Low Duration**

Gross’ departure had the most direct impact on PIMCO Total Return and other core bond funds he directly managed, including short-term bond sibling PIMCO Low Duration PTLDX.

In April 2015, we reaffirmed our Bronze ratings on PIMCO Total Return and PIMCO Low Duration. While it will take time to see how the three new portfolio managers settle into their new roles, and flows remain a concern, the ratings reflect our conviction in the strength and depth of PIMCO’s investment team. We’ve also been reassured by the relative stability of this group in the months following Gross’ departure and improvements in firm morale. The managers who replaced Gross all have significant experience and strong public records. Scott Mather, who previously headed up the fund’s global portfolio management
group and has taken the lead at both funds, is supported by Jerome Schneider (head of PIMCO’s short-term desk) at PIMCO Low Duration and Mark Kiesel (CIO global credit) and Mihir Worah (CIO asset allocation and real return) at PIMCO Total Return.

Both funds’ heavy outflows do not appear to have significantly affected their performance. PIMCO Total Return, in particular, has benefited from recent portfolio positioning, including a significant bet on the strength of the U.S. dollar against the yen and the euro in late 2014 and early 2015, as well as allocations to high yield so far in 2015. Members of the PIMCO Total Return team also note that the bond markets were relatively liquid during most of the period, and, as a result, it’s been relatively easy to transact. Exhibit 5 shows performance:

Exhibit 5: Returns for PIMCO Total Return PTTRX Since Bill Gross’ Departure

Despite solid returns since September 2014, there is still a risk that performance for PIMCO Total Return could be negatively affected should outflows pick up significantly because of additional management departures or underperformance, or should the bond markets face a liquidity crunch. We expect that a number of consultants and other institutional gatekeepers will be reviewing PIMCO at the one-year anniversary of Gross’ departure, so there is a particular risk of outflows should the fund experience a bout of underperformance during the summer and early fall that takes a toll on its one-year results.

Finally, while we view recent changes to the firm’s Investment Committee as positives for both broad-based portfolios, we continue to watch the three-manager dynamic at PIMCO Total Return. All three managers are talented and opinionated investors who, at times, have differing views, so we’re interested in seeing how their contributions get reflected in this portfolio.

**PIMCO Unconstrained Bond**

Saumil Parikh’s January 2015 departure was one exception to the general theme of PIMCO’s investment team stability. At that time, Parikh was the lead manager of PIMCO Unconstrained Bond, and when Marc Seidner then took over lead portfolio responsibilities upon Parikh’s departure, he became the fourth manager to run the fund in less than 18 months. PIMCO certainly has the resources to make good use of this fund’s broad mandate, and Seidner has an impressive resume. He’s also backed by an experienced team, with Ivascyn paying particularly close attention to this fund as a named comanager. However, the number of changes to the fund’s investment team and questions regarding the fund’s implementation of an unconstrained mandate support its Neutral rating, which was reaffirmed in January 2015.

**PIMCO Global, Foreign and Emerging-Markets Bond Funds**

We downgraded the Morningstar Analyst Ratings on a number of PIMCO’s global-bond and foreign-bond funds to Bronze from Silver in October 2014 when Scott Mather left the funds to take over the lead role.
managing PIMCO Total Return. At that time, Andrew Balls replaced him on PIMCO’s global- and foreign-bond strategies and took over as PIMCO’s CIO of global fixed-income mandates. Following our due-diligence visit to PIMCO, we recently reaffirmed these funds’ Bronze ratings.

The global-bond team appears solid and has experienced little turnover during the past several years. Comanagers Sachin Gupta, a credit and interest-rate derivatives specialist, and Lorenzo Pagani, who heads up the European government-bond and rates team, have been with the firm for more than a decade. Although Balls’ responsibilities have increased considerably, the additions of these comanagers should help to alleviate the workload. The trio is also backed by nearly 50 developed- and emerging-markets managers in several locations worldwide. One area we’ll continue to watch is the funds’ exposure to emerging-markets debt. Balls recently acknowledged that the fund may own more emerging-markets debt over time. This bears further monitoring, as the funds’ stakes have climbed as high as 30% to 40% of assets as recently as of late 2014.

Meanwhile, we downgraded the Analyst Ratings on PIMCO Emerging Markets Bond PEBIX and PIMCO Emerging Local Bond PELBX to Bronze from Silver in April 2015. These funds were not directly affected by Gross’ late-2014 departure, and manager Michael Gomez has been a constant here since 2005. However, the team had seen several departures during the past couple of years, including comanager Ramin Tolouei in 2014 and two midlevel portfolio managers in 2013. And while the funds’ process aims to reduce credit risk, the team has courted plenty of volatility through large country bets (Brazil, Russia, and Mexico) that on balance haven’t played out well lately, thus tarnishing the funds’ long-term records. We’re encouraged by recent investments in the emerging-markets team, including the addition of several experienced hires (including an emerging-markets corporate-debt expert), but downgraded the funds in light of turnover on the portfolio management team and performance challenges.

**PIMCO Real Return Funds and PIMCO Global Multi-Asset**

During the past 18 months, Morningstar has been keeping an eye on the real-return and multiasset funds managed by Mihir Worah for a number of reasons. Upon Mohamed El-Erian’s January 2014 decision to leave PIMCO, Worah was named a co-CIO, assumed leadership of PIMCO’s multiasset funds, and began to build out a dedicated multiasset team to run strategies including PIMCO Global Multi-Asset PGAIX, which had faltered under its previous management. In mid-2014, one of his key real-return lieutenants Jeremie Banet left the firm. When Gross left, Worah took on additional duties as comanager on PIMCO Total Return. Banet then returned, which helped alleviate concerns that Worah was being spread thin. Disappointingly in December 2014, key real-return team member Rahul Seksaria was fired for improper trading of securities for his own personal accounts.

