

PIMCO MUNICIPAL INCOME FUND III

Form N-CSR

November 30, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM N-CSR

CERTIFIED SHAREHOLDER REPORT OF REGISTERED
MANAGEMENT INVESTMENT COMPANIES

Investment Company Act file number 811-21187

PIMCO Municipal Income Fund III

(Exact name of registrant as specified in charter)

1633 Broadway, New York, New York
(Address of principal executive offices)

10019
(Zip code)

Lawrence G. Altadonna 1633 Broadway, New York, New York 10019

(Name and address of agent for service)

Registrant's telephone number, including area code: **212-739-3371**

Date of fiscal year end: **September 30, 2011**

Date of reporting period: **September 30, 2011**

Form N-CSR is to be used by management investment companies to file reports with the Commission not later than 10 days after the transmission to stockholders of any report that is required to be transmitted to stockholders under Rule 30e-1 under the Investment Company Act of 1940 (17 CFR 270.30e-1). The Commission may use the information provided on Form N-CSR in its regulatory, disclosure review, inspection, and policymaking roles.

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A registrant is required to disclose the information specified by Form N-CSR, and the Commission will make this information public. A registrant is not required to respond to the collection of information contained in Form N-CSR unless the Form displays a currently valid Office of Management and Budget (OMB) control number. Please direct comments concerning the accuracy of the information collection burden estimate and any suggestions for reducing the burden to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington DC 20549-2001. The OMB has reviewed this collection of information under the clearance requirements of 44 U.S.C. § 3507.

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Item 1. REPORT TO SHAREHOLDERS

Annual Report

September 30, 2011

PIMCO Municipal Income Fund III
PIMCO California Municipal Income Fund III
PIMCO New York Municipal Income Fund III

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Hans W. Kertess

Chairman

Brian S. Shlissel

President & CEO

Dear Shareholder:

Municipal bonds see-sawed during the twelve-month fiscal period ended September 30, 2011. The fiscal year began with a selloff sparked by a rise in interest rates and a surge in new issuances. Both trends soon reversed, with new issuance plunging and interest rates falling. Also contributing to the rally in the second-half of the fiscal period was a series of economic and geopolitical worries that swept the globe, prompting a flight to safety. U.S. Treasuries benefited from this trend, as did municipal bonds, which tend to track Treasuries.

The Twelve-Month Period in Review

For the twelve-month fiscal reporting period ended September 30, 2011:

PIMCO Municipal Income Fund III advanced 3.12% on net asset value (NAV) and 2.01% on market price.

PIMCO California Municipal Income Fund III returned 2.36% on NAV and declined 0.47% on market price.

PIMCO New York Municipal Income Fund III advanced 1.27% on NAV and declined 1.27% on market price.

In contrast, the Barclays Capital Municipal Bond Index returned a tax-advantaged 3.88% for the reporting period. The broad taxable bond market, represented by the Barclays Capital U.S. Aggregate Bond Index, returned 5.26% for the twelve-months ended September 30, 2011.

The underlying fiscal picture at state and local levels remained challenging during the twelve-month period. No sooner did states close a collective budget gap of \$130 billion in their 2011 fiscal year (after cutting \$191 billion in 2010) than they confronted another sea of red ink in 2012: \$103 billion, according to the Center on Budget and Policy Priorities. In addition, 57% of cities report greater financial difficulties in 2011 than in 2010, according to a separate report from the National League of Cities.

Despite these difficulties, municipal bond defaults remain quite rare. The ten-year cumulative default rate for all municipals is less than one-tenth of one percent. For higher-yielding (riskier) municipals, the rate is just over one-half of one percent.

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In terms of new issuance, the flood of new municipal bonds coming to market in the final months of 2010 slowed considerably in 2011, with supply dropping approximately 35%, according to Morgan Stanley Smith Barney. As the fiscal year drew to a close, however, there were signs that new issuance was picking up, driven largely by bond issuers taking advantage of historically low interest rates.

The Road Ahead

Municipal bonds, after an impressive rally during the second half of the fiscal period, are still priced at attractive levels relative to U.S. Treasury bonds. We believe states and cities will continue to manage their ongoing fiscal difficulties. It is also worth noting that the yield curve, a chart depicting the interest-rate relationship between shorter-term and longer-term bonds, suggests that the risk

of a recession might not be as likely as some market commentators believe. We maintain our view that the U.S. economy, troubled as it may be, will not slip into a recession.

For specific information on the Funds and their performance, please review the following pages. If you have any questions regarding the information provided, we encourage you to contact your financial advisor or call the Funds' shareholder servicing agent at (800) 254-5197. In addition, a wide range of information and resources is available on our website, www.allianzinvestors.com/closedendfunds.

Together with Allianz Global Investors Fund Management LLC, the Funds' investment manager, and Pacific Investment Management Company LLC (PIMCO), the Funds' sub-adviser, we thank you for investing with us.

We remain dedicated to serving your investment needs.

Sincerely,

Hans W. Kertess

Chairman

Brian S. Shlissel

President & Chief Executive Officer

Receive this report electronically and eliminate paper mailings. To enroll, go to www.allianzinvestors.com/edelivery.

