WURTS ASSOCIATES

MEMORANDUM

To: **Board of Trustees, Fresno County Employees' Retirement Association**

From: **Jeffrey MacLean, Wurts & Associates**

Steve Center, Manager Research Group

Date: **September 13, 2007**

Re: **PIMCO Distressed Mortgage Fund Offering**

Executive Summary

Pacific Investment Management Company (PIMCO) recently announced a limited partnership investment opportunity designed to capitalize on the recent downturn in the mortgage credit market. This partnership, called the PIMCO Distressed Mortgage Fund, hopes to earn returns of 15-20% by investing in extremely distressed mortgage and real estate-related fixed income instruments. Wurts & Associates believes clients with a long-term time horizon, and who are willing to accept limited liquidity, may find this investment attractive. Due to the unique nature of the investment opportunity, the window for accessing this fund may be limited. At this time, although PIMCO has not finalized the Private Placement Memorandum (PPM), they are anticipating closing the fund October 15. Wurts has prepared this memorandum ahead of the PPM in order to provide your plan additional time to consider this investment.

The Market

The mortgage-backed securities market became overextended during 2005 and 2006, brought on by a combination of low interest rates, "innovative" mortgage finance options, and questionable methodologies by the ratings agencies. During 2007, the downturn in the housing market, along with increased attention from rating agencies on subprime and "alternative documentation" (a.k.a. "Alt-A") lenders, has lead to a sharp downturn in the pricing of both Asset-Backed Securities (ABS) and Mortgage-Backed Securities (MBS). This downturn has created a market with many sellers and few buyers – PIMCO hopes to capitalize on this by being a source of liquidity for motivated sellers.

The Asset-Backed market in particular well illustrates how much prices have dropped in the last eight months. As shown in Chart 1, ABX (Asset-Backed Index) prices have fallen precipitously year to date. The spread on Commercial Mortgage-Backed Securities (CMBS) has also widened greatly, and not just in the subprime market. Chart 2 illustrates the widening of spreads in the CMBX (Commercial Mortgage-Backed Index) market, which have skyrocketed since February 2007.

Many of these ABS and CMBS securities are held in rating-sensitive accounts, such as those at insurance companies, banks, asset-backed commercial paper, and REITS. As downgrades are announced by the ratings agencies, many institutions are forced to liquidate their positions due to ratings-based portfolio restrictions. In other words, the expected ratings downgrades will likely trigger forced selling, and create a great opportunity for investors that are unconcerned with credit quality and short-term liquidity.

Chart 1: ABX Price History[1]

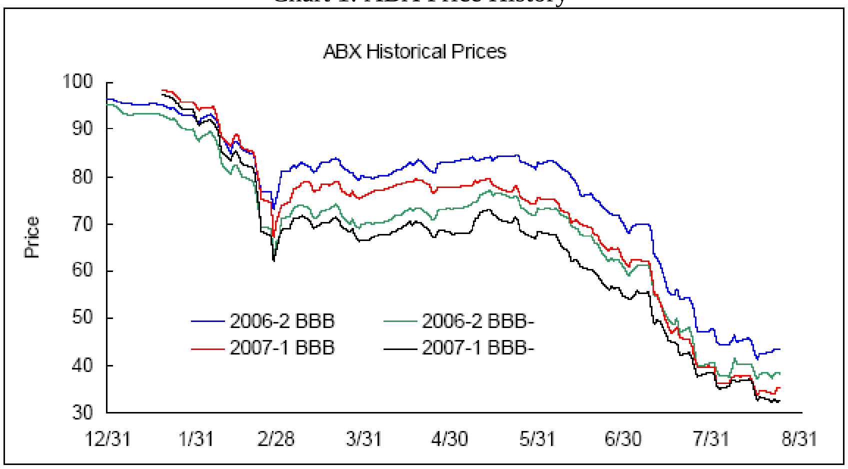
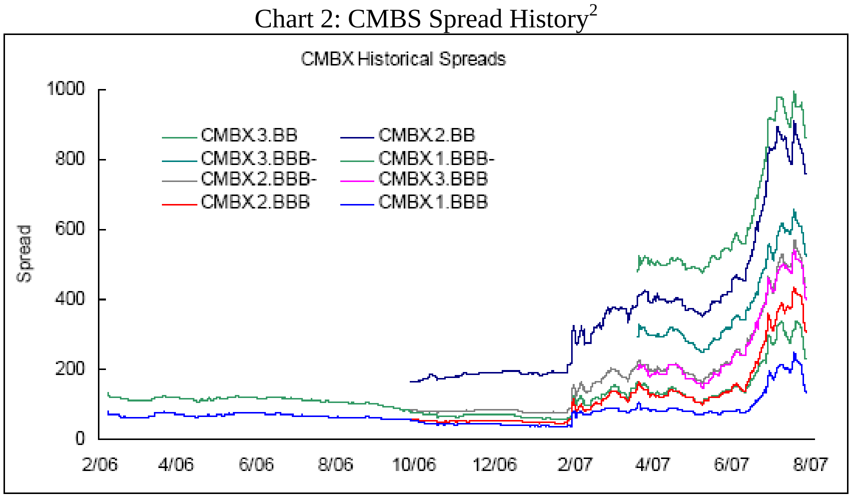


