Bill Gross’s days at the top of the bond world are more tenuous than ever as those around PIMCO begin to imagine life without his leadership.

He is the man who made bond investing sort of sexy - and now he may pay the price.

Over more than three decades, Bill Gross, co-founder of asset-management giant PIMCO, has made so much money for clients that he has become the barometer by which other bond traders are judged. His West Coast perch, prescient calls on the U.S. economy and devotion to yoga only added to the mystique.

But the very recipe that enabled Gross to dominate his industry may now be conspiring against him.

He’s coming off his worst year in the business after making a huge bet against U.S. Treasuries that backfired. Last year, for the first time in nearly two decades, investors pulled more money out of PIMCO’s flagship fund than they put in.

More troubling, U.S. regulators are now considering whether PIMCO should be deemed a “systemically important financial institution” - that is, too big to fail, and thus subject to tighter regulatory oversight. The concern: The juggernaut manages so much money for pension funds that it could hammer the economy if it ever went under.

The firm has doubled in size to $1.36 trillion in assets since the collapse of Lehman Brothers in 2008.

The firm is lobbying hard to fend off the “systemically important” designation, according to regulatory disclosures. Like
other financial firms, it also objects to impending rules that could make some of its derivatives trading more costly.

Industry analysts also wonder whether PIMCO's $250 billion Total Return Fund, the world's largest bond fund, is such a behemoth that Gross sometimes has to swing for the fences to generate the kind of returns investors have come to expect. Because PIMCO's flagship fund relies heavily on derivatives to bet on bonds, some analysts say it's unnecessarily complex and potentially at risk should one of its trading parties fail.

GROSSLY LARGE

Gross dismisses concerns about PIMCO's girth. He says the firm isn't "levered," or making bets with borrowed money, in the way that failed players like Bear Stearns or Lehman Brothers did. The asset manager is using only client money to trade.

"It's not like we are a deposit institution and there'd necessarily be a run on the bank because they thought the bank was going to fail," Gross said in an interview. "'Too big to fail' is dependent upon tens of thousands of clients' abandoning ship at once, and it's "hard to believe they'd want out at the same time."

The debate over PIMCO's centrality to the financial establishment is a turnabout: Up until the financial crisis, the 67-year-old Gross was largely seen on Wall Street as a West Coast outsider and a bit of a loner.

He holed up most of the time at Pacific Investment Management Company's headquarters in Newport Beach, California, which in September celebrated its 40th anniversary. Gross was a bond geek with a California twist - there was the yoga thing, and weekly TV appearances on business shows where he predicted the movements of bonds and the economy.

But during the crisis, scared investors piled into his funds. Policymakers from the Federal Reserve and Treasury Department turned to PIMCO to help with a raft of programs meant to rescue the financial system. That helped forge closer ties between the firm and the government and raised PIMCO's profile even more with investors.

"The concentration of bond-market assets in a few firms, which some could argue to be systemically risky, is not of those firms' design, but rather stems from their success," says Joshua Rosner, managing director of Graham Fisher & Co., an adviser to institutional investors.

LIFE AFTER GROSS?

Also bubbling up at PIMCO is a topic that few there want to discuss: Life after Bill. It's a quandary that has faced other legendary money managers who have built a firm from the ground up but must eventually find a way to let someone else steer the ship.

Some say PIMCO will be a much different place once Mohamed El-Erian, the firm's co-chief investment officer, succeeds Gross, as most expect he eventually will. Some former PIMCO traders say the firm will lose some of its edge without Gross, given that El-Erian, a former International Monetary Fund official, is more prone to wonkish discussion than hardball trading.

"If Mohamed took over, it would be the IMF and a lot of think-tank mentality," says John Brynjolfsson, who was PIMCO's lead expert on commodities and inflation-linked bonds before founding a hedge fund, Armored Wolf, three years ago.

El-Erian dismisses thoughts that PIMCO is becoming staid. Gross is responding to the firm's bigger scale by diversifying away from simply bonds and into stock funds, hedge funds and exchange-traded funds. Gross is in no hurry to leave, he adds.

"Bill's not going anywhere," says El-Erian, 53, in an interview at PIMCO's offices. "I often joke that he will outlast me. I would be considerably worse off, in every single way, if Bill wasn't here." (El-Erian writes a monthly column for Reuters.)

