February 2015
PACIFIC FUNDS
Manager Insight Series
Commentary from Pacific Asset Management, the subadvisor to the Pacific Funds℠ Fixed-Income Funds.

Loans or Bonds

In 2014, high-yield bonds and bank loans produced their lowest annual returns since 2011. While both asset classes had positive returns, year-end volatility, growth concerns, a commodity sell-off, and outflows from credit-risk assets negatively impacted performance. Entering 2015, given relative and absolute valuation measures, the outlook for bonds and loans is more attractive than at any point last year. The two asset classes, however, possess unique risk profiles and could have varying roles in an investor's asset allocation portfolio.

Table 1: Relative value favors credit risk given absolute and relative valuation measures

Index	Duration	Yield	Price	OAS
High Yield	4.17	6.46	99.40	509
Bank Loans	0.25	5.94	96.12	534
Corporate	7.35	2.78	111.26	136
Agency MBS	3.15	2.28	106.61	33
Intermediate Corporate	4.34	2.21	106.56	111
Aggregate	5.28	1.92	107.79	51
Treasury	5.68	1.09	106.54	N/A

Source: Barclays, Credit Suisse, as of January 30, 2015.

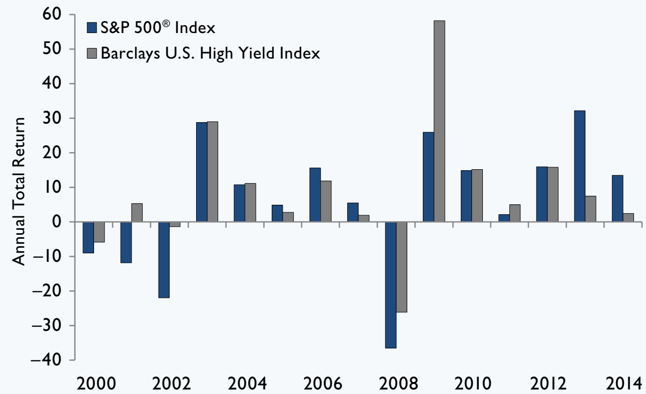
Current valuations make bank loans and high-yield bonds attractive against the absolute low yields of traditional fixed-income issues (Table 1). Late 2014 volatility has brought yield levels to three-year highs (Chart 1). Average prices are now below par, with loan prices trading around $96 and high-yield bonds trading around $99. The Barclays U.S. High Yield Index, which had a yield of 4.91% in June 2014, is now yielding 6.46% as of the end of January 2015. Given the move in U.S. Treasuries, the option-adjusted spread (OAS[1]) is now at 509, the highest since June 2013. In the following six months since the index last hit this OAS, high-yield bonds returned 5.95%, while the Barclays U.S. Aggregate Bond Index returned 0.43% as rates moved higher by 48 basis points on the 10-year Treasury. The result was an excess return of 624 basis points.

[1]OAS is a measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.

Enhancing Return or Diversifying Risk

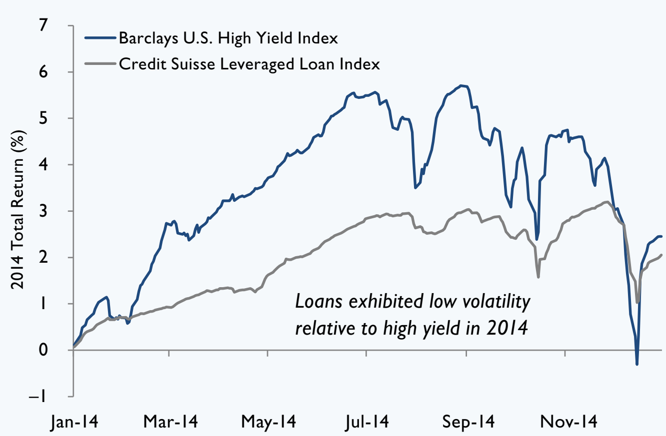
Bank loans and high-yield bonds have strong relative value entering 2015. However, each market provides a unique role in an overall asset allocation strategy.

