The demise of “bond king” Bill Gross: Financial and political implications

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4 October 2014

The sudden departure last week of Bill Gross, the “bond king,” from Pacific Management Investment Co (Pimco), the world’s largest bond trader, has, in its own way, cast a further revealing light on the fragility of the US and global financial system.

Gross announced on September 26 that he was leaving Pimco, which he founded and led for more than 40 years, to take up a post at a much smaller firm Janus Capital. Had he not departed there were expectations he would have been sacked.

The dramatic exit came after a period of upheaval at the top levels of Pimco. In January, his right hand man, and heir apparent, Mohamed El-Arian left the firm after a series of disputes with Gross. This was followed by displays of ever-more erratic behaviour, including emails in which Gross denounced other top Pimco executives, public appearances wearing sunglasses where he compared himself to Justin Bieber, and his decision to dedicate the first half of one of his widely-followed Investment Outlook letters in April to his dead cat.

Gross is also reported to have told journalists that they should repeat that he was “the kindest, bravest, warmest, most wonderful human being you’ve met in your life.”

Such behaviour can, of course, be tolerated, even welcomed, because it provides a certain “market edge,” so long as the money keeps flowing in. But the “magic” touch, which had seen Gross turn Pimco into a $2 trillion entity, consistently outperforming most other funds, deserted him.

Gross’s rise to the position of the world’s pre-eminent bond trader, amassing a personal fortune in the process—he was reported as being paid $200 million a year at Pimco—was based on an early assessment of a major shift in the global economy and financial system.

He saw that with the containment of inflation, starting in the 1980s after two deep recessions in the US, bonds had entered a bull run.

The “model” he adopted was essentially a simple one: it was based on the assumption that in conditions of lower inflation, fixed-income bonds would rise in value since their real returns would increase.

If, for example, a $100 bond returns a fixed income of 5 percent, that is $5 per year, the value of that return will be higher if inflation is 2 percent rather than 5 or 6 percent. Consequently, the value of the bond, which brings this income stream and which can be bought and sold in financial markets, will tend to rise under conditions of lower inflation.

For a whole period this “model” brought large returns. Pimco became the world’s largest bond trader and the firm’s flagship Total Return Bond fund, personally run by Gross, outstripped its rivals in most years.

However, in the recent period, the wheel has turned.

In the past 12 months, even before Gross’ departure, $42 billion had flowed out of Total Return as it lagged in the bottom 20 percent of industry tables measured by returns. September was the 17th consecutive month in which it had suffered outflows. Other Pimco funds also underperformed relative to the rest of the market and it reported that it had lost 10 percent of its assets since the start of September.

On top of the worsening financial performance came the news that the group’s $3.6 billion Total Return Exchange Traded Fund is under investigation by the Securities and Exchange Commission. At issue is whether Pimco bought investments at one price and then used a higher figure when assessing the value of its holdings in order to give a distorted picture of its performance. The company has said it is “co-operating” with the SEC and insists that its pricing procedures have been “entirely appropriate and in keeping with industry best practices.”

That may well be the case. But if it turns out to be so, it says more about the finance industry as a whole than it does about Pimco. The possibility for a discrepancy arises from the fact that in markets where bonds are traded infrequently, the calculation of their value can be made by other firms on the basis of market data and estimates of likely liquidity. Such procedures played no small part in the 2008 crisis, when it was discovered that whole classes of assets valued in this way turned out to be completely worthless.

Ultimately Gross' demise is rooted in the upheaval produced by the global financial crisis of 2008 and the extraordinary measures adopted by the US Federal Reserve and other central banks, known as "quantitative easing" (QE). This has seen trillions of dollars pumped into the bond and other financial markets to try to prevent a meltdown of the entire financial system.

Gross believed that with the end of QE2 in 2011, the bull run in bonds was over because as the Fed withdrew from the market, the value of government bonds would fall. However, the Fed stepped up its intervention and initiated a QE3. When the Fed indicated in 2013 that it would start to "taper" its involvement in the market, Gross made the same assessment.

His calculation was based on the "rational" assumption that central banks could not continue buying up government bonds and their value in the market would have to fall. But the Fed intervention has continued and, in conditions of stagnation and outright recession in the real economy, bonds remain attractive.

Commenting on the downfall of Gross, *Financial Times* commentator Gillian Tett recalled the observation of the famous British economist John Maynard Keynes (himself a noted financial market trader) that "the problem with markets is that they can remain 'irrational' longer than investors can stay solvent" or, as she observed in this case, "than eccentric investment gurus can command respect". His demise, she commented, was "a potent symbol of a distorted investment world."

It is not yet clear what the final outcome of this event will be. But it has the potential to fuel another major financial crisis.

Pimco has offered the self-serving reassurance that the "vast majority" of its clients are staying with it. Not much store should be placed on that remark because financial firms always claim they are sound, right up to the point they go under.

Moreover, as *Financial Times* commentator John Authers noted, Total Return is so large that any major withdrawals could have an impact on the entire financial system. Describing the withdrawals over the past 12 months as "huge," he warned that "the worst case scenario … is that the substantial flows out of Pimco turn into a flood."

Many of the firm's holdings are "huge" in the markets where it trades and so significant outflows could "drive a crisis."

The big issue is what institutional investors decide to do. According to Authers: "Their allocations are often effectively controlled by large actuaries and pension consultants who exert huge if unrecognised power over flows of investments throughout the world."

He concluded that while it was not a given that they would depart Pimco, neither was it a given that they would stay put.

At least one major pension consultant has downgraded Pimco and if others do the same there could be a rush for the exits. If that happens, financial markets will be thrown into turmoil with far-reaching consequences, as the events of 2008 demonstrated.

Whatever the immediate outcome of Bill Gross's departure, the event has already raised significant political issues.

It has underscored the extent to which an aristocratic elite dominates the entire financial system. There are regular denunciations of the rule of oligarchs in countries such as Russia and China but "American democracy" is not essentially different. Furthermore, the fact that sudden shifts in pension fund allocations could provoke a financial crisis, with devastating social consequences in the US and globally, points to the irrationality, not to speak of insanity, of the entire capitalist financial system.

The movement of billions of dollars of funds, accumulated through the efforts of hundreds of millions of working people to try to provide for their future and those of their families, is controlled by a tiny elite whose decisions could plunge their lives into a catastrophe.

If the Gross case has done nothing else it has surely established the necessity for bringing the entire financial system into public ownership under democratic control.