Morningstar downgraded Worah’s PIMCO Real Return and PIMCO Commodity Real Return PCRIX funds to Silver from Gold in October 2014 on concerns regarding the team’s stability in the wake of its multiple changes and Worah’s increasing involvement in other areas. PIMCO CommoditiesPLUS PCLIX retained its Silver rating because of lesser emphasis on inflation-linked bonds and lead manager Nic Johnson’s continuing tenure on the fund.
As of June 2015, the picture for the real-return and multiasset teams is brighter than expected. Banet, Johnson, and Johnson’s commodities-oriented compatriot Greg Sharenow have been named comangers on the real-return and commodities funds, in part to recognize their past contributions but also to signal they’ve taken on more explicit leadership of those funds. PIMCO Global Multi-Asset, too, is on more solid ground, following the early-2015 arrival of emerging-markets and equities specialist Geraldine Sundstrom. Although not formally named as a portfolio manager on the fund, Sundstrom is playing a key role at PIMCO Global Multi-Asset together with Rahul Devgon (formerly of Moore Capital) and Worah. While that fund’s rating remains Neutral because of the team’s relatively short tenure plying its revamped approach, the team has scored multiple successes with long and short positions across asset classes and currencies since January 2014, and it may be beginning to hit its stride.

PIMCO’s support for Worah’s multiasset team—evidenced through the green light for the team’s build-out and the continuing support of Ravi Mattu’s formidable 50-plus member quantitative analytics team—reflects PIMCO’s conscious and continuing shift from a largely U.S. core-plus fixed-income perspective to a truly global multiasset one. Sundstrom joins a number of other external hires during the past two years, including Devgon and another Moore Capital alum Mohsen Fahmi (comanager on PIMCO Unconstrained Bond), who bring considerable relative-value hedge fund expertise to the table. Given that evolution, the firm’s increasing focus on alternatives, and the early successes of Worah’s global multiasset crew, it would not be surprising to see those individuals take on more visible roles within the firm or to see the global multiasset strategy garner increased attention internally and externally in the years to come.

PIMCO Stewardship Grade and Parent Pillar Score

The Morningstar Stewardship Grade for Fund Firms and the Parent Pillar score within the Morningstar Analyst Rating are designed to help investors further research, identify, and compare fund companies that do a good job—or a poor job—of aligning their interests with those of fund shareholders. The Stewardship Grade and Parent Pillar scoring methodology both consider a firm’s Corporate Culture, Manager Incentives, Fees, Regulatory History, and Board Quality (for U.S. fund firms only). When combined, these components intend to forecast whether a fund firm is likely to be a good caretaker of investors’ capital over the long term. Drawing on quantitative Morningstar Investment-Provider Data for Funds and qualitative judgment, Morningstar analysts evaluate and assign grades from A (the best grade) to F (the worst grade) to each of these areas, and they combine the component grades to arrive at an overall Stewardship Grade and Parent Pillar score for a family of funds.

Morningstar revisited PIMCO’s Stewardship Grade and Parent Pillar score to reflect its ongoing due diligence following Bill Gross’ departure. While recognizing PIMCO’s encouraging progress in a number of areas outlined in the piece above, it’s still too soon to say whether the firm has definitely turned the corner, especially in light of uncertainties around the firm’s flows, organizational stability, and future growth. While its fund board has seen the addition of a number of independent board members, that board now needs to prove it will act in the best interests of fund shareholders. Lastly, while portfolio managers’ investment in the funds they run has improved, there is still work to do. We have attached the full Stewardship Grade text in Appendix 2.
Conclusion

We continue to view PIMCO with cautious optimism. We are encouraged by the stability of the fixed-income leadership team in the months after Gross’ departure and by signs that the culture is more collaborative and better able to take advantage of the ideas generated by the firm’s army of analysts and portfolio managers. That said, outflows have been heavier than many observers anticipated. While we are encouraged by PIMCO’s stable relationship with Allianz and by a commitment to maintaining the integrity of the investment team, the situation remains fluid. If outflows do not continue to slow, they could eventually take a toll both on morale and on the firm’s ability to attract and retain the best investment talent. Finally, the success of the firm’s Investment Committee is essential to the functioning PIMCO Total Return and a number of other strategies. While the Investment Committee boasts an impressive lineup of contributors, it too still needs time to prove its effectiveness in a post-Gross world.

About Morningstar Manager Research

Morningstar Manager Research provides independent, fundamental analysis on managed investment strategies. Analyst views are expressed in the form of Analyst Ratings, which are derived through research of five key pillars—Process, Performance, Parent, People, and Price. A global research team issues detailed analyst reports on strategies that span vehicle, asset class, and geography.

About Morningstar Manager Research Services

Morningstar Manager Research Services combines the firm’s fund research reports, ratings, software, tools, and proprietary data with access to Morningstar’s manager research analysts. It complements internal due-diligence functions for institutions such as banks, wealth managers, insurers, sovereign wealth funds, pensions, endowments, and foundations.