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PIMCO Municipal Income Funds III Fund Insights

September 30, 2011 (unaudited)

For the fiscal year ended September 30, 2011, PIMCO Municipal Income Fund III returned 3.12% on net asset value (NAV) and 2.01% on market price.

For the fiscal year ended September 30, 2011, PIMCO California Municipal Income Fund III returned 2.36% on NAV and -0.47% on market price.

For the fiscal year ended September 30, 2011, PIMCO New York Municipal Income Fund III returned 1.27% on NAV and -1.27% on market price.

The municipal bond market overcame a weak start for the year and produced a positive return during the fiscal year ended September 30, 2011. The overall municipal market (as measured by the Barclays Capital Municipal Bond Index) posted a negative return during five of the first six months of the fiscal year. This was the result of a number of factors, including rising interest rates, concerns regarding municipal defaults, increasing issuance of Build America Bonds at the end of 2010, and substantial mutual fund redemptions. The municipal market posted a positive return during each of the last six months of the fiscal year. This turnaround was the result of rising tax revenues and sharply lower new issuance. Investor sentiment for the municipal market also improved as many states took meaningful actions to improve their balance sheets. In addition, a flight to quality caused interest rates to fall sharply toward the end of the reporting period.

During the fiscal year, a slightly shorter duration than that of the benchmark detracted from all three Funds' performance, as municipal yields declined during the reporting period. A steepening yield curve bias was a negative for results, as the municipal curve flattened during the fiscal period ended September 30, 2011.

The Funds' performance was hurt by exposure to the tobacco sector. During the fourth quarter of 2010, a number of municipal tobacco settlement trusts were downgraded to below investment grade status. This triggered a sharp sell-off, which was exacerbated by forced selling into an illiquid market by mutual funds not permitted to hold non-investment grade securities. The Funds' exposure to the corporate-backed sector also adversely impacted performance, as it lagged the benchmark.

The Funds were also negatively impacted for having a preference for revenue bonds versus general obligation bonds. This detracted from results as revenue bonds underperformed the benchmark, whereas general obligation bonds outperformed the benchmark during the reporting period.

In contrast, the Funds benefited from exposure to the water and sewer sector, as it outperformed the benchmark. An exposure to the healthcare sector was also beneficial to performance during the fiscal year.

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PIMCO Municipal Income Funds III Performance & Statistics

September 30, 2011 (unaudited)

Municipal Income III:

Total Return⁽¹⁾:	Market Price	NAV
1 Year	2.01%	3.12%
5 Year	0.08%	0.77%
Commencement of Operations (10/31/02) to 9/30/11	3.38%	2.89%

Market Price/NAV Performance:

Commencement of Operations (10/31/02) to 9/30/11

Market Price/NAV:

Market Price	\$10.75
NAV	\$9.69
Premium to NAV	10.94%
Market Price Yield ⁽²⁾	7.81%

Moody's Rating

(as a % of total investments)

California Municipal Income III:

Total Return⁽¹⁾:	Market Price	NAV
1 Year	0.47%	2.36%
5 Year	4.25%	2.52%
Commencement of Operations (10/31/02) to 9/30/11	1.79%	1.83%

Market Price/NAV Performance:

Commencement of Operations (10/31/02) to 9/30/11

Market Price/NAV:

Market Price	\$9.53
NAV	\$9.08

Premium to NAV	4.96%
Market Price Yield ⁽²⁾	7.56%

Moody's Rating

(as a % of total investments)

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September 30, 2011 (unaudited)

New York Municipal Income III:

Total Return⁽¹⁾:	Market Price	NAV
1 Year	1.27%	1.27%
5 Year	5.48%	4.31%
Commencement of Operations (10/31/02) to 9/30/11	0.62%	0.85%

Market Price/NAV Performance:

Commencement of Operations (10/31/02) to 9/30/11

Market Price/NAV:

Market Price	\$9.00
NAV	\$8.82
Premium to NAV	2.04%
Market Price Yield ⁽²⁾	7.00%

Moody's Rating

(as a % of total investments)

(1) **Past performance is no guarantee of future results.** Total return is calculated by determining the percentage change in NAV or market price (as applicable) in the specified period. The calculation assumes that all income dividends and capital gain, if any, have been reinvested. Total return does not reflect broker commissions or sales charges in connection with the purchase or sale of Fund shares. Total return for a period of more than one year represents the average annual total return.

Performance at market price will differ from results at NAV. Although market price returns typically reflect investment results over time, during shorter periods returns at market price can also be influenced by factors such as changing views about the Funds, market conditions, supply and demand for each Fund's shares, or changes in the Funds' dividends.

An investment in the Funds involves risk, including the loss of principal. Total return, market price, market price yield and NAV will fluctuate with changes in market conditions. This data is provided for information purposes only and is not intended for trading purposes. Closed-end funds, unlike open-end funds, are not continuously offered. There is a one time public offering and once issued, shares of closed-end funds are traded in the open market through a stock exchange. NAV is equal to total assets attributable to common shareholders less total liabilities divided by the number of common shares outstanding. Holdings are subject to change daily.