High yield has historically been highly correlated with equity performance. High-yield bonds may participate in upside surprises in 2015, while current income may cushion downside risks relative to equities.



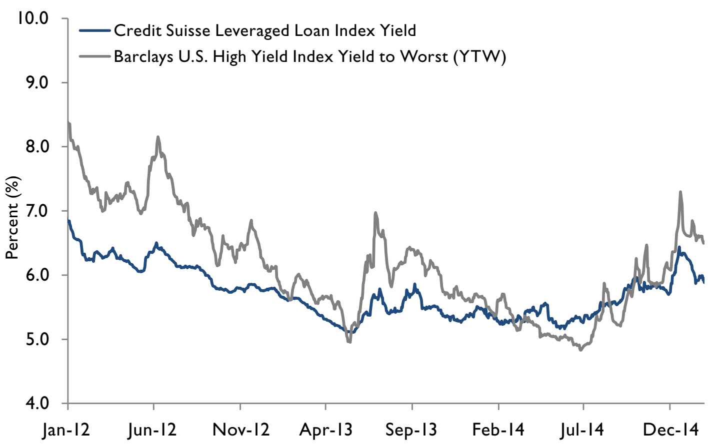
Source: Barclays, S&P, as of December 31, 2014.

In contrast to high yield, bank loans may serve as a low volatility complement to traditional fixed-income holdings



Source: Barclays, Credit Suisse, as of December 31, 2014.

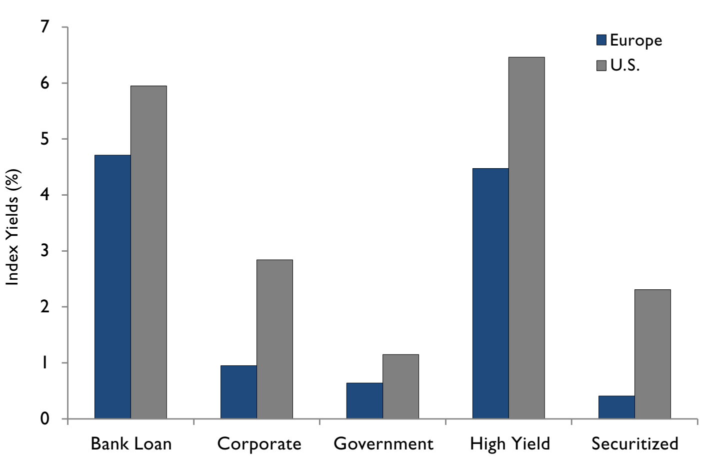
Chart 1: 2014 volatility and poor year-end technicals have left bank loan yields and bond yields at three-year highs



Source: Barclays, Credit Suisse, as of January 30, 2015.

The real question, however, is will spreads continue to widen as government bond yields plummet and investor risk-sentiment remains finicky. At a high level, corporate health measures, improving U.S. economic activity, and a lack of upcoming maturities all point to a continuation of below-average defaults. Globally, central bankers are increasing aggressiveness toward accommodative policy. The announcement of quantitative easing (QE) programs in Europe and Japan are likely to eventually be a net positive for spread products given the lack of yield opportunities elsewhere (Chart 2). Even as our Federal Reserve gets closer to increasing the overnight rate, they have shown themselves to be cautious to ensure a rate hike will only be implemented in the face of an expanding economy.

Chart 2: Global quantitative easing should benefit U.S. fixed income given higher yields and better fundamentals