Chart 2: CMBS Spread History[2]



The Firm

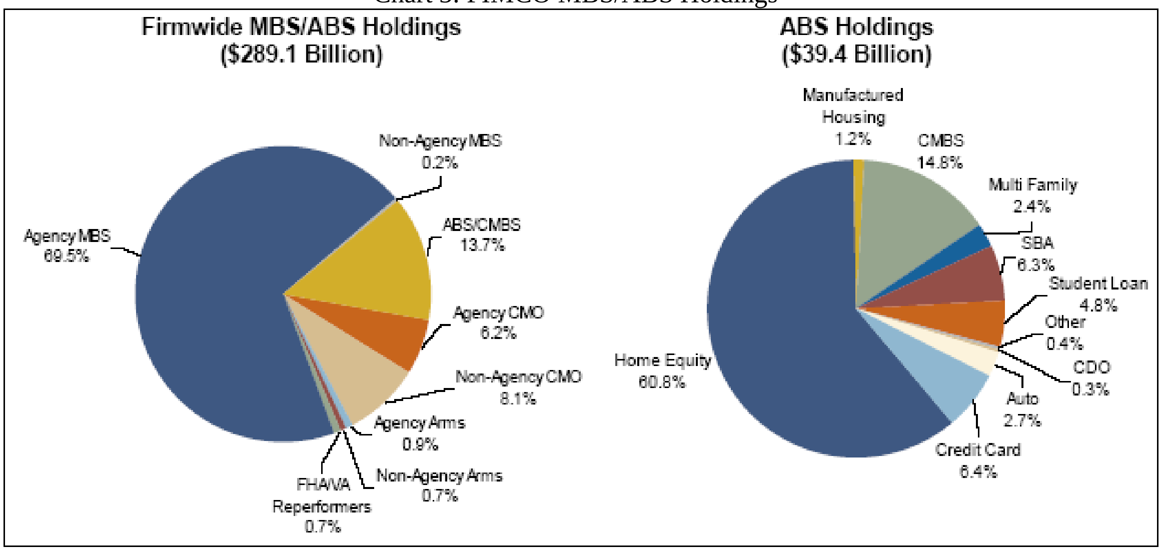
PIMCO needs little introduction. With over $690 billion under management, PIMCO is the largest fixed income manager in the country. Their asset base continues to grow organically, as they have doubled in size since 2002. PIMCO was founded in Newport Beach, California in 1971, and is now effectively 100% owned by Allianz Global Investors. Their investment team consists of over 325 investment professionals. They

[1] JP Morgan, as of 8/24/2007
[2] Lehman Brothers, as of 8/24/2007

have an exemplary track record, and are not regarded as a firm that frequently comes to market with "flavor of the month" strategies. PIMCO likes to say that they manage "products that make sense for our clients, not simply products that people will buy."