For More Information

Dan Lefkovitz
Director of Manager Research Services
+1 312 696-6649
dan.lefkovitz@morningstar.com

22 West Washington Street
Chicago, IL 60602 USA

© Morningstar 2014. All Rights Reserved. The information, data, analyses and opinions presented herein do not constitute investment advice; are provided solely for informational purposes and therefore are not an offer to buy or sell a security; and are not warranted to be correct, complete or accurate. The opinions expressed are as of the date written and are subject to change without notice. Except as otherwise required by law, Morningstar shall not be responsible for any trading decisions, damages or other losses resulting from, or related to, the information, data, analyses or opinions or their use. The information contained herein is the proprietary property of Morningstar and may not be reproduced, in whole or in part, or used in any manner, without the prior written consent of Morningstar. To order reprints, call +1 312-696-6100. To license the research, call +1 312-696-6069.
### APPENDIX 1: LIST OF U.S.-DOMICILED PIMCO FUNDS WITH MORNINGSTAR ANALYST RATINGS

<table>
<thead>
<tr>
<th>Name</th>
<th>Ticker</th>
<th>Morningstar Analyst Rating</th>
<th>Analyst Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>PIMCO All Asset All Authority Inst</td>
<td>PAUXX</td>
<td>Silver</td>
<td>Kevin McDevitt, CFA</td>
</tr>
<tr>
<td>PIMCO All Asset Inst</td>
<td>PAAX</td>
<td>Gold</td>
<td>Kevin McDevitt, CFA</td>
</tr>
<tr>
<td>PIMCO CommoditiesPLUS® Strategy A</td>
<td>PCLAX</td>
<td>Silver</td>
<td>Michael Herbst</td>
</tr>
<tr>
<td>PIMCO Commodity Real Ret Strat Inst</td>
<td>PCRIX</td>
<td>Silver</td>
<td>Michael Herbst</td>
</tr>
<tr>
<td>PIMCO Credit Absolute Return A</td>
<td>PZCRX</td>
<td>Neutral</td>
<td>Jason Kephart</td>
</tr>
<tr>
<td>PIMCO Diversified Inc A</td>
<td>PDVAX</td>
<td>Silver</td>
<td>Eric Jacobson</td>
</tr>
<tr>
<td>PIMCO Emerging Local Bond Inst</td>
<td>PELBX</td>
<td>Breeze</td>
<td>Karin Anderson</td>
</tr>
<tr>
<td>PIMCO Emerging Markets Bond A</td>
<td>PASEX</td>
<td>Breeze</td>
<td>Karin Anderson</td>
</tr>
<tr>
<td>PIMCO Emerging Markets Currency A</td>
<td>PLMAX</td>
<td>Neutral</td>
<td>Morningstar Fund Analysts</td>
</tr>
<tr>
<td>PIMCO EqS Pathfinder A</td>
<td>PATHX</td>
<td>Neutral</td>
<td>Greg Carlson</td>
</tr>
<tr>
<td>PIMCO EqS® Long/Short Institutional</td>
<td>PMHIX</td>
<td>Neutral</td>
<td>Jason Kephart</td>
</tr>
<tr>
<td>PIMCO Floating Income A</td>
<td>PFIAX</td>
<td>Neutral</td>
<td>Eric Jacobson</td>
</tr>
<tr>
<td>PIMCO Foreign Bond (Unhedged) I</td>
<td>PFLIX</td>
<td>Breeze</td>
<td>Karin Anderson</td>
</tr>
<tr>
<td>PIMCO Foreign Bond (USD-Hedged) I</td>
<td>PFRXX</td>
<td>Breeze</td>
<td>Karin Anderson</td>
</tr>
<tr>
<td>PIMCO Global Advantage Strategy Bd A</td>
<td>PGSAX</td>
<td>Breeze</td>
<td>Karin Anderson</td>
</tr>
<tr>
<td>PIMCO Global Bond (Unhedged) Inst</td>
<td>PIGLX</td>
<td>Breeze</td>
<td>Karin Anderson</td>
</tr>
<tr>
<td>PIMCO Global Bond (USD-Hedged) A</td>
<td>PAIX</td>
<td>Breeze</td>
<td>Karin Anderson</td>
</tr>
<tr>
<td>PIMCO Global Multi-Asset A</td>
<td>PGMAX</td>
<td>Neutral</td>
<td>Michael Herbst</td>
</tr>
<tr>
<td>PIMCO High Yield Inst</td>
<td>PHIX</td>
<td>Breeze</td>
<td>Sumit Desai, CFA</td>
</tr>
<tr>
<td>PIMCO High Yield Spectrum A</td>
<td>PHSAX</td>
<td>Breeze</td>
<td>Sumit Desai, CFA</td>
</tr>
<tr>
<td>PIMCO Income A</td>
<td>PONAX</td>
<td>Silver</td>
<td>Eric Jacobson</td>
</tr>
<tr>
<td>PIMCO Inflation Response Multi-Asst A</td>
<td>PZMX</td>
<td>Neutral</td>
<td>Michael Herbst</td>
</tr>
<tr>
<td>PIMCO Investment Grade Corp Bd Inst</td>
<td>PIGXX</td>
<td>Silver</td>
<td>Morningstar Fund Analysts</td>
</tr>
<tr>
<td>PIMCO Long Duration Total Return Inst</td>
<td>PLRXX</td>
<td>Breeze</td>
<td>Sarah Bush</td>
</tr>
<tr>
<td>PIMCO Low Duration Inst</td>
<td>PTLDX</td>
<td>Breeze</td>
<td>Sarah Bush</td>
</tr>
<tr>
<td>PIMCO Municipal Bond Inst</td>
<td>PMIX</td>
<td>Breeze</td>
<td>Cara Esser</td>
</tr>
<tr>
<td>PIMCO RAE Fundamental AdvantagePLUS Inst</td>
<td>PFAX</td>
<td>Neutral</td>
<td>Eric Jacobson</td>
</tr>
<tr>
<td>PIMCO RAE Fundamental PLUS A</td>
<td>PIXAX</td>
<td>Neutral</td>
<td>Jason Kephart</td>
</tr>
<tr>
<td>PIMCO RAE Worldwide Fdmt/AdvgtPLUS Inst</td>
<td>PWWIX</td>
<td>Neutral</td>
<td>Jason Kephart</td>
</tr>
<tr>
<td>PIMCO Real Return A</td>
<td>PRNXX</td>
<td>Silver</td>
<td>Michael Herbst</td>
</tr>
<tr>
<td>PIMCO RealPath™ 2020 A</td>
<td>PTTYX</td>
<td>Breeze</td>
<td>Jeff Holt, CFA</td>
</tr>
<tr>
<td>PIMCO RealPath™ 2025 A</td>
<td>PENXX</td>
<td>Breeze</td>
<td>Jeff Holt, CFA</td>
</tr>
<tr>
<td>PIMCO RealPath™ 2030 A</td>
<td>PEHXX</td>
<td>Breeze</td>
<td>Jeff Holt, CFA</td>
</tr>
<tr>
<td>PIMCO RealPath™ 2035 A</td>
<td>PIVXX</td>
<td>Breeze</td>
<td>Jeff Holt, CFA</td>
</tr>
<tr>
<td>PIMCO RealPath™ 2040 A</td>
<td>POFXA</td>
<td>Breeze</td>
<td>Jeff Holt, CFA</td>
</tr>
<tr>
<td>PIMCO RealPath™ 2045 A</td>
<td>PFZAX</td>
<td>Breeze</td>
<td>Jeff Holt, CFA</td>
</tr>
<tr>
<td>PIMCO RealPath™ 2050 A</td>
<td>PFYAX</td>
<td>Breeze</td>
<td>Jeff Holt, CFA</td>
</tr>
<tr>
<td>PIMCO RealPath™ Income A</td>
<td>PTVXX</td>
<td>Breeze</td>
<td>Jeff Holt, CFA</td>
</tr>
<tr>
<td>PIMCO Short-Term Inst</td>
<td>PTIX</td>
<td>Silver</td>
<td>Sarah Bush</td>
</tr>
<tr>
<td>PIMCO StocksPLUS® Inst</td>
<td>PSTXX</td>
<td>Neutral</td>
<td>Eric Jacobson</td>
</tr>
<tr>
<td>PIMCO StocksPLUS® Short Institutional</td>
<td>PSTIX</td>
<td>Neutral</td>
<td>Jason Kephart</td>
</tr>
<tr>
<td>PIMCO Total Return Inst</td>
<td>PTTXX</td>
<td>Breeze</td>
<td>Sarah Bush</td>
</tr>
<tr>
<td>PIMCO Unconstrained Bond A</td>
<td>PUBAX</td>
<td>Neutral</td>
<td>Sarah Bush</td>
</tr>
</tbody>
</table>

