Pacific Funds Strategic Income Portfolio Manager Q&A

As fixed-income markets are constantly changing, Pacific Funds℠ Strategic Income (the Fund) has the ability to adapt to these changing environments. The Fund's investment team seeks opportunities across an array of securities including: high-yield bonds, investment-grade corporate bonds, Treasuries, floating-rate loans, and equities. Pacific Funds Strategic Income Portfolio Manager Brian Robertson discusses the process and philosophy behind the Fund.

What was the genesis of Pacific Funds Strategic Income?

The origin of the Fund was anchored with two fundamental beliefs. The first belief is that, over time, credit risk compensates investors. The incremental interest investors receive over a U.S. Treasury bond of similar maturity has typically been much greater than the negative impact from defaults. While this premium fluctuates over time and credit risk can certainly have rough periods, long-term investors have generally been rewarded. The second belief is that as interest rates reach a much-debated secular shift, the benefit of being flexible is valuable. The frequently quoted "30-plus-year bull run in bonds eventually will come to an end" certainly has some merits. While very few, if any, investors know when interest rates will shift higher, we believe these periods warrant a high degree of flexibility. The beauty of our expertise is it allows us to adjust to a variety of income options (fixed, floating, investment grade, high yield, international, domestic, etc.). In the end, we wanted to build a fund that could capitalize on both fundamental beliefs.

How would you describe this Fund to an investor?

A very basic description of the Fund would be to call it "flexible credit." The flexibility comes in the form of having the ability to respond to various markets via sector rotation, strong underlying liquidity, and selective construction. Credit is the area of the fixed-income markets most represented in the Fund.

The goal is to generate strong risk-adjusted returns for our investors by managing asset-class allocations, sector positioning, and a selective approach to credit by leveraging the strengths of our team.

How do you approach investing in this space?

Overall, the Fund is built to be very flexible, primarily invested across high-yield bonds, floating-rate loans, and investment-grade bonds. Our uniquely experienced investment team is industry-focused and covers investment grade, high-yield, and bank loans, which we believe allows them to have a different perspective on relative value and uncover compelling investment opportunities. We utilize our research expertise to take a selective approach in each of these asset classes and ensure the ideas for which our team has the most conviction are driving portfolio returns.

Brian Robertson, CFA

Brian is a Managing Director for Pacific Asset Management. Brian is a Portfolio Manager for the Strategic Credit, High Yield, and Core Plus Strategies. In addition, Brian has credit research responsibilities across select sectors. Prior to being a founding member of Pacific Asset Management in 2007, from 2003-2006, Brian was a member of Pacific Life's securities division overseeing investments in corporate bonds, high yield, and bank loan securities. Brian has over 15 years of investment experience. He holds a bachelor's degree from the University of Michigan. Brian is a CFA Charter holder and member of the CFA Society of Orange County.

Brian M. Robertson, CFA
15 years of
investment experience

We have three primary decision points that are important as we approach investing for the Fund. We begin by determining a target asset-allocation mix based on where we believe we are in the credit cycle, but more importantly, where we feel we will see appropriate returns for the risk taken. After that initial decision, we select industry overweights and underweights based on our team's investment views and our overall macro view. We then build portfolios on a name-by-name basis looking to leverage the ideas for which our research staff has the most conviction while building appropriate portfolio diversification.

What sets your investment process apart from its peers?

Our investment process is straightforward and understandable. We determine portfolio risk positioning based on our macro views, then determine sector allocations based on relative value, and finally selectively construct the portfolio via securities for which we hold a conviction. We believe each of these steps provides an opportunity to add value. Our size allows us to be nimble enough to fluidly implement these steps and is one of our competitive advantages. It allows us to help minimize our trading costs as well as broaden our investment opportunity set to include smaller companies and securities. In contrast to many of our multi-sector peers, we don't invest heavily in emerging markets, non-U.S.-dollar currencies, or derivatives. These are markets in which it can be difficult to maintain a competitive advantage. Also, this focus on U.S. credit, and, in particular, bank loans has been a unique differentiator.

