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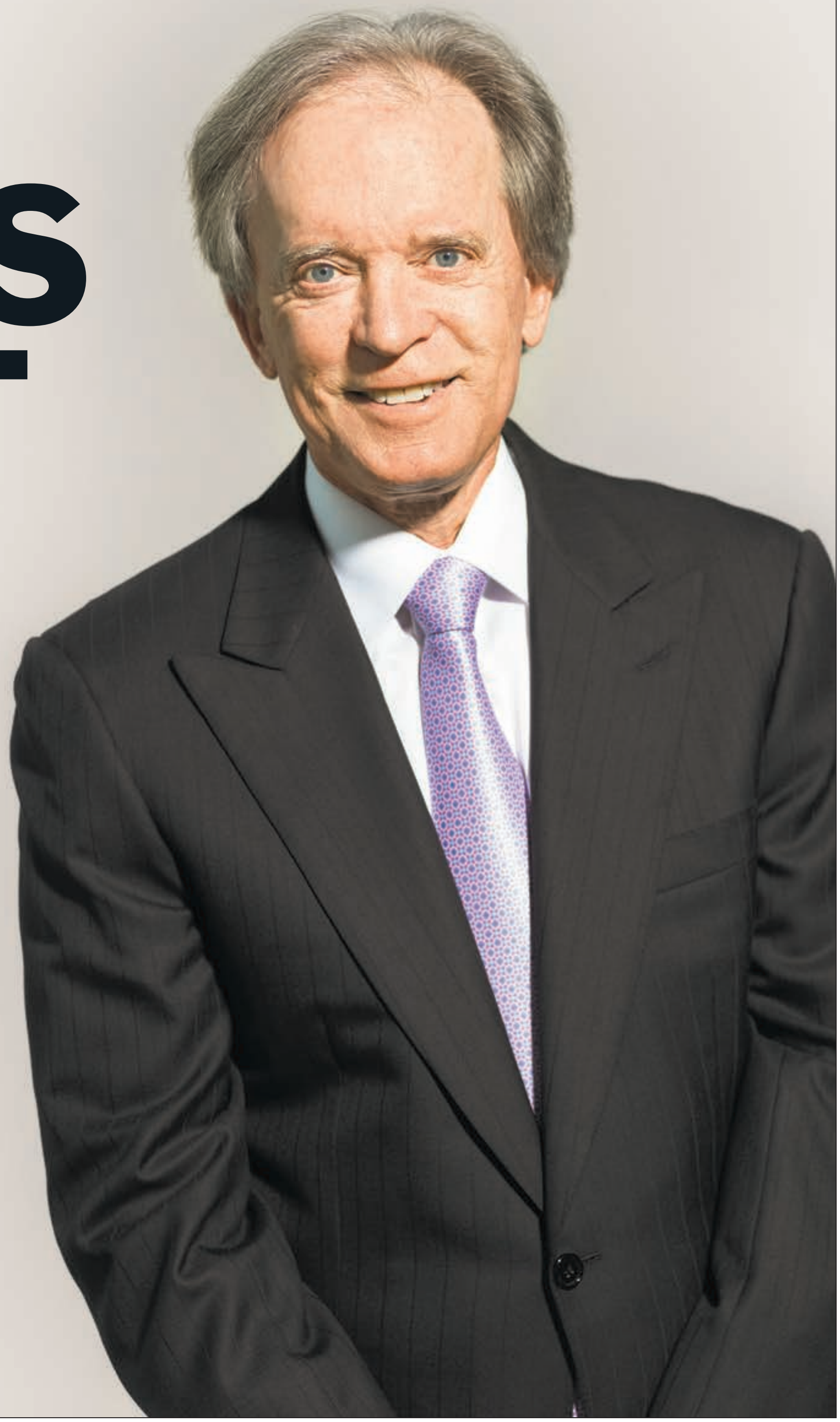
WHY RATES MUST RISE

Today's ultralow interest rates are destroying savers, who are the bedrock of capitalism. So says **BILL GROSS,** whose Janus fund is beating its peers again. Plus: Smart picks for fixed-income investors.



