PACIFIC FUNDS

DECEMBER 31, 2018

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

## Fund Performance

During the fourth quarter, Pacific Funds Strategic Income (Advisor Class) returned –4.01% versus the Bloomberg Barclays U.S. Aggregate Bond Index return of 1.64%.

## Market Overview

The fourth quarter of 2018 wiped away most, if not all, capital market gains due in large part to the culminating effects of uncertain trade policy, tightening monetary action by central banks, a slowdown in corporate earnings, and stretched asset valuations. While the U.S. economy continues to prolong the second longest expansionary period in U.S. history, there is significant concern that an inflection point will soon be reached. Efforts by the current administration to impart tariffs and alter trade policy with many of the country's largest trade partners—namely China—has given corporations reasons to slow investments due to supply chain inefficiencies and demand disruptions. While the U.S. has agreed to delay the planned increase of tariffs on $200 billion of Chinese goods that was set to take effect January 1, 2019, the further deterioration of communication between the two superpowers has had significant impact on both countries. As a direct result of implemented tariffs and strained relations, China's gross domestic product (GDP) is likely to expand at less than 6% (well below historical levels) as production metrics and export orders have decreased. Meanwhile, the U.S. has experienced a slowdown in industrial and manufacturing production. Trade policy is also weighing on future earnings growth rate of domestic companies (per FactSet, a provider of financial data and analytics, third-quarter 2018 earnings growth was 25% versus an estimated fourth-quarter 2018 growth rate of 11.4%). This fear, coupled with stretched asset prices entering the fourth quarter, led to a massive reduction in risk-based appetite, resulting in the S&P 500® index having its worst quarterly return (–13.52%) since the third quarter of 2011.

From an economic perspective, U.S. GDP growth decreased to 3.4% in the third quarter from 4.2% in the second quarter of 2018. A portion of this reduction can likely be attributed to the waning effect of the recent corporate tax cuts and concern over tariff impacts. Anecdotally, the Institute for Supply Management (ISM) Manufacturing Index softened in December to its lowest level since 2016. While still expansionary, business activity is expanding at much lower levels. The Non-ISM Manufacturing (representing service sectors) contracted in December as well—possibly stoking fears that the domestic and global economy may be slowing. Supporting this fear is the recent adjustment of the International Monetary Fund (IMF) projected global growth rate. In *Challenges of Steady Growth*, one of its October 2018 publications, the IMF stated, *"the expansion has become less balanced and may have peaked in some major economies. Downside risks to global growth have risen in the past six months and the potential for upside surprises has receded. Global growth is projected at 3.7 percent for 2018–19—0.2 percentage point lower for both years than forecast in April."* Lastly, the U.S. corporate earnings growth rate remains a concern. According to FactSet, the forecasts are for a fourth-quarter growth rate of 11.4% and single digit growth for the first three quarters of 2019.

Amid the increase in market volatility, central banks continued to tighten monetary policy. Domestically, the Federal Open Market Committee (FOMC) reaffirmed its commitment to the proposed policy path as it once again increased the federal funds rate to a target range between 2.25% and 2.50%. This hike represents the fourth hike of 2018 and the ninth since coming off "zero bound rates" in December 2015. Interestingly, the FOMC added verbiage pertaining to its *"monitoring global economic and financial developments"* in addition to altering its stance regarding rate increases in 2019, moving from three to two potential hikes. Markets did not receive the rate decision and narrative well, as risk-based assets accelerated their weakness after the decision. Meanwhile, the European Central Bank (ECB) ceased all additional stimulus, held rates steady, but continued to reinvest cash from maturing bonds.

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Following the December rate hike by the FOMC and a "flight to safety" amid a strong risk-adverse environment, the U.S. Treasury yield curve steepened (a reversal from prior quarters of 2018) during the period. The short end of the yield curve, as represented by the two-year U.S. Treasury note, decreased by 33 basis points (one basis point equals 0.01%) ending at 2.48%; the long end of the curve, as represented by the 30-year U.S. Treasury bond, decreased by 17 basis points, ending at 3.02%. Year to date, the short end of the curve has risen by 56 basis points versus the long end rising by only 21 basis points. The 10-year U.S. Treasury yield ended the quarter at 2.69%, lower by 36 basis points quarter-over-quarter.

Short-duration investment-grade bonds, as measured by the Bloomberg Barclays 1–3 Year U.S. Government/Credit Bond Index, returned 1.18%. In a reversal from prior periods, the government portion of the index outperformed the credit portion, returning 1.31% versus 0.89%, respectively. The majority of performance can be attributed to the move lower in U.S. Treasury rates that took place in December. The short end of the curve continues to be rather insulated from much of the negative technical pressures that have plagued the intermediate and long end of the curve through the year (i.e., increased bond issuance and merger & acquisition (M&A) activity, reduced corporate bond purchases due to the repatriation effect, and negative fund flows). The Bloomberg Barclays 1–3 Year U.S. Government/Credit Bond Index ended the quarter with a yield to worst of 2.75%, down 19 basis points. The price of the index moved higher, settling at $99.36, up from $98.77 at the end of the third quarter.

