

PIMCO MUNICIPAL INCOME FUND III

Form N-CSR

December 03, 2009

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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)**

1345 Avenue of the Americas, New York, NY

10105

(Address of principal executive offices)

(Zip code)

Lawrence G. Altadonna 1345 Avenue of the Americas, New York, New York 10105

(Name and address of agent for service)

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

Date of fiscal year end: **September 30, 2009**

Date of reporting period: **September 30, 2009**

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.

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, 450 Fifth Street, NW, Washington, DC 20549-0609. The OMB has reviewed this collection of information under the clearance requirements of 44 U.S.C. § 3507.

ITEM 1. REPORT TO SHAREHOLDERS

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

Annual Report
September 30, 2009

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PIMCO Municipal Income Funds III Letter to Shareholders

November 16, 2009

Dear Shareholder:

Please find enclosed the annual report for PIMCO Municipal Income Fund III, PIMCO California Municipal Income Fund III and PIMCO New York Municipal Income Fund III (the Funds) for the fiscal year ended September 30, 2009.

The U.S. bond market provided positive returns during the fiscal year. After extreme volatility in the first part of the fiscal year, municipal and high-quality corporate bonds advanced solidly as liquidity infusions served to ease a credit crisis and embolden investors who began moving capital away from Treasury securities and into riskier asset classes. In this environment, the Barclays Capital Municipal Bond Index, an unmanaged index generally representative of the long-term tax-exempt bond market, returned a tax-advantaged 14.85% for the fiscal year, outperforming the taxable, broad bond market return of 10.56%, as represented by the unmanaged Barclays Capital U.S. Aggregate Index. Monetary authorities moved aggressively during the fiscal 12-month period to stave off bank failures and inject liquidity into the banking system. The U.S. Federal Reserve (the Fed) reduced the Federal Funds rate three times during the fiscal year, lowering the benchmark rate on loans between member banks from 2.00% to a target of 0% 0.25%. In addition, the Fed pursued a policy of quantitative easing, purchasing securities from banks in order to add to the supply of cash available for lending.

On April 6, 2009, the Funds announced a change increasing the amount of Residual Interest Municipal Bonds (RIBs) in which each fund may invest to 15% from 10% of total assets. The change potentially allows the Funds to earn additional tax-free income. In addition, the use of RIBs, which results in a form of economic leverage, will allow the Funds to replace or increase leverage to some degree. A press release that includes further information on this action, including more detailed descriptions of potential benefits and risks, is available at www.allianzinvestors.com/closedendfunds.

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, 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

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PIMCO Municipal Income Fund III Fund Insights

September 30, 2009 (unaudited)

For the fiscal year ended September 30, 2009, PIMCO Municipal Income Fund III returned 3.64% on net asset value (NAV) and 11.02% on market price, compared to increases of 21.43% and 35.80%, respectively, for the Lipper Analytical General Municipal Debt Funds (Leveraged) average.

High-quality municipal bond yields moved significantly lower across the yield curve during the fiscal 12-month period ended September 30, 2009, as the municipal bond market began to move toward more normal levels during the second half of the period after a very tumultuous first half.

Municipal-to-U.S. Treasury yield ratios were very volatile during the fiscal 12-month period, crossing levels in late 2008 that were never before experienced. However, these yield ratios rebounded in 2009 with the 10-year ratio decreasing to 77% and the 30-year ratio increasing to 94%. Both ratios ended the fiscal year within historical average levels.

Duration hedging strategies detracted from performance during the fiscal 12-month period. Interest rates for Treasuries and London Inter-bank Offered Rate (LIBOR) swaps moved significantly lower due to a flight-to-quality and uncertain economic conditions. This move lower was larger than the move in high-quality municipal yields, causing municipals to underperform. However, these positions were removed from the Fund in early 2009.

During the fiscal 12-month period, tobacco-securitization sector holdings contributed positively to returns as the sector posted positive performance overall, despite showing negative performance during the first half of the reporting period.

Exposure to corporate-backed municipals contributed positively to performance as the sector produced positive returns. Similar to the taxable corporate sector, this area of the municipal market struggled in the fourth quarter of 2008, but rebounded strongly year-to-date in 2009.

Exposure to both pre-refunded and general obligation municipals helped to counter negative returns during the financial crisis in late 2008. However, these issues underperformed the general municipal bond market towards the latter part of the reporting period, which detracted from Fund returns as investors moved into riskier asset sectors in search of yield.

Exposure to longer-maturity zero-coupon municipals benefited performance as the sector posted strong positive performance during the fiscal year, as represented by the Barclays Capital Zero Coupon Index, which advanced 17.34% for the fiscal 12-month period.