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COVER STORY

After a rough year at Janus, bond guru Bill Gross is starting to hit his stride. A passel of fixed-income picks, and some advice for the Fed.

Why Rates Must Rise

The following has been excerpted

By Lauren R. Rublin

Home, they say, is where you make it. For Bill Gross, 71, manager of the Janus Global Unconstrained Bond fund, home these days is a small suite in an office tower in Newport Beach, Calif., down the road from Pacific Investment Management, or Pimco, the asset-management firm he co-founded in 1971 and ran until leaving abruptly in 2014, following a few years of poor investment results and an ugly management spat.

At Pimco, with which he is still feuding, Gross oversaw what was once the world's largest mutual fund, Pimco Total Return (ticker: PTTAX) with assets of $293 billion at its peak, and built an outstanding investment record. At Janus Capital, a Denver-based firm with assets of $192.3 billion, he runs a $1.3 billion fund (JUCAX), seeded in part with his own money, that performed dismally in 2015, losing 0.72%.

If Gross' digs, portfolio, and results are humbler today than for most of his career, his ambition seems undimmed – to go out a winner, delivering substantial gains for investors even in a business that offers diminishing returns, now that interest rates in much of the world are close to zero, or less. He doesn't think much of the central-bank policies that have repressed rates, punished savers, and failed to ignite economic growth, and says the Fed must begin to raise rates in coming years to keep the economy on track.

As of Feb. 29, Gross' fund held a broad mix of assets, including agency, corporate, and high-yield debt; options on interest-rate volatility; and riskier credit-default swaps sold on Brazilian and Mexican debt. The swaps sales reflect his view that investors "tend to overpay for protection" against defaults by certain issuers, in this case two countries dependent on energy-sector receipts.

In a recent interview in his office, Gross was candid about the pros and cons of his transition to Janus. "On the plus side, it is easier to manage $1.5 billion than $1.5 trillion [Pimco's assets at year-end 2014]," he says. "One of the negatives is that the smallness is isolating at times. It's not that I enjoyed daily investment-committee meetings at Pimco, but at some level, they were fun and engaging."

It is too soon to tell whether the onetime bond king will build a successful record at Janus – or win the breach-of-contract lawsuit he filed last fall against his former Pimco colleagues, charging that a "cabal" of executives wrongly had sought to oust him, to take his share of the firm's profits. Last week, Pimco filed its own claim in connection with the suit, saying that Gross had quit without notice, leaving a handwritten resignation letter on his desk in the middle of the night, and that he was aware he would be giving up his bonus by leaving the firm before a certain date. Gross didn't respond to queries about the latest developments in the suit.

> **The Fed has to "normalize interest rates over a period of two, three, four years or the domestic and global economy won't function."** –Bill Gross

Even as the case plays out, two things are clear: Gross is thrilled to still be in

PHOTOGRAPHY BY SAM COMEN

"In the developed financial economies, lowering interest rates to near zero has produced negative consequences. The best examples are the business models of insurance companies and pension funds."

the competitive investment game, and remains one of the smartest market observers around.

Barron's: How would you grade your performance at Janus so far?

Gross: Since I began managing the fund on Oct. 6, 2014, the I-class shares [JUCIX] are up 1.17% cumulatively through the first quarter. I'll take it. We had some ups and downs early on, but things have turned around in the past few months. You have to follow the same strategy as a golfer who is down one, with two holes to play. You can't panic; you just have to play your game. Sometimes, over short periods, it doesn't work; it didn't work for the first six months or so after I got here. But things have improved, and this year, returns have turned positive. I'd like to be 4% or 5% positive, but markets haven't allowed for that.

Fund flows are improving, as well. Is that a validation of the improvement in your performance?