Investment-grade bonds expanded on their third-quarter performance by posting their best quarterly return in 2018. As measured by the Bloomberg Barclays U.S. Aggregate Bond Index, the investment-grade market returned 1.65% during the fourth quarter. An investor "flight to safety" was the beneficiary of a strong broad market risk-off move, concerns over macro weakness, and spread widening. By way of context, the index option-adjusted spread widened by 15 basis points during the period, ending at 54 basis points. The portion of the index with bonds rated BBB experienced far more spread widening than the overall index, resulting in 61 basis points of widening, ending at 197 basis points.

High-yield bonds, as measured by the Bloomberg Barclays U.S. High-Yield 2% Issuer Capped Bond Index, suffered their worst quarterly return since the third quarter of 2015, returning –4.54%. Option-adjusted spreads widened by 210 basis points to end the period at 526 basis points. The top-performing sectors included Airlines, Office Real Estate Investment Trusts, Electric, and Media Entertainment, returning –0.23%, –0.58%, –1.39%, –1.58%, respectively. The poorest-performing sectors during the quarter included Oil Field Services, Independent Energy, Refining, and Tobacco, returning –16.12%, –10.72%, –10.13%, and –9.74%, respectively. Returns across the credit spectrum were led downward by lower-quality issues, as BB-rated issues returned –2.91%, B-rated issues returned –4.35%, and CCC-rated issues returned –9.28%. The Bloomberg Barclays U.S. High-Yield 2% Issuer Capped Bond Index ended the quarter with an average price of $92.55, down from $98.76. The yield to maturity ended the quarter at 8.00%, up 151 basis points; and the yield to worst ended higher at 7.96% versus 6.24% in the prior quarter. According to J.P. Morgan, the par-weighted U.S. high-yield default rate ended 2018 at 1.81% (1.08% excluding the iHeartMedia Inc. default), up from 1.28% at the end of 2017, but it remains low compared with the 3.57% rate from year-end 2016 and the long-term historical average of 3.46%.

In stark contrast to the prior nine months, floating-rate loans, as measured by the Credit Suisse Leveraged Loan Index, produced a negative total return of –3.08% during the quarter. Loans priced up to and including a $90 level, returned –8.40% versus –2.86% for loans priced over $90. Credit quality performance was mixed during the quarter, with BB-rated, B-rated, and CCC-rated loans returning –3.18%, –2.85%, and –4.01%, respectively. Across issue sizes, larger issuers underperformed with facility sizes greater than $1 billion returning –3.84% versus facility sizes below $300 million returning –0.76%. All index sectors were negative for the quarter, with the Transportation, Utility, Service, and Financial sectors outperforming, returning –1.97%, –2.14%, –2.38%, and –2.47%, respectively. The Retail, Metals/Minerals, Food & Drug, and Energy sectors were the poorest total return performers, returning, –4.56%, –4.51%, –4.43%, and –4.30%, respectively. The J.P. Morgan Leveraged Loan par-weighted default rate fell from 1.77% at the end of the third quarter to 1.63% at the end of the fourth quarter (excluding the iHeartMedia Inc. default, the par-weighted default rate ended at 1.02%).

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

## Portfolio Review

Pacific Funds Strategic Income (the Fund) returned –4.01 in the fourth quarter, underperforming the Bloomberg Barclays U.S. Aggregate Index, which returned 1.64%. The return differential was primarily the result of the Fund's allocation to corporate credit in a pronounced risk-off investment environment. Reflective of market sentiment, Treasuries, a material underweight for the Fund, returned 2.57%, substantially higher than the returns of index-eligible high-grade corporates, which returned –0.18%. Floating rate bank loans and high yield bonds exhibited material downside volatility returning –3.08% and –4.54% for the Credit Suisse Leveraged Loan Index and the Bloomberg Barclays High Yield 2% Issuer Capped Bond Index respectively. The Fund's cumulative allocation of approximately 61% to bank loans and high-yield bonds detracted on an absolute and relative basis. However, the Fund began the quarter at historical lows in terms of allocation to high-yield bonds, providing some opportunity to tactically allocate into market weakness. Investment-grade corporate-credit exposure of approximately 32% detracted as BBB-rated issues lagged higher-rated benchmark cohorts. On a sector basis, credit selection in Automotive and Chemicals was beneficial. Sectors detracting from relative performance include Independent Energy, Banking, and Packaging. Lastly, equity exposure of 3.91% was a modest detractor.