APPENDIX 2: MORNINGSTAR STEWARDSHIP GRADE FOR PIMCO
PIMCO
PIMCO is in better shape than expected but isn't yet out of the woods.

PIMCO Stewardship Grade -- C

Summary
PIMCO has emerged from a tough 2014 in better shape than many would have anticipated. Its investment teams and processes have largely remained intact under group CIO Dan Ivascyn. Heavy outflows haven't impaired performance of the funds most affected. The firm's investment operation continues to evolve but remains deep, experienced, and well-resourced.

That said, outflows have driven PIMCO's profitability lower and could prompt additional cost-cutting. Corporate parent Allianz has remained supportive, but continued outflows could begin to affect PIMCO's ability to retain talent.

Developments on other fronts are also mixed. Whether the firm can succeed with its alternatives business and rejiggered equity effort--both key to future growth--is an open question. Managers' investment in the funds they run has increased but isn't market-leading. The addition of several more independent fund board members is welcome, but they still need to prove that they'll act in the best interests of fundholders. Fees clock in near average overall but are still high on some funds' noninstitutional share classes.

PIMCO's recent progress is encouraging, but how well it executes on its investment strategies and business development plans in the next few years is critical. That lingering uncertainty underlies the firm's overall Neutral Parent Pillar score and Stewardship Grade of C.

Corporate Culture -- C
PIMCO's corporate culture is on much more solid ground than one might expect given the tumultuous 2014 departures of former co-CEOs Mohamed El-Erian and William Gross. The firm's leadership team--helmed by CEO Doug Hodge, president Jay Jacobs, and group CIO Dan Ivascyn--has done an admirable job navigating what has been the most challenging stretch in the firm's history. Yet given still-considerable areas of uncertainty, PIMCO's Corporate Culture score remains a C.

Following Gross' departure, PIMCO moved quickly to implement a $279 million retention package aimed at its senior-most investment personnel, and since then, the firm has seen only a small handful of senior-level departures, including central-bank watcher Paul McCulley and generalist Saumil Parikh. There is further evidence that suggests PIMCO's corporate culture may actually be healthier now than it had been under Gross. For one thing, a number of investment personnel have returned to the fold, including Marc Seidner (who serves as CIO of nontraditional strategies, and in May 2015, re-assumed oversight of the firm's fundamental equity strategies), real-return specialist Jeremie Banet, longtime generalist Chris Dialynas (who returned from sabbatical shortly after Gross left), global generalist Sudi Mariappa (who returned in early 2014 before Gross left), economic advisor and Nobel Laureate Michael Spence, and municipal-bond manager David Hammer. It's notable that PIMCO has hired 11 new portfolio managers and a number of economic advisors since October 2015.
Ivascyn has also been explicit in his intention to foster a more collaborative team-based culture, evidenced in the team structure implemented at flagship PIMCO Total Return PTTRX and the formal naming of comanagers to a number of other funds. That philosophical shift lessens the key-person risk that had existed under Gross. The multiple CIO structure instituted in 2014 after El-Erian's departure appears to be working, despite the May 2015 announcement that equity CIO Virginie Maisonneuve would be leaving the firm. Led by Ivascyn, the group also includes Seidner, Mark Kiesel (CIO of global credit), Mihir Worah (CIO of real return and asset allocation), Andrew Balls (CIO of global fixed income), and Scott Mather (CIO of U.S. core strategies). This crew and PIMCO's broader Investment Committee are soliciting a greater degree of input from members across the firm than PIMCO had under Gross. Ivascyn and others on the Investment Committee are focused on opening up lines of communication across the various teams, and that exchange is happening in a more vigorous way through other channels as well, such as the firmwide work of the formidable, 50-plus member quantitative analytics team under Ravi Mattu, and efforts to build out the bench of macroeconomic and policy-related experts that support PIMCO's cyclical and secular forums under the leadership of Rich Clarida.

