PACIFIC FUNDS
September 2017
Manager Insight Series
Informational commentary from Pacific Asset Management, the manager of Pacific Funds[SM] Fixed-Income Funds.

Portfolio Manager Viewpoints

Bank loan portfolio managers, JP Leasure and Michael Marzouk, discuss the loan market, outlook, and portfolio strategy for the remainder of 2017.

Start at the top. How would you assess the current market environment?

Marzouk: Favorable fundamental conditions along with an absence of volatility have resulted in strong returns across credit markets year-to-date (YTD) (Table 1). Corporate profits remain healthy and macroeconomic sentiment, although dampened compared to earlier in the year, remains relatively optimistic regarding fiscal policy and tax reforms. However, sentiment is not yet translating into higher gross domestic product (GDP) or inflation, which seems range-bound in the low single digits. We believe the market is exhibiting stable corporate health, which supports credit risk, but are cautious of macroeconomic risks and growth outlooks.

Table 1: Returns from credit risk have been steady, while returns from duration risk have rebounded from 2016

Index	YTD Return	1-Year Return
High Yield	6.40	9.56
Emerging-Market Debt	7.73	5.75
Bank Loans	2.76	5.67
Corporate	4.96	3.27
Aggregate	3.36	1.05
Treasury	2.82	-0.33

Source: Bloomberg Barclays, Credit Suisse, as of September 13, 2017.

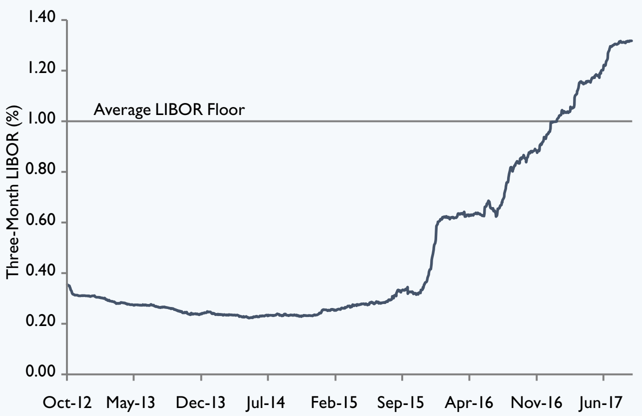
How have bank loans performed in 2017?

Leasure: Loans, as measured by the Credit Suisse Leveraged Loan Index, have performed in-line with expectations of a coupon-like return during 2017, returning 2.62% YTD through August. Loans have benefited from the risk-on sentiment, though price appreciation for performing loans has been limited, given loan prices around par and high levels of refinancing activity. Recently, distressed issuers (loans priced below $90) have begun to underperform.

Floating Rate Once Again

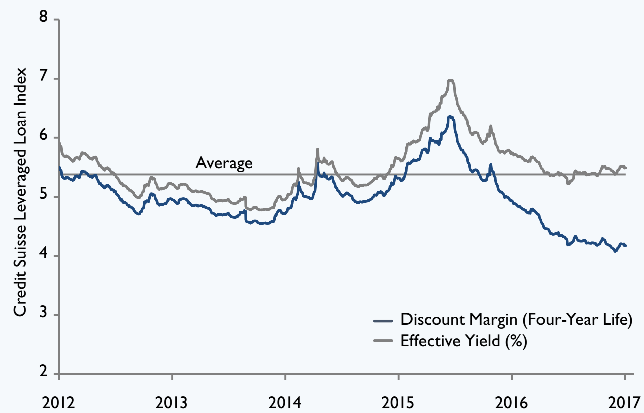
A tightening Federal Reserve (Fed) and rising short-term interest rates mean bank loans have returned to being a floating-rate asset class.

The London Interbank Offered Rate (LIBOR) has moved above 1% and means coupons are resetting higher with each Fed rate hike.



Source: Federal Reserve Bank of St. Louis, as of September 13, 2017.

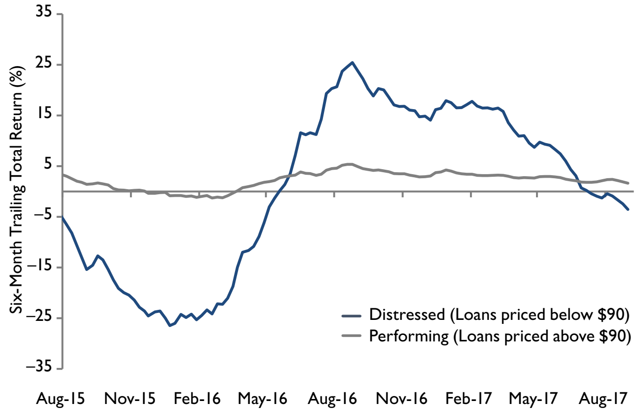
While discount margins have moved to the lower end of the post-crisis range, higher LIBOR means yields remain higher than historical averages.