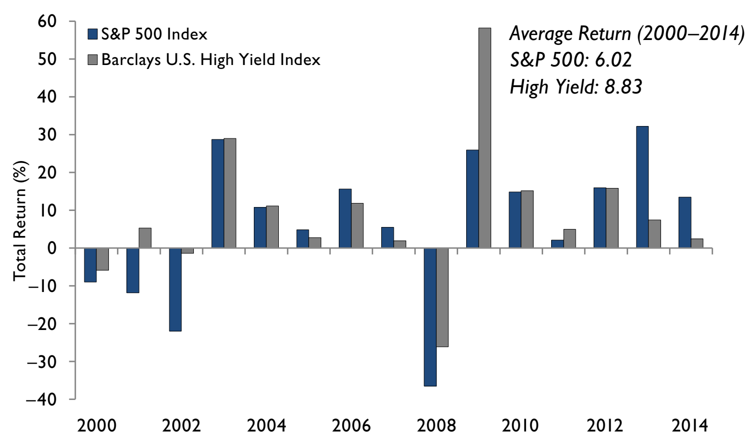
Source: Barclays, Credit Suisse, as of January 26, 2015.

Given this backdrop, 2015 appears to be a much better entry point than seven months ago, when loans had an average price of $99 and high yield bonds were yielding below 5%. But should investors allocate to high yield or loans? To answer this, we will dig a little deeper.

High-Yield Bonds: An Odd 2014 and Compelling 2015

Just how strange was 2014 for high-yield bonds? In the last 25 years, the S&P 500 index has been up more than 10% in 13 of those calendar years. With the S&P 500 index up 13% last year, the Barclays U.S. High Yield Index returned 2.45%, the lowest total return for high-yield bonds in any of these periods. Historically, the two asset classes have shown a high correlation (Chart 3). This correlation broke down in 2014 given the exposure of high-yield bonds to the energy sector and negative technicals.

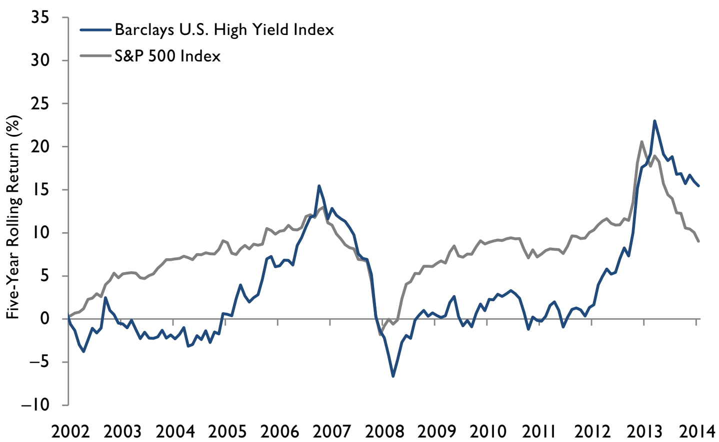
Chart 3: High yield has historically been highly correlated with equity performance



Source: Barclays, S&P, as of December 31, 2014.

In 2015, high-yield bonds are likely to be pulled by opposing forces. On the one hand, improving growth prospects in the U.S., stable balance sheets, and recent monetary policy actions abroad point to a positive credit environment and the ability for spreads to move tighter. On the other hand, high-yield bonds remain subject to higher levels of volatility, negative flows, and a greater exposure to the energy sector. With yields above 6%, low correlation with Treasuries (in particular for B-rated and CCC-rated bonds), and relatively stable balance sheets, high-yield bonds have the room to participate in upside economic or macro surprises along with equities. In addition to the reward potential, high coupon levels should help insulate downside risk, thus presenting a compelling case for high-yield bonds versus equities entering 2015.

Chart 4: High-yield bonds have historically provided a lower volatility return profile through a business cycle versus equities



Source: Barclays, S&P, as of December 31, 2014.

The Wild Card

The largest specific risk to the outlook for high-yield bonds in 2015 is the uncertainty in the energy sector and the continued stress from the collapse in commodity prices. The high-yield energy sector has grown by 133% since 2007, moving from a 6% to 14% index weighting, as U.S. debt markets have been the primary funding source for the shale gas and oil infrastructure boom. Given the higher cost and leveraged operators within high-yield bonds, $45 per barrel oil may lead to a substantial default rate for some of these energy-related companies. While many of these issuers have hedged oil prices in the short term, a majority of these hedges expire in 2015, exposing companies to lower earnings, free cash flow, and refinancing risk in 2016. J.P. Morgan estimates that with an expected average oil price of $65 through 2017, energy-sector default rates may approach 13% over the next three years (Table 2).