PIMCO remains one of the strongest, deepest, best-resourced teams in fixed income, with more than 250 portfolio managers with an average of 20 years' experience (nine years at PIMCO) as of March 2015. At that point, the firm had close to 800 investment professionals overall, averaging 14 years' experience (six at PIMCO).

Yet the firm faces a number of challenges going forward. First, outflows have been on the higher end of what PIMCO, its corporate parent Allianz, and Morningstar had anticipated. Between June 2014 and March 2015, the firm's overall assets under management fell roughly 19%, to $1.59 trillion from $1.97 trillion. During that stretch, $111.8 billion in outflows from the U.S.-domiciled open-end version of flagship PIMCO Total Return accounted for roughly 30% of that decline, with the remaining shrinkage stemming from other Total Return vehicles and a handful of other strategies, including PIMCO Unconstrained Bond PFIUX, PIMCO Low Duration PTLDX, PIMCO All Asset All Authority PAUIX, and PIMCO High Yield PHIYX.

Arguably, PIMCO went into those outflows in a relatively strong financial position. It had a cost structure well below the average for asset managers, partly due to its scale and to efficiencies gained from its 2000 decision to outsource its entire back-office operation to State Street. At the point of Gross' departure, compensation for the firm's top investment personnel topped virtually all of its rivals—providing a strong incentive for them to stay with the firm—and the portfolios for most of the funds that have experienced the heaviest outflows were highly liquid. As of May 2015, most funds' absolute and relative performance had not been markedly affected by the outflows, and the teams backing them have remained stable overall.

Although firmwide outflows have been trending down in 2015, they've put pressure on the firm, potentially weighing on morale and fueling a rising cost structure and lower profitability that may become a concern to Allianz. While Allianz has expressed patience, and Morningstar believes PIMCO's autonomous relationship with Allianz remains stable as of June 2015, sustained outflows or acceleration of those outflows could begin to affect the firm's 2015 year-end compensation pool; impact its ability to retain and attract top-caliber personnel; or ultimately test Allianz's patience—especially in light of that firm's November 2014 decision to increase its dividend.

As of June 2015, Morningstar believes a spike in outflows going forward is unlikely. But they're still a possibility if absolute or relative performance for large and high-profile PIMCO strategies does not remain strong past the September 2015 one-year mark of Gross' departure. At that point, advisors, institutional investors, and gatekeepers, including defined-contribution plan...
managers or consultants who placed PIMCO “on watch” following Gross’ departure, may be tempted to cut bait if performance is disappointing. As of May 2015, outflows have been subsiding, and relative performance across many of PIMCO’s strategies remains solid. But PIMCO will not be out of the woods financially or from a corporate-culture standpoint until the outflows eventually turn to inflows in the form of returning or new business.

Where that future growth will come from is an open question if investors continue to reallocate out of PIMCO fixed-income funds or fixed income in general. PIMCO’s first attempt to build out its fundamental equity business faltered, with multiple missteps under its former head Neel Kashkari (who left in January 2013) and more recently under his successor Virginie Maisonneuve, who was named CIO of global equities in January 2014. In May 2015, PIMCO announced Maisonneuve's departure and the liquidation of three fundamental equity funds. Although those funds accounted for less than 0.1% of the firm’s overall assets under management, the liquidations signal a shift in the future direction of PIMCO’s $50 billion equity business.

Two fundamental equity teams remain in place, the dividend-oriented team under Brad Kinkelaar and the global long-short effort under Geoffrey Johnson. But in a shift away from fundamental, actively managed equity strategies, PIMCO is likely to focus its future efforts on existing and new strategies related to the strategic-beta approaches of Research Affiliates under Rob Arnott, and others related to its “PLUS”-named portable alpha strategies (PIMCO StocksPLUS PSTKX, for example), where active management of those funds' fixed-income collateral is intended to give them a leg up versus their equity index benchmarks. While Maisonneuve's departure captured much media attention, there are multiple equity-related voices still at the PIMCO table, including Kinkelaar, Johnson, Arnott, Mattu's team, and equities and emerging-markets specialist Geraldine Sundstrom, who arrived in early 2015 from hedge fund firm Brevan Howard.

Sundstrom’s arrival is significant for several reasons. First, while not formally named as a manager, she is playing a key role at PIMCO Global Multi-Asset PGAIX, working closely with comangers Worah (who has described Sundstrom as his potential successor) and Rahul Devgon, who joined the team from hedge fund firm Moore Capital in late 2013. The hiring of Devgon and Sundstrom, in addition to other senior hires with hedge fund or multiasset expertise—including Mohsen Fahmi, comanager on the PIMCO Unconstrained Bond strategy--reflects PIMCO’s continuing shift toward a truly global, multiasset perspective. They also reflect the firm’s focus on its alternatives business. That business, an expanding range of equity strategies, and the PIMCO Global Multi-Asset strategy are likely sources of growth going forward. How these strategies fare in coming years will be a significant factor in assessing PIMCO’s business mix and overall organizational stability.