## Manager Outlook

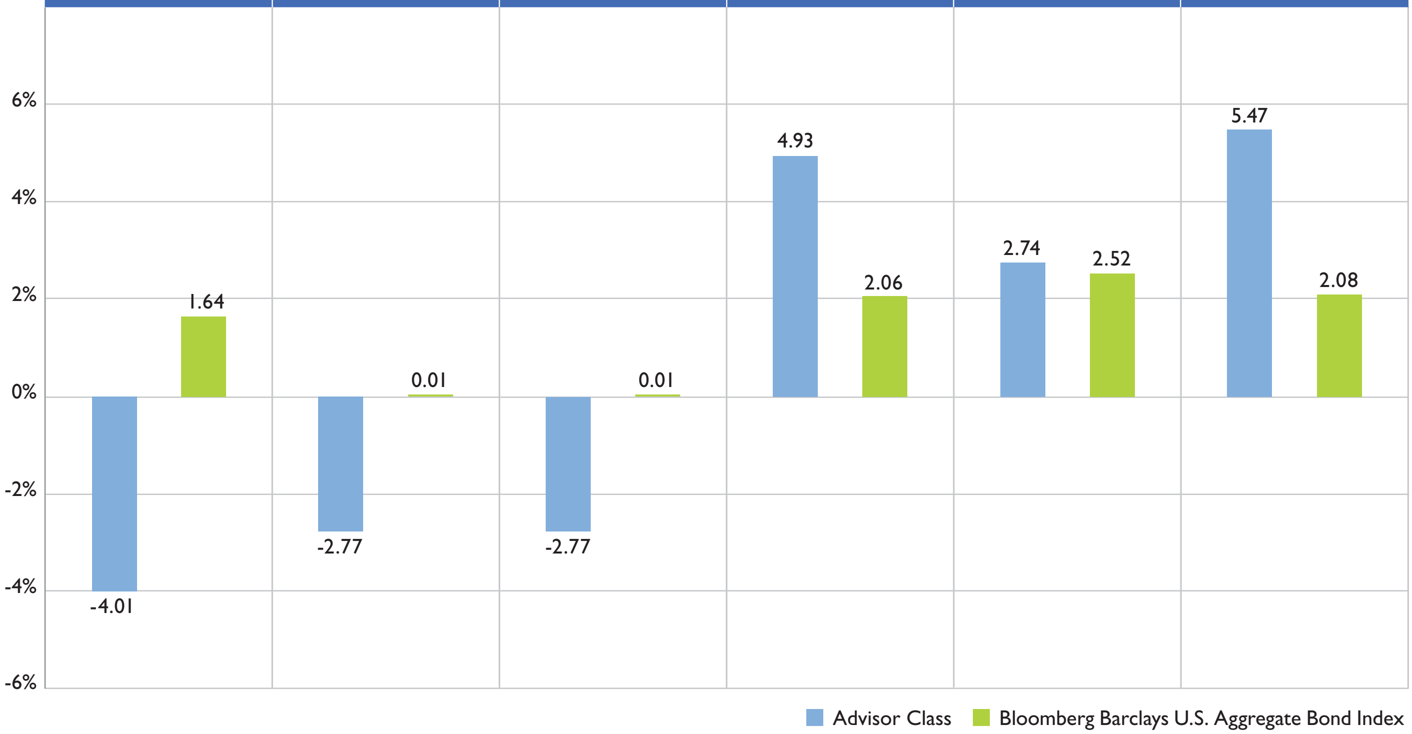
Another bout of market volatility resulted in most risk assets repricing meaningfully lower as the fourth quarter progressed. While it is difficult to pinpoint the exact cause of risk-off events, the narrative seemed to be broadly centered around end-of-cycle concerns coupled with somewhat lofty valuations. Over the course of the year, the synchronized global growth story shifted to a synchronized global slowdown, one with the U.S. entering that conversation a bit later than the rest of the developed world. Expectations have been that we would see a slowdown in U.S. growth in 2019 as the fiscal stimulus "enhanced" 2018 growth. Hard data, and even more so, consumer confidence data, released in December by the University of Michigan and the Conference Board suggests that the economy may be weakening more than expected. What is especially difficult to ascertain currently is how much of this slowdown can be attributed to the self-inflicted, and potentially reversible, damage from trade wars. We remain hopeful that calmer minds will prevail and that we will see the makings of a trade deal between the United States and China in the first quarter of 2019. We believe the recent reaction in risk assets and overall softening economic data only increases the likelihood that we see a deal sooner rather than later.

For the full year, there was almost nowhere to hide as it related to markets. Bank loans posted positive returns for full-year 2018, although they nearly gave up all their gains with the weakness in December. Most other major fixed-income and equity markets were negative for 2018 with the breadth of weakness at historically high levels. Interestingly, companies that we lend to across the broad spectrum of fixed income continue to convey a much more positive message about their businesses than you would otherwise expect given the macro narrative. This is even more so the case for companies and industries that are domestically focused and not impacted by the trade turmoil. Fourth-quarter earnings results should help guide us in determining whether this is indeed just another growth scare or the beginning of something larger.