PIMCO was one of the first MBS investors back in 1975, and introduced the first CMBS closed-end fund to take advantage of distressed opportunities in 1993. Chart 3 depicts PIMCO's current exposure to all sectors of MBS/ABS as of June 30, 2007. The firm has been vocal in their recent skepticism regarding the mortgage credit market, and began underweighting the sector, and even shorting the ABS and Collateralized Debt Obligation (a.k.a. "CDOs," which are investment pools backed by the performance of a group of bonds) market where permissible, in 2006. They have already begun opportunistically investing in the distressed mortgage market where portfolio guidelines allow.

Chart 3: PIMCO MBS/ABS Holdings[3]



The Team

The PIMCO Distressed Mortgage Fund will be co-managed by Scott Simon and Dan Ivascyn, both Managing Directors at PIMCO. Mr. Simon is the Head of Mortgage and ABS Portfolio Management, and has 24 years of investment experience (including 7 at PIMCO). Mr. Ivascyn is the Head of ABS/Structured Credit Portfolio Management and has 16 years of investment experience (including 9 with PIMCO). The management team also includes Joshua Anderson, Senior Vice President and Head of Structured Credit Research.

The portfolio management team will be supported by 13 additional investment professionals, with an average experience of 7.5 years. These professionals have expertise in MBS, ABS, CDOs, derivatives, CMBS, Home Equity Loans (HELs), and general loan performance. PIMCO has also announced plans to hire both an additional

[3] PIMCO, As Of 6/30/07

loan performance specialist and an origination specialist to assist the team in analyzing loan purchases.

In addition, PIMCO's robust credit research team and well respected public policy experts (including, among other well-respected experts, former Chairman of the Federal Reserve Alan Greenspan) will assist the team. The credit team dedicated to the mortgage market consists of fifteen individuals.

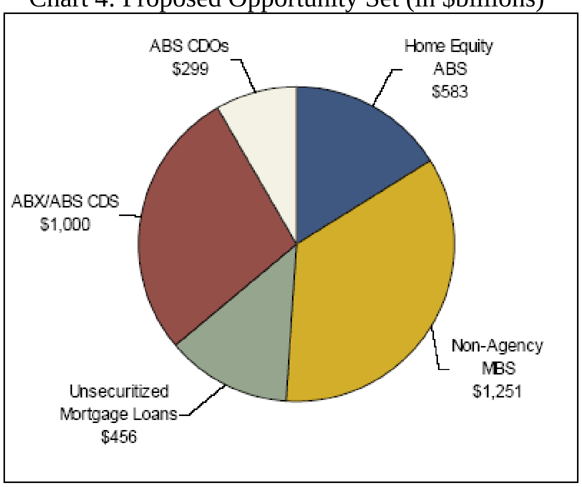
Overall, the team is experienced and deep. Our only personnel-related concerns have to do with resources and experience relating to one sector in which the Fund expects to invest. These concerns are addressed in the "Risks" section, below.

The Strategy

PIMCO has already seen investment opportunities surface in the market. Several recent hedge fund and CDO liquidations, along with forced selling from some recent CMBS downgrades, have produced buying opportunities that would be quite attractive for this Fund. PIMCO estimates the opportunity set to be approximately $3.5 trillion, as detailed in Chart 4. PIMCO expects to target opportunities in the following markets:

- Subprime, Alt-A, and Prime MBS
- CMBS
- Distressed Loan Packages
- ABS/MBS CDOs
- Residential Interests
- ABX, CMBX, TABX Indices (through derivative exposure)
- Individual Name Credit Default Swaps (CDS)
- Distressed 2nd Liens
- "Scratch-and-Dent" (Re-Performing Loan Packages)
- Warehouse Rights & Other Risk Sharing Arrangements

Chart 4: Proposed Opportunity Set (in $billions)[4]



[4] PIMCO, As Of 3/31/07

PIMCO has developed a proprietary valuation model for distressed MBS/ABS securities. This model shows a current implied yield of 15-20% on a buy-and-hold basis for some of the ABX securities currently trading. PIMCO uses multiple factors to analyze each security, including loss expectation, prepayments, leverage, interest rate sensitivity, and other qualitative factors (regulatory environment, servicer practices, etc.). Of these factors, PIMCO places a high importance on the qualitative factors as they will potentially impact all of the other factors. PIMCO expects to find attractive purchase options in both the prime and subprime space.

