PACIFIC FUNDS

Staying the Course: Rothschild's Investment Methodology

Informational commentary from Rothschild Asset Management Inc., the subadvisor to Pacific Funds℠ U.S. Equity Funds.

To better understand the investment process at Rothschild Asset Management, Inc. (Rothschild), we sat down with Tina Jones and Doug Levine, both managing directors and portfolio managers for the Pacific Funds U.S. Equity Funds. Despite a recent uptick in market volatility, it remains business as usual for the investment approach for these funds.

Q: Volatility has spiked in recent months; what's driving this?

Levine: The initial trigger may have been a January 2018 report from the Bureau of Labor Statistics showing that average hourly earnings increased by 2.9%. While the magnitude wasn't huge, it was unexpected and broke a long string of results indicating that wage inflation remained firmly in check.

Not long after, the Trump administration announced plans for tariffs targeting $50–$60 billion of Chinese imports. The Information Technology sector, once the darling of the stock market, also came under fire as investors took profits in semiconductor stocks given valuations and concerns over potential double-bookings of customer receipts. Social-media stocks also declined following privacy concerns related to data collection on Facebook. More broadly, the market sold off on higher interest rates and weather-related concerns over rising input costs that could not be passed on to consumers.

As influential as these developments were in driving volatility higher, some of the spike may have been psychological; after a particularly strong run following the 2016 U.S. presidential election, a feeling of complacency may have given way to anxiety. The unwinding of leveraged trades that had assumed continued calm and repositioning of risk-parity trades (for example, rebalancing away from equities as the asset class became more volatile) also added fuel to the fire.

Q: Amid the current market volatility, have you repositioned your portfolios?

Jones: When confronted with increased volatility, any review of our portfolios is done on a bottom-up basis. Rather than asking ourselves, "What's the outlook for the market?," we instead focus on individual stocks and whether or not the fundamentals have changed. Given the absence of a change in the fundamentals of our process as markets fluctuate, our approach is to "stay the course," and that was largely the case during the first quarter, as we did not significantly increase our turnover.

Q. In general, is it fair to say that you ignore broad-based market trends?

Levine: "Ignore" would be too strong; we certainly stay aware of market trends, such as the direction of interest rates, government policy, and so on. In individual industries, we try to remain cognizant of secular trends, such as the threat of online retailing versus a bricks-and-mortar approach. But macro-level trends can revert, and government policy can be notoriously difficult to predict. So, while we remain aware of market trends, we are first and foremost stock pickers.

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>
> *Doug Levine*

Q: So how do you go about stock selection?

Jones: Our investment philosophy is to look for discounted relative valuation with what we call "expectational upside."

With *discounted relative valuation,* we want to understand why a stock is less expensive relative to its peers. We ask, "Is there a good reason why it's inexpensive now and will it continue to be in the future? Or is there something misunderstood or underappreciated in the market?" Then, we look to determine the potential for the discount to narrow and the potential drivers of multiple expansion.

When looking at *expectational upside,* we're trying to understand the things that market participants are focused on to identify a consensus view. Once understood, we can determine if there is upside potential. For example, if a company is launching a new product or service, is this reflected in market expectations for the stock? We look to determine where the upside could come from and quantify the magnitude and likelihood of it so we can properly analyze the stock's risk/return profile.

Q: Will you walk us through a recent trade using this process?

Levine: An example of our process in action was our addition of the Grubhub stock, which is up over 47% (as of March 31, 2018) according to Bloomberg. Grubhub is an online food delivery service. Currently, there is only an estimated 5% market penetration in the food-delivery-service business, as most people still call restaurants direct, leaving huge room for growth. The industry's potential sales estimates are between $75 and $200 billion.[1] In February 2018, they announced a growth partnership with Yum! Brands (which owns Kentucky Fried Chicken and Taco Bell). The stock market reacted positively to this agreement due to the business it will funnel into Grubhub.

Q: What sets your investment process apart from its peers? And how has this served investors?

Jones: We believe our approach combines objectivity with sound judgement. We use a ranking tool to identify stocks with promising characteristics that can be objectively quantified, such as attractive relative valuations and expectational upside. While this step narrows the investment universe, it is just a starting point. We then perform fundamental analysis on these stocks to judge the potential catalysts for outperformance.

Finally, we attempt to build sound portfolios through stringent risk controls. We don't want to have a situation where we get the story right with most of our stocks, only to have that nullified by some other factor or sector exposure. So, we limit position sizes and sector weights, and minimize the influence of factor-based risks. For example, if we are struggling to find stocks that meet our investment criteria in the Energy sector, we may look for ways to reduce that underweight. Over the long term, our belief is that these controls will not only control risk, but also ensure that we drive results through stock selection.

Click on the links to learn more about Pacific Funds U.S. Equity Funds, explore videos, or read insights.

[1]Source: Rothschild analysis, May 2018.

Pacific Funds U.S. Equity Funds Offer Shareholders:

A Time-Tested Process	For more than 25 years, the investment team's process has been a thoughtful approach rooted in fundamental analysis and designed to identify potential catalysts for a stock's positive relative performance.
Focused on Expectational Upside	The Funds seek to outperform their benchmarks by investing in a mix of stocks the team believes is attractively valued and should provide a controlled level of risk in down markets.
Anchored in Style Purity	Stocks whose style and market capitalization match the stated investment approach of a Fund, and are expected to achieve above-average growth relative to the market, will be considered for inclusion.

	Class A	Class C	Advisor Class
PACIFIC FUNDS℠ LARGE-CAP	PFLAX	PFCCX	PFCDX
PACIFIC FUNDS℠ LARGE-CAP VALUE	PFAAX	PFVCX	PFVDX
PACIFIC FUNDS℠ SMALL/MID-CAP	PFDAX	PFPCX	PFMDX
PACIFIC FUNDS℠ SMALL-CAP	PFKAX	PFACX	PFQDX
PACIFIC FUNDS℠ SMALL-CAP VALUE	PFEAX	PFHCX	PFFDX
PACIFIC FUNDS℠ SMALL-CAP GROWTH	PFMAX	PFMCX	PFWDX

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For more information about Pacific Funds U.S. Equity Funds, please contact your financial advisor or call (800) 722-2333, option 2, or visit PacificFunds.com.

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