The municipal yield curve experienced both a significant steepening and then flattening, ending the period unchanged for the fiscal year. The 15- and 20-year maturity AAA General Obligation yields decreased 143 and 140 basis points, respectively, while the 30-year AAA General Obligation yield decreased 124 basis points. The two-year yield decreased 124 basis points during the fiscal year. Significant exposure to longer-maturity municipals contributed positively to performance as that portion of the yield curve outperformed due to its longer duration.

Compared to long-taxable sectors, long municipals outperformed due to the Treasury rally with the Barclays Capital Long Municipal Bond Index returning 19.78%, while the Barclays Capital U.S. Long Government/Credit and the Barclays Capital U.S. Long Treasury Indices rose 18.36% and 9.15%, respectively during the twelve months ended September 30, 2009.

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Municipal bond issuance year-to-date in 2009 was approximately 11% lower than the comparable period in 2008. Municipal bond issuance was reduced by increased supply of taxable Build America Bonds especially in the long portion of the yield curve as issuers took advantage of the interest subsidy.

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Table of Contents**PIMCO Municipal Income Fund III Performance & Statistics**

September 30, 2009 (unaudited)

Total Return(1):	Market Price	Net Asset Value (NAV)
1 Year	11.02%	3.64%
5 Year	2.10%	(0.04)%
Commencement of Operations (10/31/02) to 9/30/09	2.67%	1.83%

Market Price/NAV Performance:

Commencement of Operations (10/31/02) to 9/30/09

Market Price/NAV:

Market Price	\$11.29
NAV	\$10.16
Premium to NAV	11.12%
Market Price Yield (2)	7.44%

Moody s Ratings
(as a % of total investments)

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

annual total return.

Performance at market price will differ from its 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 Fund, market conditions, supply and demand for the Fund's shares, or changes in Fund dividends.

An investment in the Fund involves risk, including the loss of principal. Total return, market price, market yield and NAV will fluctuate with changes in market conditions. This data is provided for information only and is not intended for trading purposes. Closed-end funds, unlike open-end funds, are not continuously offered. There is a onetime public offering and once issued, shares of closed-end funds are sold 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.

- (2) Market Price Yield is determined by dividing the annualized current monthly per share dividend (comprised of net investment income) payable to common shareholders by the market price per common share at September 30, 2009.

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PIMCO California Municipal Income Fund III Fund Insights

September 30, 2009 (unaudited)

For the fiscal year ended September 30, 2009, PIMCO California Municipal Income Fund III declined 6.29% on net asset value (NAV) and rose 3.95% on market price, compared to increases of 17.96% and 26.20%, respectively, for the Lipper Analytical California Municipal Debt Funds average.

High-quality municipal bond yields moved significantly lower across the yield curve during the fiscal 12-month period ended September 30, 2009, as the municipal bond market began to move toward more normal levels during the second half of the period after a very tumultuous first half.

Municipal-to-U.S. Treasury yield ratios were very volatile during the fiscal 12-month period, crossing levels in late 2008 that were never before experienced. However, these yield ratios rebounded in 2009 with the 10-year ratio decreasing to 77% and the 30-year ratio increasing to 94%. Both ratios ended the fiscal year within historical average levels.

Duration hedging strategies detracted from performance during the fiscal 12-month period. Interest rates for Treasuries and London Inter-bank Offered Rate (LIBOR) swaps moved significantly lower due to a flight-to-quality and uncertain economic conditions. This move lower was larger than the move in high-quality municipal yields, causing municipals to underperform. However, these positions were removed in early 2009.

During the fiscal 12-month period, tobacco-securitization sector holdings contributed positively to returns as the sector posted positive performance overall, despite showing negative performance in the first half of the reporting period.

Exposure to corporate-backed municipals contributed positively to performance as the sector produced positive returns. Similar to the taxable corporate sector, this area of the municipal market struggled in the fourth quarter of 2008, but showed a strong rebound year-to-date in 2009.

Exposure to both pre-refunded and general obligation municipals helped to counter negative returns during the financial crisis in late 2008. However, these issues underperformed the general municipal bond market towards the latter part of the reporting period, which detracted from returns as investors moved into riskier asset sectors in search of yield.

Exposure to longer-maturity zero-coupon municipals benefited performance as the sector posted strong positive performance during the fiscal year, as represented by the Barclays Capital Zero Coupon Index, which returned 17.34% for the fiscal 12-month period.

Municipal bonds within California slightly underperformed the Barclays Capital Municipal Bond Index returning 14.32% compared with 14.85% for the national index during the fiscal 12-month period. California was able to balance its budget, which helped spur a rebound in performance during the latter part of the period. Year-to-date through September of 2009, issuers in California issued \$46.6 billion in municipal bonds, which was 4% lower than the same period in 2008.