Can you provide an example of a sector you like to illustrate your investment process?

In managing credit-focused portfolios, relative value is of utmost importance when selecting sectors and securities. There are many examples of situations where we have favored a sector given our economic views, but trading levels have caused us to be positioned underweight. At the end of the day, the price we pay for an asset needs to compensate us for the risks that we are taking as it relates to any individual security; our view of the cycle, the sector, the company, the structure, and the asset's spread are going to all factor into that determination.

A brief example of an industry in which we have found strong relative value currently has been in the packaging space. We have generally been constructive on the underlying fundamentals of the industry and how it fits into our macro views. The end markets are relatively defensive, and the companies, in general, generate strong, free cash flow through a cycle. Overall organic growth rates are modest, but this is broadly offset by the recession-resilient nature of the industry. In the last several quarters, many packaging names, both stocks and bonds, have underperformed with one of the primary reasons being input cost pressures, mostly from higher oil-related product pricing, which has compressed margins. We are broadly of the belief that most, if not all, of these margin pressures are temporary, and input costs will either decline or the higher prices will be passed through to the end customer. We believe this has provided an opportunity in the sector, and through our research process we identified and invested in names where we feel we have strong risk-adjusted return opportunities if our thesis is correct.

Do you believe you have an advantage versus most peers?

We believe that our experienced investment team, corporate credit focus, and consistency of our portfolio-construction process provide us with an advantage that we can leverage. We have used the flexibility of Pacific Funds Strategic Income since its inception to manage through the multiple, varying points of the credit cycle.

Our firm and portfolio size are also an advantage to us in multiple ways. They allow us to trade in and out of positions without heavily impacting pricing. They also broaden our investment opportunity set by not being limited to the largest, most liquid securities, allowing us to go wherever we see value across the corporate credit universe. We believe the performance of the Fund since inception is a testament to the advantages mentioned above.

How do you define and manage risk?

The primary risks that we manage in our portfolios are credit risk, liquidity risk, and duration risk.

Credit risk: The main risk in the portfolio is credit risk. To manage this risk, we rely on the experience and expertise of the investment staff to flush out and understand the risks and their mitigators in our underwriting process and through the continuous monitoring of portfolio investments. The primary measurement mechanism is the Option Adjusted Spread (OAS) of our portfolios at an aggregate level as well as on an asset-class by asset-class basis. We ensure the amount of spread we have incorporated in our portfolio is consistent with our macro views, our assessment of relative value, and our sector opinions.

Liquidity risk: Ensuring we have adequate liquidity to satisfy investor withdrawal requests is a vital step in portfolio construction. Issue size, percentage of issue owned, issue trade frequency, and the number of dealers making a market in a security are all measures we use to determine liquidity. We are not heavily involved in middle-market loans or direct lending, and we believe the areas of the market in which we invest allow us to comfortably mitigate potential liquidity risks.

Duration risk: The risk of a sell-off in rates and the duration impact to our portfolios is something we constantly monitor and consider in the portfolio-construction process. We generally use effective duration as the primary measurement tool. Bank loans provide us with a strong lever to pull, which allows us to maintain reasonable yield while moving to a floating-rate asset class that generally benefits from rising rates. Rate risk and credit risk also are negatively correlated at different points in the cycle, so we believe balancing the duration of the portfolio with the credit risk inherent in the high yield market can lead to strong outcomes over time.

What part have floating-rate assets played in the Fund?

We believe that one of our competitive advantages as a firm and in Pacific Funds Strategic Income is our expertise in bank loans. We have a strong track record in managing loans as a stand-alone asset class and firmly believe bank loans can serve an important role in a portfolio's asset-allocation. Bank loans provide reasonable yield in an asset class that generally benefits from rising rates, and we expect bank loans to provide diversification benefits to the overall portfolio during an economic downturn due to their secured nature. As noted earlier, we have increased our exposure to bank loans in recent quarters given our view of relative value across fixed-income asset classes.

Given the Fund's flexibility to invest in equities, up to 10%, when do you choose a company's equity versus its bond?