More broadly, Morningstar is also watching the overall evolution of PIMCO’s investment culture. Despite a more collegial tone under Ivascyn, PIMCO's hard-charging, competitive ethos has definitely remained intact--that's a positive in terms of attracting high-performers, but also a contributor to the firm’s historically persistent level of personnel turnover, particularly in the ranks just below the CIOs and other long-tenured lead portfolio managers. Thus far, PIMCO has bucked the odds and has continued to attract a steady stream of high-caliber personnel. But the stakes remain high for continuing to do so going forward, when considering the expertise and experience of those who have left the firm in recent years, including Gross, El-Erian, and McCulley during the past 18 months, Scott Simon in 2013, Bill Powers in 2010, Mark Hudoff in 2009, Pasi Hamalainen and John Brynjolfsson in 2008, Zhu Changhong and Ray Kennedy in 2007, and so on.
There are a few other areas to watch in the background. Historically, PIMCO hasn't been particularly fund shareholder-friendly in its approach to fund expenses. While its institutional share classes are generally reasonably priced, expenses on some of its noninstitutional share classes had remained stubbornly high. The firm has made some progress on that front via expense waivers, and many of its D shares appear more reasonably priced when considering investors in comparable shares may be paying transaction fees not reflected in other funds' expense ratios. Even so, historically PIMCO hasn't passed on the benefits of economies of scale of large funds to fund investors via fee breakpoints, as other firms have.

The firm has also been very prolific in its new fund launches. Most have been driven by ideas and developments in institutional management or, in some cases, developments in financial markets that have made one strategy or another newly feasible. Yet some, like PIMCO's forays into target-date funds and the actively managed fundamental equity strategies that are being liquidated, have struggled to find a wide investor base. And while Ivascyn has voiced greater openness to the idea of closing funds, PIMCO doesn't have a historical record of doing so. How those trends evolve under its new leadership bears watching.

To reiterate, the firm's current leadership is off to an encouraging start, and its CIOs represent a reassuring level of continuity amid 2014's turbulence. PIMCO continues to attain or approach best-in-class status across many of its investment capabilities, while its more collaborative approach, new Investment Committee structure, and evolving secular/cyclical forum process are still works in progress. So is the manager structure on PIMCO Total Return, where lead manager Mather works closely with comanagers Kiesel and Worah. PIMCO's steps to providing additional support for those managers—via Sundstrom, Banet, and commodities experts Nic Johnson and Greg Sharenow for Worah, and via credit specialists Mohit Mittal and Jon Horne for Kiesel—are positive signs, as is investment in the forum process and other support structures, including Mattu's quantitative analytics team. But it's still relatively early days for the post-Gross PIMCO, and given the uncertainty remaining around flows and their potential ripple effects, as well as the firm's future growth trajectory, it's difficult to say the firm has definitively turned the corner. Thus, despite laudable efforts from PIMCO and encouraging signs its corporate culture could actually be healthier than it was under Gross, its Corporate Culture score remains C.

Fund Board Quality -- D

A mutual fund board's sole purpose is to act as an advocate for fundholders, helping to ensure they are treated fairly and honorably. Only mutual fund directors have a seat at the negotiating table when it comes to hiring mutual fund advisors and setting fees, for example. Most boards of directors take their responsibility seriously, but those that stand out have established a track record of independence and shareholder-friendly practices.

For the purposes of governance, PIMCO's open-end funds are divided into two groups for board oversight. The PIMCO Funds Trust board has made considerable improvement to its structure during the past several months, after two independent-trustee departures resulted in a five-person board that was just 60% independent. Meanwhile, the small PIMCO Equity Series Trust board remains challenged by a growing workload. Overall, PIMCO continues to earn a D for Fund Board Quality.

The PIMCO Funds Trust board, which oversees the majority of PIMCO's open-end funds (more than 90) as well as its Variable Insurance Trust and ETF Trust, has undergone some recent turmoil and transition. After losing two of its independent trustees in mid-2014, the board was left with just five members, three independent and two interested, including chairman Brent Harris. This situation not only highlighted the board's lack of succession planning, but also came
at a time when PIMCO was stressed after Bill Gross abruptly left the firm, and one of his former charges and the company’s largest offering, PIMCO Total Return, subsequently suffered massive shareholder redemptions. That fund’s liquidity and its ability to meet redemptions were of utmost importance to the board, and for some time, the board received weekly liquidity reports.

It took roughly six months for the PIMCO Funds Trust board to vet and recommend new trustees, which it did in January 2015. Their seats on the board were further delayed because the board didn’t immediately realize that it required a shareholder vote on at least some of the trustees in order to satisfy rules about what percentage of trustees must be elected versus appointed. In April 2015, PIMCO funds’ shareholders elected four independent trustees new to the board as well as two existing board members, interested director and PIMCO CEO Doug Hodge and independent trustee Ronald Parker. Today, all nine of PIMCO’s directors have been elected by shareholders.

The additional board members represent an improvement, for several reasons. One, it brings the percentage of independent trustees to 78%, more in line with the characteristics of boards of similarly sized fund complexes and industry norms. Two, the recent election gives the PIMCO Funds Trust board a little bit of wiggle room and will provide better continuity in light of two near- to intermediate-term retirements. (Previously, the board had been more relaxed about a retirement rule that requires trustees to retire one meeting after his or her 76th birthday, but has indicated it will stick to that rule going forward.) Independent trustee J. Michael Hagan is retiring at the end of August 2015, and E. Philip Cannon will retire in either late 2016 or early 2017, depending on the board’s meeting schedule. According to PIMCO, the board will not replace Hagan, leaving the makeup at six independent and two interested independent. The board has said it is committed to a 75% independent board going forward (which means Cannon will be replaced).