Source: Credit Suisse, as of September 13, 2017.

This underperformance has been particularly notable in the Energy and Retail sectors, the two most distressed sectors. This situation is important to monitor, given distressed issuers' outperformance during the past year.

Chart 1: Distressed issuers are underperforming following sizeable outperformance in 2016

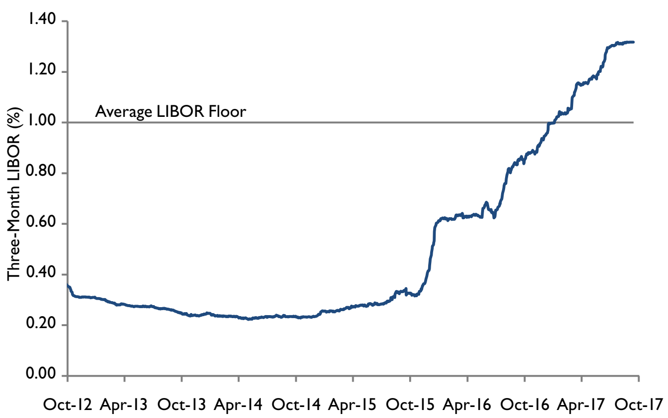


Source: Credit Suisse, as of September 8, 2017.

Discuss the relationship of LIBOR with floating-rate loans.

Marzouk: With LIBOR now around 1.31%, above the 1% average LIBOR floor, coupons are floating with short-term rates (Chart 2). This scenario has particularly benefited loans, given the record level of refinancing activity, which would have otherwise reduced average coupons by 30–40 basis points (one basis point equals 0.01%).

Chart 2: The move of LIBOR above 1% means coupons are resetting higher with each Fed rate hike



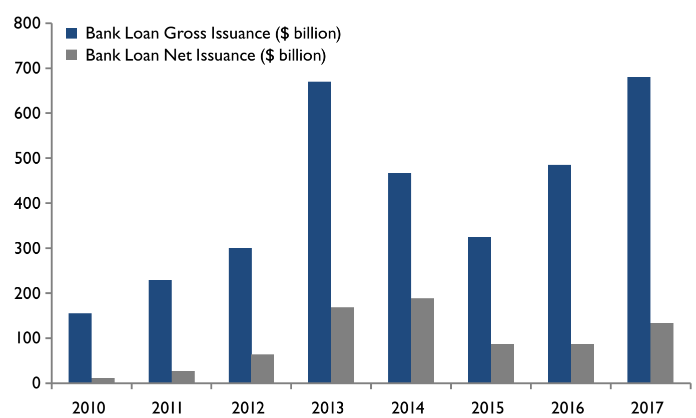
Source: Federal Reserve Bank of St. Louis, as of September 13, 2017.

Leasure: There have been headlines recently regarding the potential end of LIBOR by 2021. What will replace LIBOR is unknown, given mixed reviews for some of the alternatives. The impact on trillions of dollars of securities and derivatives, which is a much larger market, could be significant. The Loan Syndications and Trading Association (LSTA) has distributed some good research on LIBOR alternatives, which can be found at www.lsta.org.

Discuss the technical environment.

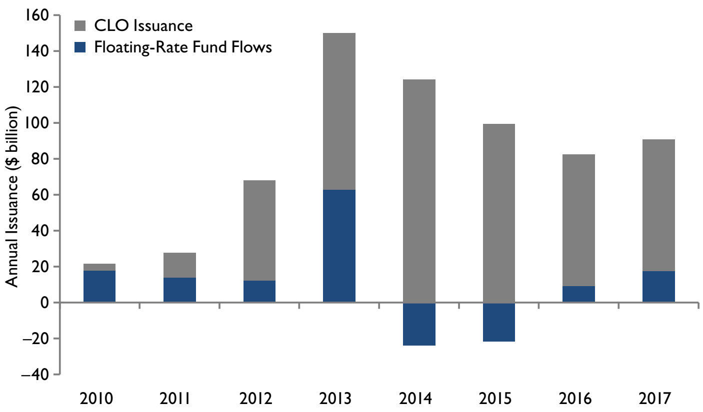
Marzouk: The technical environment is robust, given flat net issuance and strong demand. While the year is on pace to see record gross issuance, the majority of loan issuance has been for refinancing. Net issuance is more in line with the past few years (Chart 3). On the demand side, retail floating-rate fund flows have recently been flat, but are still up over $15 billion YTD, given reflationary concerns and rising short-term rates (Chart 4). Collateralized loan obligation (CLO) issuance has also been robust despite Dodd-Frank legislation, which went into effect in December 2016. The market has easily absorbed new risk retention rules with YTD CLO issuance of $75 billion, and an expected $80–100 billion for the full year.

