

To: State of North Carolina Investment Subcommittee  
Cc: Mercer  
From: Galliard Capital Management  
Date: October 24<sup>th</sup>, 2014

Re: Response to inquiry regarding the PIMCO allocation in the North Carolina 401(k) and 457 plans

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Dear Mary:

Thank you for your inquiry regarding Galliard's take on PIMCO in light of Mercer's recommendation to seek a potential replacement for the PIMCO allocation within the North Carolina 401(k) and 457 stable value funds.

It is our understanding that the Committee is not directing us to find a replacement for PIMCO; rather, to carefully consider whether or not PIMCO should be replaced within the stable value funds – and if so, recommend a replacement. Our response to the Committee's request is herein.

#### **Executive Summary**

Galliard continues to maintain close communication with PIMCO, including hosting a visit with representatives from PIMCO's New York office and meeting with senior PIMCO investment professionals in PIMCO's Newport Beach headquarters. Through these recent meetings and discussions, Galliard's External Manager Team has affirmed our comfort with PIMCO's core investment process, namely the top-down macro focus which is a key component of the diversification PIMCO brings to Galliard's stable value portfolios.

We believe Daniel Ivascyn is a good fit to lead PIMCO, and the overall PIMCO team seems energized to move past recent events. Neither Mr. Gross nor Mr. El-Erian were directly managing any of Galliard client assets. The named portfolio managers at PIMCO for Galliard client portfolios have not changed following Mr. Gross's departure. Additionally, the investment guidelines under which PIMCO manages for Galliard client portfolios are tighter than in many of the other portfolios they manage, which provides additional protection.

Lastly, while PIMCO has demonstrated strong historical performance – which we believe to be process-driven and not people-driven, we are continuing our evaluation process and will be hosting a PIMCO visit in early November as part of the ongoing dialogue.

**Absent further notable turnover or other material changes, Galliard's External Manager Team continues to remain comfortable with PIMCO, and therefore recommends retaining the PIMCO allocation within the North Carolina 401(k) and 457 stable value funds at this time.** This being said, should the Committee direct Galliard to do otherwise, we have a number of readily available alternatives – albeit with less emphasis on top-down macro investment strategies, a key component of the diversification PIMCO brings to Galliard's stable value portfolios.

For your reference, we've included on the following pages further details regarding our evaluation of PIMCO and our reasoning for this recommendation.

Kind regards,  
William Weber  
Galliard Capital Management

## **PIMCO Evaluation Update**

### **Background**

Following the departure of Mohamed El-Erian earlier this year, Galliard had been actively monitoring PIMCO and the new DCIO structure put in place under then CIO Bill Gross. As part of our monitoring and evaluation, Galliard's External Manager Team met with key PIMCO individuals in Newport Beach in the second quarter, including Mihir Worah, Saumil Parikh and Sudi Mariappa. Galliard's opinion of the changes earlier this year was that they served as a distraction within the organization, but that the Deputy-CIO model provided a potential succession plan for the eventual departure of Bill Gross. Galliard's External Manager Team had continued to closely monitor PIMCO throughout the summer with an eye on both portfolio positioning and the evolution of the co-CIO model.

Following the announced departure of Bill Gross in late August, Galliard formally placed PIMCO on our Watch list, downgraded our manager rating from Superior to Good and restricted any further asset placements. Consistent with Galliard's conservative, measured approach to investing, since making our initial assessment we have been focused on continuing our evaluation in order to form a complete, well-considered opinion. We believe it is important to carefully consider what additional actions, if any, are appropriate in light of Mr. Gross's departure. In evaluating any manager, Galliard evaluates a number of factors, including people, process, performance, organizational stability, support and compliance functions and how the broader firm is managed.

Specific to the PIMCO situation, we identified the following factors as key to our evaluation:

- Potential disruption to PIMCO's investment process
- Assessing how big a role did Mr. Gross play in strategy formulation
- Assessment of new CIO and Investment Committee members and team dynamics
- Increased workload for PMs managing our portfolios
- Potential for additional departures
- Financial impact of declining AUM on ability to attract/retain talent and invest in the business
- Protracted focus on servicing to retain clients vs. investing

While the portfolios PIMCO manages on behalf of Galliard clients have underperformed since mid-2013, this is not the primary component of our decision making process.

### **Notes from Recent Meetings with PIMCO**

Galliard continues to maintain close communication with PIMCO, including hosting a visit with representatives from PIMCO's New York office and meeting with senior PIMCO investment professionals in PIMCO's Newport Beach headquarters. In Newport Beach, we met with Daniel Ivascyn (Group CIO), Mihir Worah (CIO and member of the Investment Committee), Sudi Mariappa (Senior Portfolio Manager) and Jay Jacobs (PIMCO President). During these meetings, we have gained confidence that PIMCO is continuing to focus on investment performance and their investment process remains in place and largely unchanged. Daniel Ivascyn presents as a thoughtful investor with significant experience in a leadership role at PIMCO and a nearly innate

feel for PIMCO's investment process. We found it clear that Mr. Ivascyn is a natural leader with the ability to strike a balance between effective collaboration and individual accountability.