Table 2: Energy-sector default rate could be significant, potentially leading to further risk aversion by market participants

U.S. Energy Sector Default Rate

Scenario	2015	2016	2017	Average
$65 average oil price	3.9%	20.5%	15.5%	13.3%

U.S. High Yield Index Default Rate

Scenario	2015	2016	2017	Average
$65 average oil price	3.0%	5.6%	5.0%	4.5%

Source: J.P. Morgan, estimates as of December 31, 2014.

Bank Loans: A Risk Diversifier

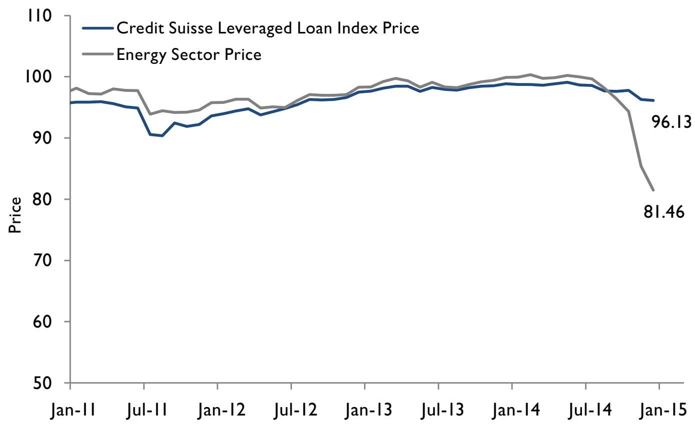
Bank-loan returns were below coupon in 2014, with the Credit Suisse Leveraged Loan Index returning 2.06%. Bank-loan returns were underwhelming given the year-end volatility, energy sell-off, and negative fund flows. Despite the relative underperformance when compared to traditional fixed-income holdings, bank loans showed low volatility in 2014. Bank loans only material weakness came in December, when poor technicals and year-end liquidity demands impacted the asset class. Over the past two years, during two distinct bear and bull markets for Treasuries, we have seen bank loans prove to be a low volatility complement, essentially performing as a risk diversifier.

Supporting the low volatility outlook for bank loans in 2015 is its limited exposure to energy. The energy sector accounts for 4% of the Credit Suisse Leveraged Loan Index versus 14% for the Barclays U.S. High Yield Index, limiting the downside risk arising from a continued energy-related sell-off and price volatility. Further, given the secured status and seniority in the capital structure, many energy-related bank loans now trade at potential recovery values, limiting downside from these price levels (Chart 5).

Bank-loan yields are at three-year highs, stable balance sheets are likely to suppress default rates, and limited duration risk[2] gives substantial relative value versus the absolute low-yield level of traditional fixed-income holdings. In our view, bank loans are attractive and a preferred complement to diversify a traditional fixed-income portfolio and to reduce interest-rate risk.

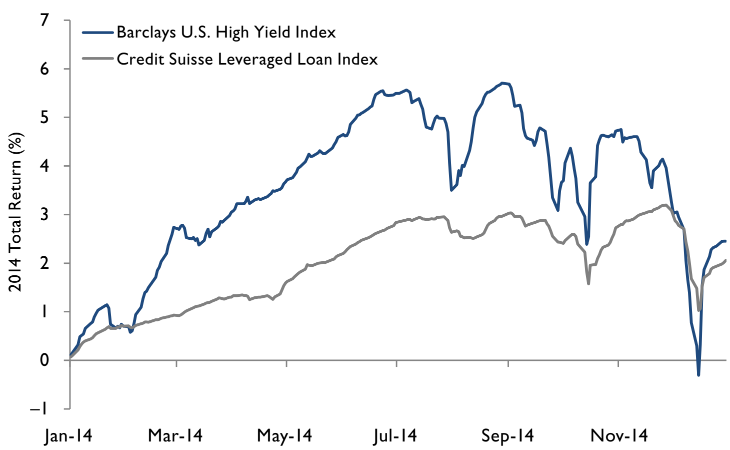
[2]Duration is a measure of the sensitivity of the price of a fixed-income investment to a change in interest rates.