Chart 3: Record gross issuance in 2017, though net issuance is much more muted given the high levels of refinancing activity



Source: J.P. Morgan, as of September 8, 2017.

Chart 4: Strong demand from retail and institutional buyers

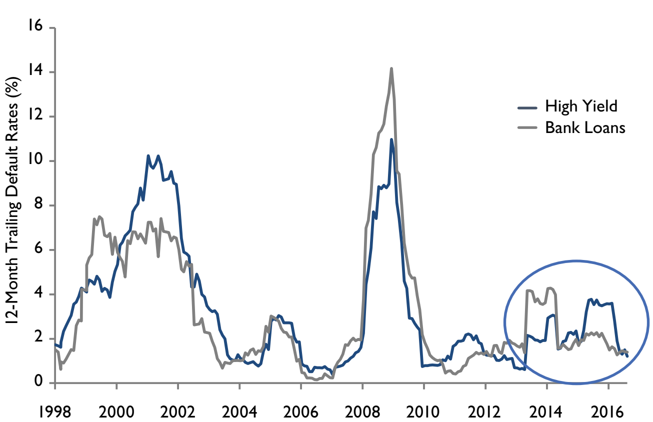


Source: J.P. Morgan, as of September 13, 2017.

Describe the economic outlook.

Leasure: Our base case is that the U.S. GDP remains in a slow-growth environment but is supportive for corporate health. A key factor has been a broad stabilization of economic data and higher corporate profits that began to materialize in the summer of 2016. While the hope of fiscal, tax, and regulatory reform following the U.S. November 2016 elections certainly added business confidence, the fundamental improvement started mid-year 2016. Market measures of credit risk–such as implied defaults, distressed prices, and risk premiums–all support low-default rates in the near term (Chart 5). August was the first month since 2014 in which there were no bank-loan defaults.

Chart 5: After the tick up in 2015, default rates are now back to multi-year lows



Source: J.P. Morgan, as of July 31, 2017.

Marzouk: A concern of ours in the short term is that growth sentiment remains too high, and downward revisions may bring back volatility. Record sentiment and confidence measures have not led to an acceleration in spending and investment necessary for a breakout in GDP. Yes, there is some evidence of a pulling forward of demand for capital investment, though nothing at the level necessary to drive accelerated rates of growth above 3%. There likely needs to be a reconciliation between what the Treasury market is saying, confidence levels, and growth expectations.

What about the Retail sector?

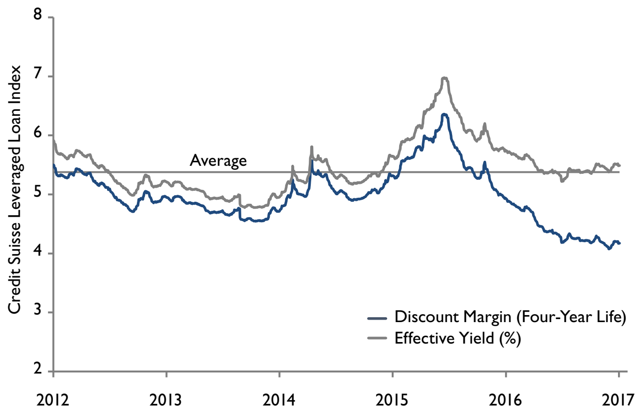
Leasure: We have had a negative view on the Retail sector for several years. The ongoing secular pressures and downsizing of retail footprints and square footage is significant. The sector is now one of the most distressed within non-investment-grade credit, with the potential for several high-profile bankruptcies during the next year. We currently have a limited appetite for distressed retailers or specialty fashion brands.

Putting this fundamental and technical picture together, how would you assess bank loan valuations?

Marzouk: We would say valuations are around historical averages. Four-year discount margins, our preferred measure of spread, are at the lower end of the range seen this cycle (Chart 6). The rise in three-month LIBOR has offset the contraction in spreads, with effective yields at 5.50%, which are above the post-crisis average. Given prices around par for performing loans, carry or coupon will be the primary driver of returns for the asset class at this time.

In addition, I would add that we find the risk/return profile to be compelling for loans relative to high yield, given the nominal difference in yields between the two asset classes and the better downside protection offered by bank loans.

Chart 6: While discount margins have moved to the lower end of the post-crisis range, higher LIBOR means yields that remain above historical averages



Source: Credit Suisse, as of September 13, 2017.

Discuss portfolio positioning.