Fund flows are a function of two things. One is performance. The other is interest in the asset class – in this case, the interest of the public in mutual funds, exchange-traded funds, or alternative types of assets. Mutual funds are on the bottom rung at the moment, having been displaced to some extent by lower-cost ETFs. Also, the unconstrained-fund universe has disappointed investors as an asset class. It hasn't been profitable in the past 15 months. Still, I'm glad that fund flows have turned positive. The object wasn't to build this into a $1 trillion company or fund, but every manager wants his or her fund to be popular.

Was it difficult to take charge of an unconstrained bond fund after running a portfolio of mostly U.S. Treasuries and corporate bonds?

It is challenging. A manager of an unconstrained fund not only has more choices, but has to accept more risk. The unconstrained universe was born six or seven years ago from the idea that interest rates would bottom at some point, and bonds no longer would provide a decent return; in fact, returns might be negative. From conception, these funds were relatively neutral, duration-wise. To the extent that duration is minimized, a greater emphasis must be put on other elements of return, including credit, volatility, currency, and liquidity.

What do you emphasize in Janus Unconstrained?

I begin with the premise that money returns nothing at the moment. There's an old song that goes "Nothing from nothing . . .

". . . leaves nothing."

That's right. The song is about a relationship, not money, but the fund is positioned with that in mind. If you start at zero and aim to deliver a 4% or 5% annual return, you've got to lever your assets to some extent. The positions in the fund are primarily volatility-related, because volatility has the lowest amount of risk, relative to return, of the elements I mentioned.

Years of easing by central banks mean that interest rates in most of the developed world will fluctuate narrowly. That offers an opportunity to sell volatility to create return. If you bought a 10-year Treasury bond today and nothing changed, you would get a 1.9% yield. If you bought a seven-year German Bund, you'd get zero. If, however, you sold a three-month call or three-month put on that same Treasury with a 20-basis-point [hundredths of a percentage point] variation – in other words, the yield stayed in the range of 1.7%-2.1% for three months – the trade would produce an annual return of 6%, as opposed to 1.9%.

The risk is that interest rates will go up or down by more than 20 basis points over a three-month period. But my premise is that central bankers will do anything possible to contain interest-rate fluctuations. The sale of volatility is producing the predominant amount of return in my fund.

How is the fund structured?

If you make a pie, you have the crust and the filling. The crust in a $1.3 billion fund is 12- to 18-month corporate bonds and notes, triple-B rated – hopefully, with no credit sinkholes – that yield about 2%. That's where all the cash goes. If you start your pie with a 2% yield, you aim to get to 5% with a derivatives-based filling, much like the options I just discussed. You do it by assuming credit risk or selling credit risk, buying or selling volatility, taking mild currency positions, or buying or selling liquidity.

You have taken central bankers to task for impotence and ignorance, among other sins. In particular, you have written that Fed Chair Janet Yellen and others are ignorant of the harm done by their policies "to a classical economic model that has driven prosperity." Just what did you mean, and what sorts of dangers do we face?

The Federal Reserve was created in 1913. President Nixon took the U.S. off the gold standard in 1971. For the past 40-plus years, central banks have been able to print as much money as they wanted, and they have. When I started at Pimco in 1971, the amount of credit outstanding in the U.S., including mortgages, business debt, and government debt, was $1 trillion. Now it's $58 trillion. Credit growth, at least in its earlier stages, can be very productive. For all the faults of Fannie Mae and Freddie Mac, the securitization of mortgages lowered interest rates and enabled people to buy homes. But when credit reaches the point of satiation, it doesn't do what it did before.

Think of the old Monty Python movie, *The Meaning of Life*. A grotesque, rotund guy keeps eating to demonstrate the negatives of gluttony, and finally is offered one last thing, a "wafer-thin mint." He swallows it and explodes. It's pretty funny. Is our financial system, with $58 trillion of credit, to the point of a wafer-thin mint? Probably not. But we're to the point where every bite is less and less fulfilling. Even though credit isn't being created as rapidly as in the past, it doesn't do what it did before.