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(2) Market Price Yield is determined by dividing the annualized current monthly per common share dividend (comprised of net investment income) payable to common shareholders by the market price per common share at September 30, 2011.

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September 30, 2011

Principal Amount (000s)		Credit Rating (Moody s/S&P)*	Value
MUNICIPAL BONDS & NOTES 96.7%			
Alabama 1.3%			
\$ 5,000	Birmingham-Baptist Medical Centers Special Care Facs. Financing Auth. Rev., Baptist Health Systems, Inc., 5.00%, 11/15/30, Ser. A	Baa2/NR	\$ 4,384,000
500	Birmingham Special Care Facs. Financing Auth. Rev., Childrens Hospital, 6.00%, 6/1/39 (AGC)	Aa3/AA+	551,485
1,500	Colbert Cnty. Northwest Health Care Auth. Rev., 5.75%, 6/1/27	Ba1/NR	1,450,320
1,000	State Docks Department Rev., 6.00%, 10/1/40	NR/BBB+	1,069,450
			7,455,255
Alaska 1.2%			
3,900	Housing Finance Corp. Rev., 5.00%, 12/1/33, Ser. A	Aaa/AAA	3,913,260
1,000	5.25%, 6/1/32, Ser. C (NPFGC)	Aa2/AA+	1,005,600
3,100	Northern Tobacco Securitization Corp. Rev., 5.00%, 6/1/46, Ser. A	B2/NR	1,974,266
			6,893,126
Arizona 5.1%			
1,250	Health Facs. Auth. Rev., Banner Health, 5.00%, 1/1/35, Ser. A	NR/AA-	1,274,725
900	5.50%, 1/1/38, Ser. D	NR/AA-	944,424
2,250	Beatitudes Campus Project, 5.20%, 10/1/37	NR/NR	1,713,712
13,000	Pima Cnty. Industrial Dev. Auth. Rev., 5.00%, 9/1/39 (h)	Aa2/AA	13,148,460
750	Tuscon Electric Power Co., 5.25%, 10/1/40, Ser. A	Baa3/BBB-	714,638
5,000	Salt River Project Agricultural Improvement & Power Dist. Rev., 5.00%, 1/1/39, Ser. A (h)	Aa1/AA	5,363,250
5,600	Salt Verde Financial Corp. Rev., 5.00%, 12/1/37	A3/A	5,015,584
			28,174,793
California 13.3%			
1,500	Bay Area Toll Auth. Rev., San Francisco Bay Area, 5.00%, 10/1/29	A1/A+	1,599,480
500	5.00%, 4/1/34, Ser. F-1	Aa3/AA	528,325
3,260	5.00%, 10/1/42	A1/A+	3,418,729
2,000	Golden State Tobacco Securitization Corp. Rev., Ser. A-1, 5.00%, 6/1/33	B3/BB+	1,402,740
4,600	5.125%, 6/1/47	B3/BB+	2,929,602
2,120	5.75%, 6/1/47	B3/BB+	1,497,102
2,500	Health Facs. Financing Auth. Rev., Catholic Healthcare West, 6.00%, 7/1/39, Ser. A	A2/A	2,676,800
600	Sutter Health, 5.00%, 11/15/42, Ser. A (IBC-NPFGC)	Aa3/AA-	592,500
1,500	6.00%, 8/15/42, Ser. B	Aa3/AA-	1,637,625

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September 30, 2011 (continued)

Principal Amount (000s)		Credit Rating (Moody /s/S&P)*	Value
	California (continued)		
\$ 3,350	Indian Wells Redev. Agcy., Tax Allocation, Whitewater Project, 4.75%, 9/1/34, Ser. A (AMBAC)	A2/A	\$ 2,784,822
130	Los Angeles Unified School Dist., GO, 5.00%, 7/1/30, Ser. E (AMBAC)	Aa2/AA-	134,100
1,660	Municipal Finance Auth. Rev., Azusa Pacific Univ. Project, 7.75%, 4/1/31, Ser. B	NR/NR	1,785,745
1,250	Palomar Pomerado Health, CP, 6.75%, 11/1/39	Baa3/NR	1,293,075
1,600	San Marcos Unified School Dist., GO, 5.00%, 8/1/38, Ser. A State, GO,	Aa2/AA-	1,683,616
3,000	5.00%, 12/1/31 (NPFGC)	A1/A-	3,074,700
5,000	5.00%, 6/1/37	A1/A-	5,095,800
250	5.00%, 11/1/37	A1/A-	255,105
5,300	5.00%, 12/1/37	A1/A-	5,409,339
1,350	5.25%, 3/1/38	A1/A-	1,401,178
1,300	5.25%, 11/1/40	A1/A-	1,367,964
3,200	5.50%, 3/1/40	A1/A-	3,435,648
2,500	5.75%, 4/1/31	A1/A-	2,728,325
5,000	6.00%, 4/1/38	A1/A-	5,535,950
1,000	Statewide Communities Dev. Auth. Rev.,		