Chart 5: Only 4% of the Credit Suisse Leveraged Loan Index is energy related, limiting the downside risk for bank loans from further energy related volatility



Source: Credit Suisse, as of January 29, 2014.

Chart 6: Bank loans had similar returns to high yield in 2014 while exhibiting low volatility, which is a pattern we believe will continue in 2015



Source: Barclays, Credit Suisse, as of December 31, 2014.

Loans or Bonds: What's the Role in the Portfolio?

In 2014, credit risk was a clear loser to duration risk. As a result, high-yield bonds and bank loans currently have a more compelling relative-value starting point than at any point in the past three years. So which asset class is more compelling? In our opinion, that answer depends on what an investor hopes to accomplish in their portfolio. Outside of having a similar yield profile, each asset class may respond differently to various markets, giving each a distinct role in a portfolio allocation strategy.

High-yield bonds, given their current valuations and historic return profile, provide the potential to participate in upside surprises via spread compression, and thus, price appreciation, while current income cushions downside risks relative to equities. For investors who are rebalancing their portfolios after another strong year of equity performance, high-yield bonds offer a compelling risk/reward profile.

Bank loans provide the ability to diversify traditional fixed-income risk, reduce portfolio duration, and increase portfolio yields. Additionally, given the limited exposure of bank loans to the energy sector, we believe bank loans will continue to provide a low volatility return profile relative to other spread-based assets.

Pacific Asset Management
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High-Yield is based on the Barclays U.S. High-Yield Index, which covers the universe of fixed rate, non-investment-grade debt.

Bank Loans is based on 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 based on the Barclays U.S. Corporate Index which includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be registered with the Securities and Exchange Commission (SEC).

Agency Mortgage Backed Securities (Agency MBS) is based on the Barclays Mortgage-Backed Securities Index, which is a market value-weighted index composed of agency mortgage-backed passthrough securities of the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac) with a minimum $150 million par amount outstanding and a weighted-average maturity of at least 1 year.

Intermediate Corporate is based on the Barclays U.S. Intermediate Corporate Bond Index, which is the intermediate component of the Barclays U.S. Corporate Bond Index. The Barclays U.S. Corporate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

Aggregate is based on the Barclays U.S. Aggregate Bond Index, which is composed of approximately 7,000 asset-based, corporate, government, and mortgage-backed bonds.

Treasury is based on the Barclays U.S. Treasury Index, which includes public obligations of the U.S. Treasury.

Government is based on the Barclays U.S. Government/Credit Index, which is the nonsecuritized portion of the U.S. Aggregate Index and includes Treasuries, government-related issues, and corporates.

Securitized is based on the Barclays U.S. Securitized Index, which includes asset-backed securities, collateralized mortgage-backed securities, and fixed-rate mortgage-backed securities.

S&P 500 is based on the S&P 500 Index, which is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. S&P 500 is a registered trademark of Standard & Poor's Financial Services LLC.

Indexes are unmanaged and cannot be invested in directly.

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 and a wholly owned subsidiary of Pacific Life Insurance Company (Pacific Life). As of December 31, 2014, Pacific Asset Management managed approximately $4.8 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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You should carefully consider an investment's goals, risks, charges, strategies, and expenses. This and other information about Pacific Life Funds are in the prospectus available from your financial advisor or by calling (800) 722-2333, option 2. Read the prospectus carefully before investing.

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Effective December 31, 2014, Pacific Life Funds and its family of mutual funds changed its name to Pacific Funds. In addition, individual funds were also renamed. For more information, please visit www.PacificFunds.com.
Mutual funds are offered by Pacific Funds. Pacific Funds are distributed by **Pacific Select Distributors, LLC** (member FINRA & SIPC), a subsidiary of Pacific Life Insurance Company (Newport Beach, CA), and are available through licensed third-party broker/dealers.

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