Long-California municipals underperformed the Barclays Capital Long Municipal Bond Index returning 18.19% compared to a rise of 19.78% for the long national index during the fiscal year. The California municipal yield curve steepened notably during the reporting period with 30-year yields decreasing 109 basis points, while two-year yields decreased 228 basis points. Significant exposure to longer maturities contributed positively to performance as the longer durations outperformed.

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Table of Contents**PIMCO California Municipal Income Fund III Performance & Statistics**

September 30, 2009 (unaudited)

Total Return(1):	Market Price	Net Asset Value (NAV)
1 Year	3.95%	(6.29)%
5 Year	0.27%	(1.19)%
Commencement of Operations (10/31/02) to 9/30/09	0.73%	0.71%

Market Price/NAV Performance:

Commencement of Operations (10/31/02) to 9/30/09

Market Price/NAV:

Market Price	\$10.03
NAV	\$9.55
Premium to NAV	5.03%
Market Price Yield (2)	7.18%

Moody s Ratings
(as a % of total investments)

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

annual total return.

Performance at market price will differ from its 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 Fund, market conditions, supply and demand for the Fund's shares, or changes in Fund dividends.

An investment in the Fund involves risk, including the loss of principal. Total return, market price, market yield and NAV will fluctuate with changes in market conditions. This data is provided for information only and is not intended for trading purposes. Closed-end funds, unlike open-end funds, are not continuously offered. There is a onetime public offering and once issued, shares of closed-end funds are sold 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.

- (2) Market Price Yield is determined by dividing the annualized current monthly per share dividend (comprised of net investment income) payable to common shareholders by the market price per common share at September 30, 2009.

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PIMCO New York Municipal Income Fund III Fund Insights

September 30, 2009 (unaudited)

For the fiscal year ended September 30, 2009, PIMCO New York Municipal Income Fund III declined 14.34% on net asset value (NAV) and rose 4.19% on market price, compared to increases of 16.47% and 29.42%, respectively, for the Lipper Analytical New York Municipal Debt Funds average.

High-quality municipal bond yields moved significantly lower across the yield curve during the fiscal 12-month period ended September 30, 2009, as the municipal bond market began to move toward more normal levels during the second half of the period after a very tumultuous first half.

Municipal-to-U.S. Treasury yield ratios were very volatile during the fiscal 12-month period, crossing levels in late 2008 that were never before experienced. However, these yield ratios rebounded in 2009 with the 10-year ratio decreasing to 77% and the 30-year ratio increasing to 94%. Both ratios ended the fiscal year within historical average levels.

Duration hedging strategies detracted from performance during the fiscal 12-month period. Interest rates for Treasuries and London Inter-bank Offered Rate (LIBOR) swaps moved significantly lower due to a flight-to-quality and uncertain economic conditions. This move lower was larger than the move in high-quality municipal yields, causing municipals to underperform. However, these positions were removed from the Fund in early 2009.

During the fiscal 12-month period, tobacco-securitization sector holdings contributed positively to returns as the sector posted positive performance overall, despite showing negative performance during the first half of the reporting period.

Exposure to corporate-backed municipals contributed positively to performance as the sector produced positive returns. Similar to the taxable corporate sector, this area of the municipal market struggled in the fourth quarter of 2008, but rebounded strongly year-to-date in 2009.

Exposure to both pre-refunded and general obligation municipals helped to counter negative returns during the financial crisis in late 2008. However, these issues underperformed the general municipal bond market towards the latter part of the reporting period, which detracted from Fund returns as investors moved into riskier asset sectors in search of yield.

Exposure to longer-maturity zero-coupon municipals benefited performance as the sector posted strong positive performance during the fiscal year, as represented by the Barclays Capital Zero Coupon Index, which advanced 17.34% for the fiscal 12-month period.

Municipal bonds within New York slightly underperformed the Barclays Capital Municipal Bond Index returning 14.57% compared to 14.85% for the national index during the fiscal year. Year-to-date through September 2009, issuers in New York State raised \$28 billion in bonds, which was 12% lower than the comparable period in 2008. New York ranks second in total municipal bond issuance.

Long-New York municipals slightly underperformed the Barclays Capital Long Municipal Bond Index, returning 18.96% compared with 19.78% for the long national index during the fiscal twelve months ended September 30, 2009. The New York yield curve did not change significantly during the fiscal year, 30-year yields decreased 135 basis points and two-year yields decreased 125 basis points. The Fund also had significant positions in the long portion of the municipal yield curve, which helped performance as longer-duration municipals performed well as yields moved lower.