Central banks believe that the historical model of raising interest rates to dampen inflation and lowering rates to invigorate the economy is still a functional model. The experience of the past five years, and maybe the past 15 or 20 in Japan, has shown this isn't the case.

So where does that leave our economy?

In the developed financial economies, as a bloc, lowering interest rates to near zero has produced negative consequences. The best examples of this include the business models of insurance companies and pension funds. Insurers have long-term liabilities and base their death benefits, and even health benefits, on earning a certain rate of interest on their premium dollars. When that rate is zero or close to it, their model is destroyed.

To use another example, California bases its current and future pension payments to civil workers on an estimated future return of 8% or so from bonds and stocks. But when bonds return 1% or 2%, or nothing in Germany's case, what happens? We've seen the difficulties that Puerto Rico, Detroit, and Illinois have faced paying their debts.

Now consider mom and pop and other people who read *Barron's*. They are saving for retirement and to put their kids through

"When rates are low, it pays to borrow rather than invest. How do you do that relatively safely? I try to do it in the fund [by] investing in merger-arbitrage situations, where the acquirer is borrowing for you."

college. They might have depended on a historic 8%-like return from stocks and bonds. Well, sorry. When interest rates get to zero – and that isn't the endpoint; they could go negative – savers are destroyed. And savers are the bedrock of capitalism. Savers allow investment, and investment produces growth.

Are you suggesting a recession looms?
No. I see very slow growth. In the U.S., instead of 3% economic growth, we have 2%. In euroland, instead of 2%, growth is 1%-plus. In Japan, they hope for anything above zero.

What governments want, and what central banks are trying to do, is produce, in addition to minimal growth, a semblance of inflation. Inflating is one way to get out from under all the debt that has been accumulated. It isn't working, because with interest rates at zero, companies and individual savers sense the futility of taking on risk. In this case, the mint eater doesn't explode, but the system sort of grinds to a halt.

It doesn't look like anything is grinding to a halt around here. You can see gorgeous golf courses from one window and a yacht basin from the other.
This isn't the real economy. It is Disneyland and Hollywood. It is finance-based prosperity, based on money that doesn't produce anything anymore because yields are so low.

Even in a negative-rate environment, as in Germany or Switzerland, banks and big insurance companies have little choice but to park their money electronically with the central bank and pay 50 basis points. But an individual can say "give me back my money" and keep it in cash. That's what would make the system implode. I'm not talking about millionaires or Newport Beach –aires, but people with $25,000 or $50,000. Without deposits, banks can't make loans anymore, so the system starts to collapse.

Let's say Yellen steps down and President Obama appoints you the new head of the Fed. What would you do differently?
What you're really asking is: What is the way out? The way out is a little bit of pain over a relatively long period of time. That is a problem for politicians and central bankers who are concerned with their legacy. It means raising interest rates and returning the savings function to normal. The Fed speaks of normalizing the yield curve but knows it can't go too fast. A 25-basis-point increase [in the federal-funds rate] in December had consequences in terms of strengthening the dollar and hurting emerging markets.

Will the Fed raise rates this year?
Yes, as long as the stock market permits it. They have to normalize interest rates over a period of two, three, four years, or the domestic and global economy won't function. In today's world, normalization would mean a 2% fed-funds rate, a 3.5% yield on the 10-year bond, and a 4.5% mortgage rate. Would this create some pain? Of course. Housing prices probably would stop rising, and might fall a bit. The Fed has to move gradually.