Our current belief is that the recent weakness, especially in high yield and leveraged loans, has created attractive entry points for these asset classes. This belief is based on our expectation for some stabilization of growth at lower levels in 2019, a benign inflation outlook, and a more cautious Federal Reserve (Fed). We increased cash in the Fund by primarily reducing investment-grade and bank-loan exposure. This reduction was done leading into the Fed hike in December, given the potential for an increase in volatility during a less-than-liquid time of the year for fixed income. As the market traded lower toward the end of the year and valuations became more attractive, we started to slowly deploy some of this cash, primarily into high yield. We are finding value in some domestic-facing sectors that are generally insulated from trade wars, as well as industries such as building products and packaging that should see meaningful input cost relief and follow-on margin expansion opportunities in 2019 given lower commodity prices. While we still believe valuations may warrant a continuation of that asset-allocation shift, there are no shortage of macroeconomic risks that will hang over the market in early 2019. Three of the most important data points we will be looking to in the near term will be fourth-quarter earnings and outlooks, shifts in Fed policy, and tangible progress on trade talks with China. We believe selectivity in fund construction will be crucial at this point in the cycle, and security selection will be the primary driver of returns in the near term.

## Advisor Class

| Total Returns (%) | | | Annualized Total Returns (%) | | |
|---|---|---|---|---|---|
| 3-Month | YTD | 1-Year | 3-Year | 5-Year | Since Fund Inception 12/19/11 |




**Net annual operating expenses for Advisor Class are 0.71% and total (gross annual) expenses are 0.99%. Returns reflect reinvestment of dividends and distributions. The Fund's annual operating expenses shown above are effective 8/1/18 through 7/31/19. Gross Expense Ratio** reflects the total annual operating expenses paid by the Fund. **Net Expense Ratio** reflects waivers, reductions, reimbursements, and the limitation of certain "Other Expenses." Expense caps and/or fee waivers are reevaluated annually. There is no guarantee that the investment adviser will continue to cap expenses after the expiration date. Please see the current prospectus for detailed information.

Indexes are unmanaged and cannot be invested in directly. Further, they hold no cash and incur no expenses. All share classes may not be available at all firms and not all investors may be eligible for all share classes.

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## Definitions

The **Bloomberg Barclays 1–3 Year U.S. Government/Credit Bond Index** is a performance benchmark of U.S. investment-grade government and corporate bonds with maturities of one to three years.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is composed of investment-grade U.S. government bonds, investment-grade corporate bonds, mortgage pass-through securities, and asset-backed securities, and is commonly used to track the performance of U.S. investment-grade bonds.

The **Bloomberg Barclays U.S. High-Yield 2% Issuer Capped Bond Index** measures the performance of high-yield bonds with a 2% maximum allocation to any one issuer.

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

**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.

**Flight to safety** refers to a sudden shift in investment behavior typically due to uncertainty in the financial or international markets where investors sell what they perceive to be high-risk investments and place those assets in low-risk investments.

The **Institute for Supply Management Purchasing Managers Index** surveys senior executives at over 400 companies on five areas: new orders, inventory levels, production, supplier deliveries, and employment. The data is used as an indicator of economic health for manufacturing and service sectors.

**International Monetary Fund** is an organization of 189 countries whose main purpose is to ensure the stability of the system of exchange rates and international payments that enables countries to transact with each other.

The **J.P. Morgan Leveraged Loan Index** is designed to mirror the investable universe of U.S. dollar institutional leveraged loans, including U.S. and international borrowers.

**LIBOR** is the benchmark interest rate that banks charge each other for loans. It serves as the benchmark reference rate for debt instruments, including government and corporate bonds, mortgages, student loans, and credit cards.

The **S&P 500 index** is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the U.S. stock market.

The **yield curve** is a graph showing the term structure of interest rates by plotting the yield of fixed-interest securities against maturity.

**Yield to maturity** is the anticipated rate of return on a bond assuming it will be held until its maturity date (the specific period of time until final payment (principal and any applicable interest) is due) and not called.

**Yield to worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

## About Risk

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.

This commentary represents the views of the portfolio managers at Pacific Asset Management as of 12/31/18, and are presented for informational purposes only. These views should not be construed as investment advice, an endorsement of any security, mutual fund, sector or index, or to predict performance of any investment. Any forward-looking statements are not guaranteed. All material is compiled from sources believed to be reliable, but accuracy cannot be guaranteed. The opinions expressed herein are subject to change without notice as market and other conditions warrant. Sector names in this commentary are provided by the Fund's portfolio managers and could be different if provided by a third party.

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