Pacific Funds Strategic Income will be predominantly invested in fixed income, and we expect our ability to manage credit risk to be the primary driver of returns for the Fund. That being said, we do have a small portion of the Fund that can be allocated to individual equities. We believe there is a lot of overlap in processes between leveraged credit underwriting and equity investing, which is proven by the correlations between high-yield and equity returns.

Our research staff looks for opportunities to invest in companies or sectors in which we feel the individual security is mispriced and, at times, feel the most mispriced part of the capital structure in the equity. We believe we have a competitive advantage in this regard, especially with smaller, high-yield rated companies that are less covered by the sell side, but our team has followed closely from the debt side.

One broad equity-investing theme that we utilize occurs when we have high conviction in a company, yet feel our bond exposure no longer offers an attractive risk-adjusted return opportunity. If we determine the incremental value to our thesis playing out is more likely to accrue to the stockholders and the valuation of the equity is attractive, we will sell some or all our bonds and relocate to the equity. We will scale the exposure appropriately given increased volatility that presents itself in stocks.

How would you assess the current market environment?

When we look at the markets today, we see an economic backdrop that is most likely the strongest it has been in the last decade. It still, in our estimation, can be described as a "goldilocks" economy, although we may be toward the end of the term's usefulness. Growth in the U.S. has accelerated, helped greatly by recent fiscal stimulus; but despite very low unemployment, we haven't seen a meaningful increase in inflation. This has allowed the Federal Reserve to continue to move slowly in its removal of accommodation.

In contrast to what the environment looked like in 2007, we don't currently see any extreme excesses in the market. There are certainly pockets of concern, namely growing inflationary pressures and constant geopolitical risks, but nothing that warrants considerable defensiveness in our positioning.

Balanced against the favorable backdrop is the largest challenge in today's market: valuations. Most asset classes, in our opinion, are fully valued, and finding meaningful value is increasingly difficult. It is in this environment that we believe individual security and sector positioning will be increasingly impactful, because we feel the indiscriminate beta moving higher in asset prices is likely behind us.

If we begin to enter a default cycle, how different do you envision the portfolio relative to what we have seen since its inception?

While we believe the ability to consistently and accurately predict the timing of a downturn in the economy and the market is quite challenging, there are certainly times for risk-taking and times for a more defensive posture. If we believe the market is mispricing the risk of a near-term default cycle, we will look for opportunities to move up in the capital structure and up in credit-quality ratings categories. Across our main asset classes, this will generally mean an increase in investment grade and bank loans and a reduction in high-yield bonds. Actual allocation changes, though, will take into consideration where our concerns are focused and the relative value opportunities we see in each asset class.

Where do you see relative value in your investment universe? What areas give you the most concern?

Consistent with our prior comments about a favorable economic backdrop yet full valuations, some of the places in which we are seeing relative value are in slightly more defensive areas of the credit markets. We continue to like bank loans and have been increasing our exposure to the asset class in the last several quarters. We have also seen continued tightening in the relationship between BB-rated and BBB-rated bonds, and have recently been moving up in credit quality. Credit selection is crucial in this area as there has been a very large increase in BBB-rated bonds as a result of shareholder-friendly activities as well as mergers and acquisitions, so we believe it is vital to find the right names that can weather a downturn in the economy.

Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest).

PACIFIC FUNDS STRATEGIC INCOME

Class A		Class C		Advisor Class	
Ticker	**Fund Number**	**Ticker**	**Fund Number**	**Ticker**	**Fund Number**
PLSTX	114	PLCNX	314	PLSFX	014

Speak with your financial advisor today
about investing in Pacific Funds Strategic Income.
For additional information, call us at (800) 722-2333, option 2,
or visit PacificFunds.com.

Definitions

Duration is often used to measure a bond's or fund's sensitivity to interest rates. The longer a fund's duration, the more sensitive it is to interest-rate risk. The shorter a fund's duration, the less sensitive it is to interest-rate risk.

Default cycle is part of the credit cycle and is characterized by an increase in the default rate.

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Past performance does not guarantee future results. 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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