What will be the 10-year Treasury yield at the end of 2016?
Close to what it yields now. I expect the Fed to raise rates once or twice this year. That would put the fed-funds rate at 1%. Does the 10-year deserve to yield 1.90% with fed funds at 1%? Yes, so long as inflation is 2% or less. If the Fed raises rates, the euro and yen could weaken. That would mean rates in Europe and Japan don't have to go negative, or to extreme lows. In a sense, the Fed is driving everything. But it can't raise rates too much without threatening a country like Brazil, whose corporations have tons of dollar-dominated debt.

What will the global economy look like in five or 10 years?
Structurally, demographics are a problem for global growth. The developed world is aging, with Japan the best example. Italy is another good example, and Germany is a good, old society, too. As baby boomers get older, they spend less and less. But capitalism has been based on an ever-expanding number of people. It needs consumers.

Another thing happening is deglobalization, whether it's Donald Trump building a wall to keep out Mexicans, or European nations putting up fences to keep out migrants. Larry Summers [former secretary of the Treasury] has talked about secular stagnation, or a condition of little or no economic growth. At Pimco, I used the term "the new normal" to refer to this condition. It all adds up, again, to very slow growth. The days of 3% and 4% annual growth are gone.

Bill Gross' Picks

Among the fund chief's favorites are closed-end funds and a mortgage REIT. All use moderate leverage to boost returns.

Company/Ticker	Recent Price
Nuveen Preferred Income Opportunities / JPC	$9.42
Duff & Phelps Global Utility Income / DPG	15.23
Annaly Capital Management / NLY	10.35

E=Estimate Source: FactSet

How can an investor prosper in a world of low bond yields and sluggish growth?
When rates are low, it pays to borrow, rather than invest. How do you do that relatively safely? One way I try to do it in the fund is to invest in merger-arbitrage situations, where the acquiring company is borrowing for you.

Here's an example. Anheuser-Busch InBev [BUD] is planning to buy rival SABMiller [SAB.UK] for 44 British pounds [$61.85] a share. The deal could close by year end. A-B InBev has already borrowed about $50 billion by selling bonds cheaply in the U.S. and Europe. You're letting the company borrow for you, and you're taking advantage of the gap between the current stock price, in this case GBP 42, and the deal's expected closing price. Plus, you're collecting a dividend in the intervening months. It's a pretty safe bet.

Merger arbitrage hardly seems safe, given the possibility that a deal will unravel before the closing, as many have.
It is never risk-free, but that is why you want to hang your banner with a Warren Buffett [chairman of Berkshire Hathaway] or a company such as Anheuser-Busch that has already borrowed a substantial amount of money to do the deal. This sort of arbitrage accounts for maybe 10% of fund assets, and these types of situations can produce returns of 4% to 5%.

Another way to borrow and invest is to sell puts and calls around the current yield on the 10-year Treasury bond, as we discussed. A third way is to buy a closed-end fund. Most closed-end funds borrow, and lever their assets 35% to 50%. They might borrow at Libor [London interbank offered rate] types of rates, and use the funds to buy municipal bonds, which yield more. When an investor can buy a municipal closed-end fund at a discount to net asset value – most are trading at discounts of 6% to 10% of NAV – that's a head start. The leverage then produces a return of 5% or 6%, tax-free. Janus Unconstrained has 8% to 9% of assets in closed-end funds selling at a discount to NAV. Sure, there is risk in this leverage, but so long as rates stay low, it is unlikely to be a problem.

What are some closed-ends you like?

Nuveen Preferred Income Opportunities fund [JPC] holds bank preferred stock, and sells at a 6% discount to NAV. It is preferable to a large preferred-stock ETF because the mild use of leverage produces a higher yield. JPC currently yields 8.5%. I also like the Duff & Phelps Global Utility Income fund [DPG]. This is a global utility-stock closed-end fund trading at a 14% discount to net asset value. It yields 9.2%.