All these challenges come as many in the investing world question how much value money managers really add. Some of the
Planet PIMCO

PIMCO’s Total Return Fund is the largest bond fund in the world and has been posting positive returns for the past ten years.

**TEN LARGEST U.S. BOND FUNDS IN EACH YEAR**

**A REALLY SHREWD CALL**

Gross cemented his reputation as the Bond King with his famous prediction in 2005 that the subprime mortgage crisis would imperil all financial markets and major economies.

His call about subprime helped rocket his Total Return Fund to new heights. In 2007, the fund returned over 9 percent, ranking him No. 1 in his peer category. Equally important, the fund returned 4.82 percent in 2008 while most of its competitors’ funds were down an average of 4.69 percent at the height of the financial crisis, according to Morningstar. In 2008 and 2009 alone, the Total Return Fund attracted over $65 billion in net inflows as investors fled falling equity and real-estate markets.

The 2007-2009 period may be remembered as Gross’s peak. It’s also when Gross, a man who doesn’t like to travel much or schmooze with peers, began to shift from outsider to establishment figure, as a trusted advisor to federal policymakers.

**Around the time Lehman Brothers collapsed in September 2008, Gross wrote in an email that PIMCO was “in crisis management mode with frequent contacts with Treasury and Fed” officials, and that he was working 18-hour days and getting little sleep.**

PIMCO and rival money manager BlackRock Inc were soon tapped to manage several critical financial rescue programs.

**POWERFUL PEOPLE**

Gross brought in former Fed chairman Alan Greenspan as a consultant in 2007. Also gracing PIMCO’s ranks are former top advisors to the Bush administration: Joshua Bolten, a former White House chief of staff, Richard Clarida, assistant secretary of Treasury, and Neel Kashkari, who ran the Wall Street bailout program better known as TARP.

Currently, Stephen Rodosky, a top portfolio manager at PIMCO, sits on the 13-member Treasury Borrowing Advisory Committee, an important adviser to the government.

PIMCO even came close to getting one of its own on the Federal Reserve. President Obama in 2010 considered Paul McCulley, a
portfolio manager and the firm’s defacto Fed watcher, for a Fed governorship. But McCulley didn’t make the final cut. He left PIMCO in December 2010 and is now a director of the Global Interdependence Center public policy group.

Gross bristles at talk among some competitors, financial columnists and bloggers that PIMCO is too close to U.S. monetary policy makers. He says the firm doesn’t get special treatment. In fact, Gross says, the first time he met Treasury Secretary Timothy Geithner “or any of them” in person was October 2010.

“It’s just a suspicion” to characterize PIMCO as being cozy with the government, he added.

The PIMCO subsidiary operations that were helping the Treasury and the Fed buy mortgages and run their commercial paper programs were completely detached from the firm, he added in an interview. “They were in a separate building, and when Mohamed and I wanted to wish (traders) a Merry Christmas, we needed two lawyers and a special key to get in the door,” Gross said.

HOUSE OF GROSS

PIMCO still radiates Gross’s workaholic culture.

On a recent visit to PIMCO’s headquarters, the trading floor was graveyard quiet. People who have worked for PIMCO say Gross prefers traders to swap electronic messages rather than speak — believing too much talk is a distraction.

It’s not uncommon for PIMCO traders and portfolio managers, who start work at 4 a.m. Pacific time, to find a sheet of paper with their bond holdings circled by Gross himself, asking them to justify their trades.

Gross’s temper has been known to flare at work, where he has slammed desk drawers in anger. He discourages employees from socializing and speaking with competitors, and once fumed at an employee for attending an industry conference: “I don’t want you to attend the conference, I want you to be a speaker at the conference.”

The aggressive culture has minted millionaire traders and portfolio managers. The top 30 partners have pulled down an average $33 million a year in compensation in recent years, say people familiar with the firm.

Gross himself is rolling in it. Last year, Forbes magazine estimated his net worth at $2.2 billion and ranked him as the 188th wealthiest American. In July, he and his wife, Sue, purchased the Beverly Hills home of actress Jennifer Aniston for a reported $37 million. They own a 11,316-square-foot mansion in Indian Wells, California. They also have a 7,091-square-foot house on 17 Mile Drive in Pebble Beach that backs up to one of the finest golf fairways in the world.