Leasure: It's worth reviewing our positioning during the past year. In the summer of 2016, we commented that our strategy was one of caution. We were underweight risk relative to the benchmark and had limited exposure to distressed issuers. With economic data, commodity prices, and profits improving, we moved to a slight risk overweight by the third quarter of 2016. We also re-entered the Energy sector after having little to no exposure for the prior 12 months. This benefited performance through early 2017, given appreciation in several bank loans in the Energy sector.

We have reduced our risk appetite during the past few months, moving to an underweight in risk relative to the benchmark. We find ourselves with a favorable bottom-up view of fundamentals; however, very optimistic market sentiment makes us cautious in the near term. We are underweight risk primarily through limited exposure to distressed or defaulted issuers. We continue to focus on the performing segment of the loan market.

With respect to sectors, we are overweight Housing and Packaging, which are heavily focused on U.S. domestic earnings, and are underweight Retail and Healthcare. With respect to the Healthcare sector, we find limited relative value in many of the large issuers, which have low coupons and yields. We have a high conviction portfolio of domestically focused companies. We would welcome a return of volatility and the opportunities for issuer selection it may bring.

What do you think brings back volatility?

Marzouk: Two likely areas are geopolitical concerns or fiscal policy. Geopolitical concerns have been present and escalating throughout the year. On the fiscal front, policy disappointments around tax and regulatory reform could see a re-rating of growth expectations. Both could bring back credit-risk premiums in areas of the market that have benefited from record-low volatility. We believe this favors loans into the end of the year given its lower sensitivity to macroeconomic risks compared to other asset classes. Loans also benefit from a domestically focused earnings picture, which continues to be stable for corporate health, regardless of fiscal policy action.

Summarize the value proposition today for loans.

Leasure: The past year has shown bank loans to be a low-volatility asset class that can diversify credit or duration risk. A return profile of 4–6% during the next 12 months is in line with historical averages for the asset class as measured by the Credit Suisse Leveraged Loan Index. However, given relative-value considerations and the potential for a return of volatility, bank loans may serve as a strong complement to other risk factors in an asset allocation.

Pacific Asset Management

September 2017

Definitions

Bank Loans are represented by the Credit Suisse Leveraged Loan Index, which is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market.

Corporate is represented by the Bloomberg Barclays U.S. Corporate Investment Grade Index, which includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements.

The **Credit Suisse Leveraged Loan Index** is designed to mirror the investable universe of the U.S. senior secure-credit (leveraged-loan) market.

Discount margin is the expected return on a floating-rate bond above the value of a fixed-rate bond that an investor stands to earn by taking on the additional risk.

The **Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)** is financial-reform legislation passed by the Obama administration in 2010 as a response to the financial crisis of 2008 with the intention to decrease various risks in the U.S. financial system.

Effective yield is the yield of a bond, assuming the periodic interest payments or coupons received are reinvested.

High Yield is represented by the Bloomberg Barclays U.S. High-Yield Index, which covers the universe of fixed rate, non-investment-grade debt.

The **London Interbank Offered Rate (LIBOR)** is the benchmark reference for interest rates that banks charge each other for debt instruments and loans.

The **Loan Syndications and Trading Association (LSTA)** is an industry organization that advocates for the syndicated loan market.

Treasury is represented by the Bloomberg Barclays U.S. Treasury Index, which includes public obligations of the U.S. Treasury.

About Pacific Asset Management

Founded in 2007, Pacific Asset Management specializes in credit-oriented fixed-income strategies. Pacific Asset Management is a division of Pacific Life Fund Advisors LLC, an SEC-registered investment adviser. As of June 30, 2017, Pacific Asset Management managed approximately $7 billion. Assets managed by Pacific Asset Management include assets managed at Pacific Life by the investment professionals of Pacific Asset Management.

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All investing involves risks including the possible loss of the principal amount invested. Debt securities with longer durations or fixed interest rates tend to be more sensitive to changes in interest rates, making them generally more volatile than debt securities with shorter durations or floating or adjustable interest rates. The Fund is subject to liquidity risk (the risk that an investment may be difficult to purchase and sell within a reasonable amount of time at approximately the price the fund has valued the investment) and credit risk (the risk an issuer may be unable or unwilling to meet its financial obligations, risking default). Floating-rate loans (usually rated below investment grade) and high-yield/high-risk bonds ("junk bonds") have greater risk of default than higher-rated securities/higher-quality bonds that may have a lower yield. Interest rates and bond prices have an inverse relationship. The fund is also subject to foreign markets risk.

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Mailing address:
P.O. Box 9768, Providence, RI 02940-9768
(800) 722-2333, Option 2 • www.PacificFunds.com