Although the PIMCO Funds Trust board has repaired its structure, four new trustees to a nine- person board can change the board’s dynamic, and thus it could take some time for shareholders to figure out its personality. Moreover, most boards report a steep learning curve for new trustees, given the increasing regulatory burden on funds and scrutiny on fund boards. It seems likely considering PIMCO’s complexity and organizational changes, as well as its forays into alternative strategies and ETFs, that these new trustees could bear a heavier burden than some others. PIMCO says it was careful to select trustees with the time and capacity to undertake a heavy workload, and it has put in place a more rigorous training program to bring the new directors quickly up to speed. Nonetheless, it’s likely to take time for these directors to be fully engaged. Consider, for example, that none of the new trustees has yet been assigned to any of the board’s three standing committees—Audit, Governance, and Valuation. (Currently, no independent trustees sit on the Valuation committee, but new language in the trust’s most- recent SAI suggests its makeup could change at any time.)

Meanwhile, the PIMCO Equity Series Trust remains a disappointment. After losing two members in mid-2013, it remains a three-person board and just 67% independent. Now that Peter McCarthy has been elected to the PIMCO Funds Trust board, all three of the Equity Series Trust’s directors also serve on the larger board. There is currently no search for additional or successor trustees for the equity board. (As he will from the PIMCO Funds Trust board, Cannon will retire in late 2016 or early 2017, depending on this board’s meeting schedule.) Nor are there plans to consolidate the PIMCO Funds Trust board and the PIMCO Equity Series Trust board, even considering that, as is, the equity board is akin to a subcommittee of the larger board.
Three funds are scheduled to be liquidated in July 2015 as a result of recent changes to PIMCO’s equity strategy; however, the equity board will have oversight of six new and existing funds run by Rob Arnott. The board also recently took on the PIMCO RealPath Blend target-date series, which was introduced in December 2014. Furthermore, there have been recent leadership and strategic changes on the equity side that may require the trustees' attention. In addition, PIMCO has indicated there may be more equity funds to come, based on strategies conceived by Arnott's firm Research Affiliates or similar to PIMCO's portable alpha strategies akin to a number of its existing "PLUS"-named funds, such as PIMCO StocksPLUS.

Another elusive issue that falls under the boards' domain is the way in which PIMCO accounts for and reports the expenses of its funds. In essence, it uses a unified fee structure, which means the funds pay a fee, and it’s up to PIMCO to figure out how to best provide those services at (or below or above) the agreed-upon price. The arrangement has historically meant less transparency in its accounting of some of the services provided to the funds by both PIMCO and other vendors, though. To be sure, PIMCO isn't the only fund complex to use a unified fee structure. Nonetheless, especially considering the SEC's recent interest in distribution and transfer-agency and sub-transfer-agency fees, the board might push for a more transparent accounting.

Meanwhile, the board might do more to ensure that appropriate economies of scale are being passed to shareholders. The funds aren't subject to management-fee breakpoints as assets increase. That lack of breakpoints might be less glaring today, as PIMCO has been in net redemptions in the wake of Bill Gross' departure and as investors have shied away from many of the kinds of fixed-income offerings that PIMCO offers. But the lack is notable in light of PIMCO Total Return's former stature as the United States' largest actively managed mutual fund: Most of the fund's share classes are reasonably priced relative to similarly distributed peers, but arguably its expense ratios should have been lower still, considering its massive size. As of May 2015, the fund still clocked in at a hefty $110.4 billion in assets, and with PIMCO Income PIMIX at $44.9 billion, PIMCO All Asset PAAIX at $30.4 billion, and PIMCO All Asset All Authority PAUIX at $17.5 billion, the funds' lack of breakpoints remains notable.

These long-standing issues surrounding fee disclosure and economies of scale, combined with the unproven Funds Trust board and the concerns about the Equity Series Trust board, are still enough to maintain a Board Quality grade of D.

**Fund Manager Incentives -- C**

PIMCO has made significant progress on its manager incentives, particularly in terms of managers' ownership of the funds they run, since late 2014. Yet its overall Manager Incentives score still lands at a C.

Portfolio managers who invest alongside their fundholders show conviction in their investment approach and portfolios and share in a true fundholder experience as they endure the same tax and cost consequences as their fund shareholders. Further, Morningstar's research has found that portfolio managers who invest significantly in their funds simply perform better on average, particularly on a risk-adjusted basis. For these reasons, Morningstar's Manager Incentives score is determined primarily by how heavily and predominantly a fund family's managers own the funds they oversee. Specifically, Morningstar considers what percentage of assets are in funds in which at least one portfolio manager has at least $1 million invested (the highest ownership range reported to the SEC).

PIMCO’s Manager Incentives score has historically been driven largely by the manager ownership level in PIMCO Total Return, which had represented nearly 40% of the firm’s overall
assets at its peak in mid-2013. Following Gross' September 2014 departure and heavy outflows since then, the fund accounted for a slimmer 20% of the firm's open-end mutual fund assets. The firm's March 31, 2015, Statement of Additional Information showed that new managers Scott Mather and Mihir Worah both had more than $1 million invested in the fund, while comanager Mark Kiesel disappointingly had less than $10,000 invested.

PIMCO has made notable progress on manager ownership overall, with 58.9% of the firm's fund assets invested in funds where a manager has more than $1 million invested as of May 2015; that figure lands just short of the second-highest quintile for firms offering U.S.-domiciled funds and doesn't fully capture the breadth of managers' ownership. For instance, London-based Andrew Balls invests more extensively in non-U.S. domiciled funds, and a number of managers have smaller amounts invested across a greater number of funds that they run.

