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As Bond Market Tumbles, Pimco Seeks to Reassure Investors

By NATHANIEL POPPER

As investors prepare for a long-term shift in interest rates, few large financial firms are as vulnerable as the giant money manager Pimco.

Over the last 30 years, the company has been one of the biggest beneficiaries of steadily falling interest rates, which have made bonds, and Pimco's trademark bond mutual funds, into star investments. The environment propelled Pimco's transformation into the fifth-largest asset manager in the world, landed it in many retirement plans and gave its leader, William H. Gross, an aura of invincibility.

Now, as interest rates have surged in the last two months, the company is showing several signs of stress.

Three-quarters of the company's popular exchange-traded funds have experienced outflows during June, with two of them losing nearly 40 percent of their holdings, according to data from Lipper. At the same time, nearly 70 percent of Pimco's mutual funds and E.T.F.'s have been underperforming their benchmarks, data from Morningstar shows.

Two of its top executives have written articles in the last week comparing their customers to passengers afloat in treacherous waters, with reassurances as to why they will survive. Pimco, formally the Pacific Investment Management Company, is far from the only asset manager to deliver subpar returns in the last few weeks. Stock prices have fallen, and the broad universe of bond mutual funds has had the biggest monthly outflow since the peak of the financial crisis in 2008, largely because of fears that the Federal Reserve will ease up on its stimulus program. But no other big-name firm has tied its fate as closely to bonds as Pimco.

Nearly 90 percent of the Pimco assets tracked by Morningstar are in bond-focused funds. And 5 percent are in commodity funds, which are sensitive to interest rates. By contrast, a competing money manager that began with a focus on bonds, BlackRock, now has only a quarter of its assets in bond funds, the data shows.

That concentration could present a challenge for Pimco, even if the current volatility fades, because many economists are predicting that the era of falling interest rates has ended. It is not impossible for bond investors to see good returns when rates are going

up; Mr. Gross himself has done it before. But industry experts say Pimco failed to heed the most elementary advice given to mutual fund customers: the value of diversification as a buffer against unexpected turns in the market.

“They focused on their strengths, but now we have to ask, ‘If we’re going to be in an essentially flat or bear market for bonds, what comes next?’ ” said Kurt Brouwer, chairman of the financial advisory firm Brouwer & Janachowski. “I don’t think they have an answer to that.”

In the last few weeks, Pimco’s leaders have shown their awareness of the threat by churning out opinion articles in the financial news media and making frequent television and radio appearances. On Thursday, Mr. Gross, Pimco’s guiding light, sent customers a letter titled “The Tipping Point” that used the metaphor of a ship in danger of sinking.

“Yell, ‘This ship’s going to make it to port,’ Fed, Pimco and Pimco co-captains willing,” Mr. Gross wrote, adding, “Have a cocktail, tell the band to stop playing dirges, because you’re gonna be just fine with Pimco at the helm.”

Pimco leaders have said that even if rates are no longer declining, demand for bonds will be sustained by the aging, who want regular interest payments. What’s more, company executives have said that if interest rates rise, they are likely to do so at a slower pace than they have during June and May, which would allow Pimco managers to seek out the corners of value in the bond market.

The company’s executives declined to comment for this article, a spokesman, Michael Reid, said.

But on Friday, Mr. Gross wrote on Twitter: “We like bonds here.”

Pimco’s parent, the German insurer Allianz, is likely to be insulated from any challenges Pimco faces, given its wide array of business lines. But Pimco has long been run as a nearly independent company from its sunny office complex in Newport Beach in Southern California.

Its immediate fate most likely rests with Ben S. Bernanke, the Fed chairman, who began the recent market turmoil by indicating that the central bank might start paring back its bond-buying programs sooner than many investors anticipated. Mr. Gross has argued that the markets overreacted to those comments and that interest rates are unlikely to rise much if economic growth continues to be sluggish.

Financial advisers like Mr. Brouwer are prepared to give Pimco the benefit of the doubt, given the big returns its funds have delivered in the past. The firm’s flagship fund, the Total Return Fund, has provided an average annual return of 6 percent over the last 10 years, while the benchmark index against which it is graded returned 4.5 percent a year.

"They have a very strong brand name and a tremendous customer loyalty," Mr. Brouwer said.

The loyalty was apparent in 2011, when Mr. Gross incorrectly bet that United States government bonds would become less attractive. Customers initially fled the Total Return Fund, but the company as a whole drew in more money than it lost that year. And once Mr. Gross regained his footing, customers returned to the fund in 2012 and early 2013, maintaining its status as the largest mutual fund in the world.

In recent months, though, Mr. Gross made another bad bet on Treasury bonds, leading the Total Return Fund to even bigger losses than the bond market as a whole. This time, it looks like investors might be a little less forgiving. Only two of the 20 Pimco E.T.F.'s tracked by Lipper attracted money in June, and one of those was its low-risk, low-fee money market fund.

The broader problem facing Pimco is not monthly returns but instead an outlook of rising interest rates that could turn investors away from bond managers of all sorts, including smaller rivals like DoubleLine Capital and Western Asset Management.

"People were buying Pimco products because bonds were good and it was a name associated with success," said Jeff Tjornehoj, a mutual fund analyst at Lipper. "Once that inertia is lost, it's hard to regain."

Pimco has previously made efforts to expand its offerings beyond bonds. Neel T. Kashkari, a former Treasury official, was brought on in 2009 to expand the company's stock-focused mutual funds. But Mr. Kashkari left Pimco this year, and stock funds account for only about 4 percent of the assets tracked by Morningstar, with most of that in foreign stocks.

Craig J. Ferrantino, a financial adviser on Long Island, says he sold about 15 percent of his customer's Pimco funds in recent months. Even if interest rates do turn back down, he added, "I don't see us returning in the near future."

"This thing was the de facto place to go for investing safely," Mr. Ferrantino said. "I want to stop playing defense and start playing offense."

This post has been revised to reflect the following correction:

Correction: July 1, 2013

An earlier version of this post gave the incorrect average annual return of the benchmark index against which Pimco's flagship fund, the Total Return Fund, is graded. It was 4.5 percent a year over 10 years, not 1.5 percent.

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