PIMCO expects to limit the Fund's use of leverage to 50%. They clearly state that leverage will not be a source of return for the strategy, but rather will be used to provide capital in instances where attractive securities are offered to PIMCO for which they do not have the funds necessary to act quickly.

PIMCO does reserve the right to hold short positions in securities, although it is unclear how they expect to use this ability. This should be outlined in more detail in the finalized offering memorandum.

The PIMCO Distressed Mortgage Fund is being marketed as an attractive opportunity for investors with a long-term horizon, with limited liquidity requirements, and lacking rating sensitivity. The fund will be illiquid, have a low credit rating, and will potentially be difficult to mark-to-market. However, investors who are comfortable with these constraints could be rewarded with relatively high returns. PIMCO believes this Fund can realistically return 15-20% annually after fees. Annual risk levels will be difficult to predict, and even measure, since the securities they will be investing in will be difficult to reliably mark-to-market on a consistent basis.

Fund Structure and Terms

PIMCO has opted to set up the PIMCO Distressed Mortgage Fund as a Limited Partnership, as opposed to a mutual fund, so that cash flows do not detract from their opportunity. PIMCO plans to invest as a General Partner, with investors supplying an additional $2 billion in capital. PIMCO has yet to determine their investment amount as the General Partner. Following an 18-month initial commitment period, the Fund will have a minimum five-year lock-up, with two optional additional years at the discretion of PIMCO.

As of September 10, 2007, PIMCO has yet to release a finalized offering memorandum for the Fund. Many important items, such as the Fund's administrator and custodian, have yet to be determined. These details will be included in the final offering memorandum. Below are the preliminary terms provided by PIMCO as of September 4, 2007. Please note these terms are subject to revision.

Target Fund Size	$2 billion in Limited Partnership interests
Minimum Commitment	$5 million (subject to discretion by General Partner)

General Partner Commitment	Not yet determined
Offering Period	No longer than six months from initial closing
Commitment Period	18 months after initial closing.
Commitment Term	Five (5) years from initial closing, may be extended by the General Partner for up to two consecutive one-year periods. No limited partner will be permitted to withdraw, and no redemptions will be made, prior to Fund termination.
Management Fees	1.5% per annum on invested commitments
Administrative Fees	0.25% per annum on invested commitments (approximated)
Distributions/ Performance Fees	Proceeds of dispositions to be distributed in priority to return (i) all funded Limited Partner commitments (including amounts drawn down to pay management and administrative fees), (ii) 8% per annum Preferred Return to Limited Partners on all funded commitments, (iii) a General Partner make-up of the LP Preferred Return, and thereafter (iv) 80% to the Limited Partners and 20% to the General Partner in respect of its carried interest (i.e., its performance fee). Current Income to be distributed in priority to return (i) 8% per annum Preferred Return to Limited Partners, (ii) a General Partner make-up of the LP Preferred Return, and thereafter (iii) according to the 80%/20% split. Current income and proceeds from dispositions may be reinvested to the extent received on or prior to the second anniversary of the final closing date.

Strengths

It is obvious that PIMCO is a strong candidate to launch this type of product. Many features stand out as reasons to select PIMCO as a manager of distressed mortgage securities. These reasons include:

- PIMCO has been publicly critical of the mortgage securities market for some time, and has been preparing a team to begin investing in the space once prices approached what they believed to be correct levels. They believe now is the time, and they have the team in place to do so.
- The team outlined by PIMCO is very impressive, particularly regarding the level of experience analyzing mortgage related securities.
- Mr. Simon and Mr. Ivascyn, along with many other members of the investment team, will be making personal investments in the Fund, thereby providing for strong alignment of interests. Demand by other employees at PIMCO for investment opportunities has also been very high.
- PIMCO has taken the step to prohibit the Fund from purchasing any CDOs managed by PIMCO. Some distressed vehicles launched by other firms have had

the ability to 'bail out' their underperforming CDOs, and PIMCO will not allow this Fund to do so.
- The investment opportunities as outlined by PIMCO are very attractive, and the expected return assumptions, even net of management fees, are very appealing.