Even so, there is still work to do, with fund ownership levels landing under $1 million for a number of prominent portfolio managers, including Marc Seidner, Jerome Schneider, Kiesel, and Andrew Jessop. To some extent, smaller manager investment may be expected at a predominantly fixed-income shop. It's not unreasonable to expect limited investment in municipal-bond funds, for example, or other narrowly focused fixed-income funds. Nonetheless, too many of PIMCO's funds, representing about 17.9% of assets, have no manager investment at all. That figure would be lower if accounting for Balls' non-U.S. fund investments, but it's still a higher percentage than three quarters of PIMCO's rivals, and less acceptable given PIMCO's above-average compensation and the long tenure and prominent stature of some of the more lightly invested managers mentioned above.

Morningstar also considers a firm's manager-compensation plan in its Manager Incentives assessment, and characteristics that are particularly strong or deficient may affect the final grade. PIMCO's plan, however, neither boosts nor detracts from its Manager Incentives score. As is common in the fund industry, PIMCO's manager compensation comprises a base salary, a bonus, and equity or long-term incentive compensation. Although a series of positive factors may be considered when determining managers' earnings, compensation may also be tied to the performance of the firm, which can be seen as a potential conflict of interest, insofar as the interests of firm stockholders and fund shareholders may be misaligned. Furthermore, compensation for portfolio managers can also be linked to the amount and nature of assets managed by the portfolio manager, which can act as incentive for managers to take shortcuts to chase performance or disregard capacity concerns.

PIMCO's compensation plan is also linked to performance, which is a plus for shareholders. Specifically, it's based on one-, two-, and three-year dollar- and account-weighted pretax investment performance versus predetermined appropriate benchmarks. That said, a compensation structure that stresses longer-term investment performance (many asset managers emphasize five-year results and longer-term periods) would better align managements' interests with those of fund shareholders.

**Fees -- C**

Morningstar calculates a fund family's Fees grade based on the average Morningstar Fee Level percentile for all the family's funds. These percentiles compare each fund share class with similarly distributed share classes of funds in the same fee-level group, ranging from 1 (for the cheapest funds in each group) to 100 (for the most expensive). To find a family's overall fee-level percentile, Morningstar takes the straight average of the fee-level percentiles for all the funds in the family, counting each share class separately. Morningstar's research indicates that a fund's price tag is among the best predictors of its future relative performance. Funds with
below-average price tags are likely to outperform typical rivals; those with above-average expense ratios are more likely to underperform.

As of May 2015, PIMCO's average fee level is 48 (on a scale of 1 to 100, with 1 being the least expensive and 100 being the most expensive), which has been fairly consistent during the past few years. This earns the firm a C for fees overall. One minor improvement: At one point, share classes had been fairly evenly distributed across higher and lower fee-level groups, whereas now there is now a slight skew toward Average, Below Average, and Low fee levels. For the most part, PIMCO's Institutional share class expense ratios are Low or Below Average; however, they require a $1 million minimum investment, though investors may find them in their 401(k) plans. Many of PIMCO's A share classes are also Low or Below Average. In many cases, the Institutional and A share classes together represent each fund's largest portion of assets, so PIMCO is giving the majority of its fundholders a good deal relative to competitors.

Meanwhile, PIMCO's “PLUS” series of funds, such as its StocksPLUS funds, tend to run with expense ratios that are Low or Below Average (there are some pricier vehicles among those funds, however). These funds are essentially index funds backed by actively managed collateral, so it stands to reason that they would be cheaper than their category peers. Also, PIMCO's remaining suite of actively managed fundamental equity funds is generally competitively priced. While its no-load D shares appear relatively expensive, many of them appear more reasonably priced when considering some investors in similarly distributed share classes are likely to pay transaction fees not reflected in some rival funds' expense ratios.

Even so, expenses on some share classes of some funds remain relatively high when compared with similarly distributed funds or with all of those funds' Morningstar Category peers. In addition, the firm historically has not passed on greater economies of scale for its larger funds (including PIMCO Total Return, until recently the industry's largest) via breakpoints in its fee schedule. Time will tell whether or not the expense ratios for a number of the firm's shrinking funds will rise, as has often been the case on funds that lose a considerable amount of assets. The overall trajectory of fund expenses at PIMCO has been positive, but more progress would be necessary to shift the firm's Fees score beyond C.

**Regulatory History -- Neutral**

Because investors should expect fund companies to comply with laws and regulations, the highest Regulatory History rating a firm can receive is Neutral. Two regulatory incidents at PIMCO are worth noting in this section of PIMCO's Stewardship Grade, but neither warrants lowering the firm's Regulatory History grade.

In December 2014, PIMCO terminated trader Rahul Seksaria after he was censured by the Chicago Mercantile Exchange for a 2012 trade. Seksaria executed both sides of a transaction of eurodollar futures contracts, selling those contracts on PIMCO's behalf and purchasing them for his personal account. The CME's penalty included a $65,000 fine and restitution of $2,675 to be paid to the funds affected (PIMCO Real Return PRRIX and PIMCO Commodity Real Return PCRIX) and barred him from all CME-affiliated trading platforms for three months. Seksaria's star at PIMCO had been rising prior to the CME's findings. He had been Mihir Worah's main lieutenant on a number of real-return-oriented accounts in recent years and had been transitioning to a new role on Worah's global multiasset team. Seksaria's transgression appears to be an isolated event, and the monetary penalty is relatively small. PIMCO's move to terminate Seksaria on the regulatory action upholds the firm's ethics policy, which is on file with the Securities and Exchange Commission.
Elsewhere, in September 2014, PIMCO confirmed that the SEC is investigating securities pricing within the exchange-traded fund version of its Total Return strategy. The findings of the investigation have not yet been made public, and firm has not been accused of wrongdoing.