In his role as Group CIO, Mr. Ivascyn does play the role of official tie-breaker for Investment Committee decisions, but acknowledges he will weigh the opinions and views of others who are more knowledgeable in specific areas. Mr. Ivascyn spoke at length about the evolution and refinement of the firm's investment process over time, and the central role the process itself plays in creating steady, predictable outcomes. Despite Mr. Ivascyn's background in managing structured credit and income-oriented products, he communicated a strong commitment to "Macro" strategies and "structural" trades which have been a focus for PIMCO over the last 20 years or more. Mr. Worah, who we had met during a visit earlier this year, spoke about the support and respect he and the other CIOs have for Mr. Ivascyn and his selection as the Group CIO.

PIMCO President Jay Jacobs discussed PIMCO's planning and management process for the transition following Mr. Gross's departure. He acknowledged that a continued decline in assets would reduce profitability, but noted that the impact of outflows in Core Fixed Income were not as significant to the overall firm due to continued product diversification and the growth of other strategies. Mr. Jacobs indicated that approximately 50% of PIMCO's costs are variable, as opposed to fixed, including all back-office processing which has been outsourced to State Street for some time. This fact, plus PIMCO's significant margin cushion, will help to temper the impact of the decline in AUM on profitability. Mr. Jacobs indicated that PIMCO expects to announce significant staff retention programs and is actively hiring new talent to assist during the transition. He further communicated that Allianz (PIMCO's parent) has been tremendously supportive and they fully expect Allianz to maintain a hands-off role.

#### **Galliard's Opinion:**

Through meetings and discussions with PIMCO, Galliard's External Manager Team has gained comfort that PIMCO's core investment process, including the top-down macro focus that is an important component of the diversification PIMCO brings to the overall Stable Value portfolios, remains largely intact. Ideally, the co-CIO model would have had additional time to develop, but all-in-all the transition appears to be proceeding relatively smoothly. Mr. Ivascyn has a history of serving in key executive roles at PIMCO, including on the PM Management Committee, the Compensation Committee and others.

While Mr. Gross is widely recognized as a great fixed income investor, he has also developed and grown an organization comprised of a number of talented and thoughtful investors. From a macro perspective, some of the key Investment Committee members (or rotating members) include Mohsen Fahmi, Sudi Mariappa, Tony Crescenzi, and Scott Mather. Additionally, Rich Clarida led the secular forum earlier this year and Saumil Parikh continues to lead the Cyclical Forum, a role he has held since 2010.

We believe that during the last decade at PIMCO, Mr. Gross most likely played a role of orchestra conductor for a talented group of musicians, rather than a composer of original work. Reading between the lines – and reading the press – it seems clear that Mr. Gross had become increasingly difficult to work with and that he was increasingly frustrated with the evolution of his role within the team structure following Mr. El-Erian's departure. We sense a great deal of positive energy and optimism surrounding Mr. Ivascyn's appointment to lead the firm. PIMCO's senior managers are clearly energized to take heightened roles and accountability for

PIMCO's next phase. As such, we are comfortable with Mr. Ivascyn in this role, although we clearly will be watching events closely.

Jay Jacobs provided comfort that PIMCO understands the risks of losing additional personnel and is actively focusing on retention. He also indicated an understanding within the organization, and acknowledgement from their parent, Allianz, that PIMCO will likely experience a temporary decline in profit margin in order to continue to invest in their people and the broader organization during the transition due to the decline in assets.

Galliard is continuing our evaluation process of the changes and will be hosting a PIMCO visit in early November as part of the ongoing dialogue. Absent further notable turnover, Galliard's External Manager Team continues to remain comfortable with PIMCO.

### **Galliard's Exposure to PIMCO**

As we have noted, neither Mr. Gross nor Mr. El-Erian were directly managing any of Galliard client assets. The named portfolio managers at PIMCO for Galliard client portfolios have not changed following Mr. Gross's departure. In managing portfolios for Galliard's Stable Value clients, PIMCO manages assets either in client Separate Accounts or Collective/Commingled Funds exclusively for Galliard clients. We believe this offers substantial insulation against the impact of any immediate outflows experienced by PIMCO. Additionally, the investment guidelines under which PIMCO manages for Galliard client portfolios are tighter than in many of the other portfolios they manage, which provides additional protection. These restrictions include portfolio duration bands, liquidity minimums, sector maximums, quality restrictions (including a minimum rating of AAA on structured securities), limits on derivative exposure and the types of derivatives that may be employed, and a prohibition against any leverage.