Risks

Wurts & Associates believes there are numerous risks associated with this unique opportunity. Some of these risks are similar to traditional fixed income portfolios and some are as unique as the strategy itself. These risks include, but are not limited to, the following:

- Default Risk: Like any fixed income investment, the securities purchased in this portfolio will be subject to default risk. With their proprietary valuation model, though, PIMCO believes the price of these securities provides sufficient return opportunities despite some level of defaults.
- Interest Rate Risk: Like any fixed income investment, the value of the securities purchased in this portfolio will fluctuate as prevailing interest rates fluctuate.
- Prepayment Risk: Mortgage-backed and other ABS securities have prepayment risk, since borrowers can repay the underlying loans at no penalty. However, this risk should be minor in the case of distressed issues. Still, in the cases where borrowers are able to refinance through alternative channels, or if the U.S. Government decides to institute a mass bail-out of subprime borrowers, prepayment risk will definitely impact performance.
- Illiquidity Risk: Investors must be comfortable with having their capital locked-up for a minimum of five years, and possibly as long as seven years.
- Potential of No Income Distributions: There is a minimum of two years with no income distributions. Even after the initial two year reinvestment period, the level of income distributed to investors should be minimal. As such, this Fund may not be suitable for investors with short-term income requirements.
- Dedication of Resources: Both Mr. Simon and Mr. Ivascyn manage multiple other portfolios at PIMCO, and they will not be dedicated full-time to the Fund. The same can be said for the analysts working on the Fund. In addition, PIMCO notes that the securities held in this Fund fall outside the normal PIMCO portfolio eligibility, and as such, will necessitate a great deal of attention.
- Market Timing Risk: PIMCO expects the bottom of the distressed mortgage security market to occur some time in the next eighteen months to two years. There is a risk that they will improperly judge when the bottom has come, or will miss the bottom entirely.
- Representative Track Record: There is no applicable track record from which we can judge PIMCO's performance in this area. Although they do have a published track record for an ABS portfolio (a portion of their Global Credit Opportunity Fund) and a CMBS fund (the PIMCO Commercial Mortgage Securities Fund), the majority of the securities purchased in the PIMCO Distressed Mortgage Fund will be much different than what is held in these two funds.
- No Experience Purchasing Loan Packages: PIMCO has no experience actively purchasing loan packages, such as distressed 2nd liens, "scratch-and-dent" loans,

and warehouse rights. They expect to purchase these securities within the Fund. Although they have been following these securities for some time, they have no experience purchasing them.

- No Experience with Limited-Term Partnerships: PIMCO has never before offered a limited term private placement of this structure. Although we are confident they have the infrastructure and expertise to implement such a vehicle, it is a concern that this is new ground for them.
- Private Partnership Memorandum Not Yet Finalized: Most importantly, **PIMCO has yet to finalize their offering memorandum or private partnership agreement (PPM).** Many important factors concerning the overall strategy structure and risks will remain unclear until the document is finalized. Without these formal documents, it is impossible to fully analyze both the terms and the risks of this strategy.

Conclusion

PIMCO has come forth with a very interesting concept with the PIMCO Distressed Mortgage Fund. The team they have assembled is impressive, and it is difficult to claim anything other than expert-status for PIMCO when it comes to analyzing MBS/ABS securities. The current market environment points towards it being a good time to make an opportunistic investment in this area. However, it is difficult to make the final suggestion to pursue this opportunity with PIMCO before reviewing their finalized PPM. Due to the short timeframe PIMCO is operating under, though, we must quickly notify PIMCO as to our potential desire to invest in the strategy in order to 'earmark' space within the Fund. We can, of course, decide against investing if any red flags arise upon receiving the final PPM.