The Gross family’s charitable foundation had $272 million in net assets, according to a 2010 federal tax return. The foundation paid out $25.8 million in grants and donations in 2010.

MAN FROM MIDDLETOWN

It’s quite a contrast from Gross’s upbringing in Middletown, Ohio, and later San Francisco. The son of Shirley, a homemaker, and Sewell, a sales manager for AK Steel Holding, Gross obtained a degree in psychology from Duke University in North Carolina. He briefly played blackjack professionally in Las Vegas, before heading back to California to get his start in the bond business. Gross says he’s applied his gambling methods for spreading risk and calculating odds to his investment decisions.

Like a number of other big-name managers who suffered in 2011, Gross is off to a good start this year. As of Feb. 6, the Total Return Fund was up 2.58 percent, beating its main benchmark, the Barclays Capital US Aggregate Bond Index, which was up just 0.88 percent.

Prior to the stumbles of 2011, the Total Return Fund beat 97 percent of its peers in the intermediate-term bond category over 10 years. That winning streak produced total returns of 7.335 percent per annum – an “extremely rare” feat, says Eric Jacobson, director of fixed-income research at Morningstar. Over the 15 years prior to 2011, the Total Return Fund surpassed 99 percent.

But roughly a year ago, Gross took one of the biggest bets of his life, one that would tarnish his record. He sold all of the U.S. government debt holdings in the Total Return Fund on the expectation that interest rates would climb for a long time. They didn’t. He ratcheted up his bet month by month thereafter, taking short positions in U.S. interest-rate swaps, financial instruments that traders sometimes use to speculate on a rise or fall in rates.
Gross was betting that inflation would spike because of the vast injections of cash into the economy by the Federal Reserve and heavy deficit spending by the U.S. government. Instead, prolonged economic weakness prompted a big rally in long-dated Treasuries, driving returns over 33 percent higher last year, according to the Barclays Aggregate Index.

By comparison, the PIMCO Total Return Fund returned 4.16 percent last year, placing it in the bottom 10 percent of its peer group, which averaged a return of 6.39 percent.

**DEVIL IN THE DERIVATIVES**

Gross and PIMCO are facing questions from industry analysts over the Total Return Fund’s wide use of derivatives — financial instruments that derive their value from another security — to generate some of the fund’s returns.

For years now, a number of industry experts have warned pension investors that the PIMCO Total Return Fund relies heavily on derivatives to gain exposure to bonds and makes leveraged bets using borrowed money — ones that allow it to buy more bonds with less cash as the fund gets bigger.

“This is a fund that is a real challenge for us, especially when you look at its underlying holdings, because of all the derivatives,” says Todd Rosenbluth, a senior director and analyst with S&P Capital IQ. “They are accessing parts of the market without having to put as much money up.” The catch for investors is that it is difficult to fully fathom the risk of what is in the portfolio.

In a 2009 report, pension consulting firm Ennis Knupp found that the Total Return Fund used hundreds of derivatives, including futures contracts and credit-default swaps — a type of insurance contract written on corporate bonds. The consultants said that by using derivatives, Gross had managed to sometimes outperform competitors.

**‘NOT A CASINO’**

It is in part because of its use of derivatives, and the amount of money it manages for state and corporate pensions, that regulators are considering whether PIMCO poses a potential danger to the financial system and should be subject to heightened scrutiny.

Representatives for PIMCO last year met with regulators on more than a dozen occasions to safeguard its turf, public records show.

Regulators are expected to decide sometime in the next few months about which non-bank financial institutions should be treated as systemically important firms.

Gross is hoping regulators won’t lump his firm with the likes of Goldman Sachs, JPMorgan and Citi. While he has embraced the lessons of blackjack as a trader, he insists PIMCO doesn’t take the kind of risks Wall Street is famed for.

“This is definitely not a casino,” he said. “This is a well-managed, conservatively risked shop where innovation has a significant place.”

(Reporting By Jennifer Ablan and Matthew Goldstein; Editing by Chris Kaufman)