Table of Contents**PIMCO New York Municipal Income Fund III Performance & Statistics**

September 30, 2009 (unaudited)

Total Return(1):	Market Price	Net Asset Value (NAV)
1 Year	4.19%	(14.34)%
5 Year	(1.82)%	(3.22)%
Commencement of Operations (10/31/02) to 9/30/09	(0.26)%	(0.54)%

Market Price/NAV Performance:

Commencement of Operations (10/31/02) to 9/30/09

Market Price/NAV:

Market Price	\$9.65
NAV	\$9.10
Premium to NAV	6.04%
Market Price Yield (2)	6.53%

Moody s Ratings
(as a % of total investments)

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

annual total return.

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- (2) Market Price Yield is determined by dividing the annualized current monthly per share dividend (comprised of net investment income) payable to common shareholders by the market price per common share at September 30, 2009.

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September 30, 2009

Principal Amount (000)		Credit Rating (Moody s/S&P)*	Value
MUNICIPAL BONDS & NOTES 96.9%			
Alabama 1.1%			
\$ 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	\$ 4,346,250
500	Birmingham Special Care Facs. Financing Auth. Rev., Childrens Hospital, 6.00%, 6/1/39	Aa2/AAA	545,085
1,500	Colbert Cnty. Northwest Health Care Auth. Rev., 5.75%, 6/1/27	Baa3/NR	1,451,445
			6,342,780
Alaska 1.3%			
3,900	Housing Finance Corp. Rev., 5.00%, 12/1/33, Ser. A	Aaa/AAA	3,932,253
1,000	5.25%, 6/1/32, Ser. C (NPFGC)	Aa2/AA	1,011,220
3,100	Northern Tobacco Securitization Corp. Rev., 5.00%, 6/1/46, Ser. A	Baa3/NR	2,193,529
			7,137,002
Arizona 5.1%			
1,250	Health Facs. Auth. Rev. Banner Health, 5.00%, 1/1/35, Ser. A	NR/A+	1,265,912
900	5.50%, 1/1/38, Ser. D	NR/A+	944,883
2,250	Beatitudes Campus Project, 5.20%, 10/1/37	NR/NR	1,639,688
1,500	Maricopa Cnty. Pollution Control Corp. Rev., Palo Verde Project, 5.05%, 5/1/29, Ser. A (AMBAC)	Baa2/BBB-	1,348,830
13,000	Pima Cnty. Industrial Dev. Auth. Rev., 5.00%, 9/1/39	Aa2/AA	13,114,790
5,000	Salt River Project Agricultural Improvement & Power Dist. Rev., 5.00%, 1/1/39, Ser. A (h)	Aa1/AA	5,362,750
5,600	Salt Verde Financial Corp. Rev., 5.00%, 12/1/37	A3/A	5,216,120

28,892,973

California 5.7%

2,500	Health Facs. Financing Auth. Rev., Catholic Healthcare West, 6.00%, 7/1/39, Ser. A State, GO,	A2/A	2,651,075
250	5.00%, 11/1/37	Baa1/A	250,815
5,300	5.00%, 12/1/37	Baa1/A	5,317,278
6,000	6.00%, 4/1/38	Baa1/A	6,586,740
3,060	Statewide Communities Dev. Auth. Rev., Baptist Univ., 9.00%, 11/1/17, Ser. B (a)(c) Methodist Hospital Project (FHA),	NR/NR	2,595,920
2,900	6.625%, 8/1/29	Aa2/AA	3,325,082
10,300	6.75%, 2/1/38	Aa2/AA	11,761,982
			32,488,892

Table of Contents**PIMCO Municipal Income Fund III Schedule of Investments**

September 30, 2009 (continued)

Principal Amount (000)		Credit Rating (Moody s/S&P)*	Value
	Colorado 3.0%		
\$ 9,955	Colorado Springs Utilities Rev., 5.00%, 11/15/30, Ser. B (h)	Aa2/AA	\$ 10,508,498
500	Confluence Metropolitan Dist. Rev., 5.45%, 12/1/34	NR/NR	359,800
500	Health Facs. Auth. Rev., Evangelical Lutheran, 6.125%, 6/1/38, Ser. A	A3/A-	515,325
1,500	Housing & Finance Auth. Rev., Evergreen Country Day School, Inc. Project, 5.875%, 6/1/37 (a)(c)	NR/BB	1,044,975
500	Public Auth. for Colorado Energy Rev., 6.50%, 11/15/38	A2/A	558,780
4,000	Saddle Rock Metropolitan Dist., GO, 5.35%, 12/1/31 (Radian)	NR/BBB-	3,834,480
			16,821,858
	District of Columbia 2.0%		
10,000	Dist. of Columbia Water & Sewer Auth. Rev., 5.50%, 10/1/39, Ser. A (h)	Aa3/AA	11,472,900
	Florida 5.1%		
3,480	&nb		