Wurts & Associates believes the PIMCO Distressed Mortgage Fund poses a unique opportunity that your plan may benefit from. While the risks are significant, and may include risks not detailed herein, the fund has the potential to provide long-term investors a generous yield above what is commonly anticipated from fixed income investments. Given the various risks, in particular the illiquidity of the strategy, we would not recommend placing more than 10% of your fixed income allocation in the Fund. Meaning, if you have a 30% allocation to fixed income, no more than 3% of the total fund should be committed to the PIMCO Distressed Mortgage Fund. If your plan has unique cash flow considerations, a custom solution may be warranted. This suggestion is subject to a review of the finalized Private Placement Memorandum (PPM). An updated memorandum from Wurts & Associates will be produced upon receipt and review of the finalized PPM.

THIS MEMORANDUM IS INTENDED FOR THE RECIPIENT(S) IDENTIFIED IN THE TO: LINE AND MAY NOT BE REDISTRIBUTED WITHOUT EXPRESS PERMISSION FROM WURTS & ASSOCIATES. THE MEMO RECIPIENT MUST ACKNOWLEDGE THE RISKS ASSOCIATED WITH THIS INVESTMENT. THE GOVERNING TERMS OF THE PIMCO DISTRESSED MORTGAGE FUND WILL BE STATED IN THE PRIVATE PLACEMENT MEMORANDUM (PPM) AND MAY DIFFER FROM WHAT IS DESCRIBED IN THIS MEMORANDUM. THIS INVESTMENT CONTAINS RISKS WHICH CAN LEAD TO A LOSS OF CAPITAL. SOME OF THESE RISKS ARE ARTICULATED IN THIS MEMORANDUM. THE RECIPIENT OF THIS MEMORANDUM MUST ASSUME THAT THERE ARE OTHER RISKS NOT CONTEMPLATED AT THIS TIME THAT COULD HAVE AN ADVERSE AFFECT ON THIS INVESTMENT. WURTS & ASSOCIATES DOES NOT PRESUME TO BE AN EXPERT ON THE INTRICACIES OF THE MORTGAGE MARKET. THEREFORE, WURTS & ASSOCIATES CAN NOT BE HELD FINANCIALLY RESPONSIBLE FOR ANY CAPITAL LOSSES THAT RESULT FROM A DECISION BY THE RECIPIENT TO INVEST IN THIS INVESTMENT. WURTS & ASSOCIATES CAN NOT GUARANTEE ANY INVESTMENT PERFORMANCE OR WARRANT THAT PIMCO WILL PROPERLY PERFORM THEIR RESPONSIBILITIES TO MANAGE THESE ASSETS CONSISTENT WITH HIGH FIDUCIARY STANDARDS. PLAN SPONSORS SHOULD HAVE LEGAL COUNSEL REVIEW THE FUND AGREEMENT AND PPM PRIOR TO INVESTMENT.

THERE CAN BE NO ASSURANCE THAT THE FUND'S INVESTMENT OBJECTIVE WILL BE ACHIEVED, AND CERTAIN INVESTMENT PRACTICES EMPLOYED BY THE PORTFOLIO MANAGER (*E.G.* THE USE OF LEVERAGE, SHORT SALES, AND DERIVATIVES) CAN, IN SOME CIRCUMSTANCES, POTENTIALLY INCREASE ANY ADVERSE IMPACT ON THE FUND'S INVESTMENT PORTFOLIO.

THE INVESTMENT IS SUITABLE ONLY FOR SOPHISTICATED INVESTORS WHO DO NOT REQUIRE IMMEDIATE LIQUIDITY FOR THEIR INVESTMENTS, FOR WHOM AN INVESTMENT IN THE FUND DOES NOT CONSTITUTE A COMPLETE INVESTMENT PROGRAM AND WHO FULLY UNDERSTAND AND ARE WILLING TO ASSUME THE RISKS INVOLVED IN THE FUND'S INVESTMENT PROGRAM. THE FUND'S INVESTMENT PRACTICES, BY THEIR NATURE, MAY BE CONSIDERED TO INVOLVE A SUBSTANTIAL DEGREE OF RISK.