Another example of letting others borrow for you is Annaly Capital Management [NLY]. Annaly and American Capital Agency [AGNC] are bank-like real estate investment trusts without a bank infrastructure. Annaly is levered four to six times – less than banks, which are levered eight to nine times – and invests in government-guaranteed mortgages. It borrows money in the overnight repo [repurchase agreement] market. It yields about 11% because of leverage, not risky assets. The concept, again, is letting corporations borrow for you to produce a return higher than the 1% to 2% return the bond market gives you today.

You've had an extraordinary career. Who, among today's younger bond managers, might become the next Bill Gross?

I don't think there will be another, and that's not because I'm some kind of Babe Ruth. My career coincided with a unique period in which credit expanded from $1 trillion to $58 trillion, and returns justified that growth. That isn't going to happen again. The Earth is fully formed now; it isn't in a molten stage anymore. In other words, the system itself has matured. There will always be bond kings and queens, but less cachet will be attached to the job.

Thank you, Bill. ■

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Fixed income securities are subject to interest rate, inflation, credit and default risk. As interest rates rise, bond prices usually fall, and vice versa. High-yield bonds, or "junk" bonds, involve a greater risk of default and price volatility. Foreign securities, including sovereign debt, are subject to currency fluctuations, political and economic uncertainty, increased volatility and lower liquidity, all of which are magnified in emerging markets.

Derivatives involve risks in addition to the risks of the underlying securities, including gains or losses which, as a result of leverage, can be substantially greater than the derivatives' original cost. Short sales are speculative transactions with potentially unlimited losses, and the use of leverage can magnify the effect of losses. No investment strategy can ensure a profit or eliminate the risk of loss.

Closed end funds may trade at a discount (or premium) to their NAV and are subject to the market fluctuations of their underlying investments. Shares of closed end funds frequently trade at a market price that is a discount to their NAV. Closed end funds are subject to management fees and other expenses.

As of 3/31/16, average annual total returns for Janus Global Unconstrained Bond Fund – T Shares were 0.30% and -0.11% respectively for the 1-year and since inception (5/14) periods.

The Fund's annual gross and net expense ratios as of the Fund's fiscal year-end as of 3/31/16 were 1.01% and 1.01%, respectively.

As of 3/31/16, average annual total returns for Janus Global Unconstrained Bond Fund – A Shares @NAV were 0.36% and -0.11%, respectively for the 1-year and since inception (5/14) periods.

The Fund's annual gross and net expense ratios as of the Fund's fiscal year-end as of 3/31/16 were 1.07% and 1.07%, respectively.

As of 3/31/16, average annual total returns for Janus Global Unconstrained Bond Fund – A Shares @MOP were -4.39% and -2.72%, respectively for the 1-year and since inception (5/14) periods.

The Fund's annual gross and net expense ratios as of the Fund's fiscal year-end as of 3/31/16 were 1.07% and 1.07%, respectively.

As of 3/31/16, average annual total returns for Janus Global Unconstrained Bond Fund – I Shares were 0.64% and 0.15% respectively for the 1-year and since inception (5/14) periods.

The Fund's annual gross and net expense ratios as of the Fund's fiscal year-end as of 3/31/16 were 0.76% and 0.76%, respectively.

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As of 3/31/16, the top ten portfolio holdings of the Janus Global Unconstrained Bond Fund were Ally Financial Inc. 3.6 05/21/2018 (Long), Ally Financial Inc. 3.25 02/13/2018 (Long), Sabine Pass 7.5 11/30/2016 (Long), SABMiller (Long), Icahn Enterprises LP / Icahn Enterprises Finance Corp 3.5 03/15/2017 (Long), General Motors Financial Co. Inc. 2.75 05/15/2016 (Long), Lennar Corp 6.5 04/15/2016 (Long), MGM Resorts International 7.5 06/01/2016 (Long), Anadarko Petroleum Corp 5.95 09/15/2016 (Long), and Ally Financial Inc. 5.5 02/15/2017 (Long) respectively. There is no assurance that any Janus portfolio currently holds these securities or other securities mentioned in this article.

Bond ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest).

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