Commentary from Pacific Asset Management, the manager of the Pacific Funds℠ Fixed Income Funds.

Portfolio Manager Viewpoints

Bank loans have had a strong start in 2015. Positive technicals, improved risk sentiment, and a recovery in energy credits have been the primary drivers. In this commentary, Portfolio Managers Jason Rosiak, JP Leasure, and Michael Marzouk discuss the bank loan market and their outlook for 2015.

Assess The Capital Market Environment

Rosiak: Entering 2015, valuations for credit assets, notably bank loans and high yield bonds, were attractive given the weakness seen in late 2014. An improvement in investor risk sentiment and technicals along with a rebound in the energy market have created above coupon returns thus far. As we enter the middle of 2015, investor focus remains on the Federal Reserve and the timing of a tightening cycle. Market sentiment supports a gradual path to policy hikes, which would be conducive for credit risk given a satisfactory economic backdrop and stable corporate fundamentals. With unattractive valuations on government debt, we believe credit will continue its relative outperformance.

Table 1: 2015 has thus far been a reversal of 2014, with credit risk outperforming duration risk

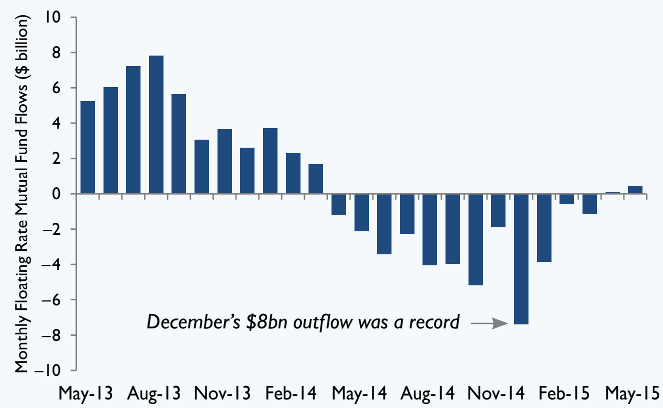
Total Return (%)	2014	2015
High Yield	2.45	4.07
Bank Loans	2.07	3.19
Intermediate Corporate	4.35	1.82
Agency MBS	6.08	1.08
Aggregate	5.97	1.00
Treasury	5.05	0.92

Source: Barclays, Credit Suisse Indices, as of May 29, 2015.

Going With The Flow

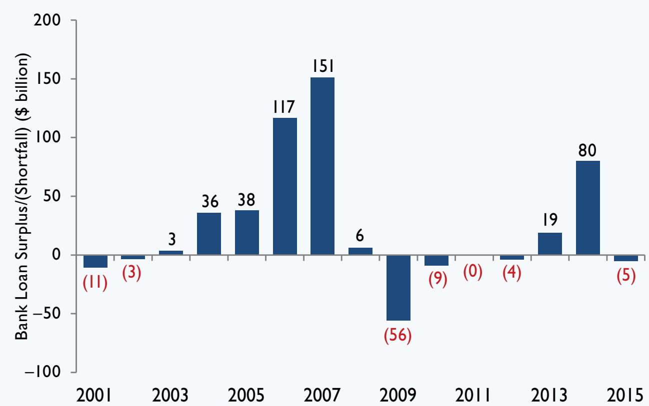
Recent fund flows and technicals have helped fuel above coupon returns for bank loans thus far in 2015.

Floating rate mutual fund flows have turned positive over the past two months, and may continue if duration is a headwind to fixed income returns



Source: Lipper, as of May 24, 2015.

Demand is outpacing net supply for the first time since 2012



Surplus/shortfall takes net primary issuance and subtracts retail fund flows and CLO issuance to get a net demand. A positive number means supply outpaced demand.

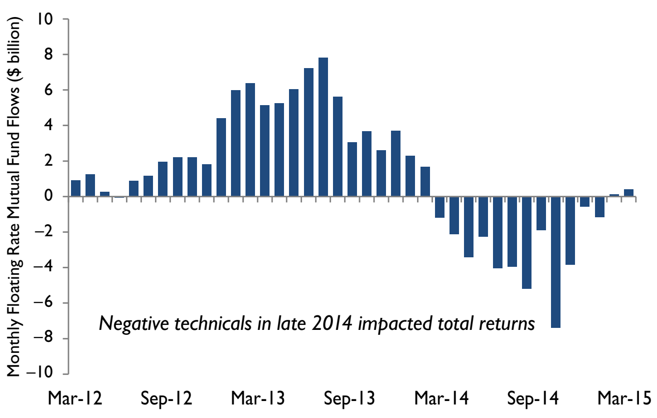
Source: JP Morgan, as of May 29, 2015.

Describe The Bank Loan Market Performance Over The Past 12 Months

Leasure: The past year has seen two distinct periods. The headwinds of late 2014, caused by poor technicals, risk aversion, and energy-related volatility. Thus far in 2015, these factors have reversed and become tailwinds. Bank loans have benefited and have returned above coupon.

Marzouk: Technicals in the bank loan market have been critical in the short term. With the growth of assets invested in floating rate mutual funds to more than $130 billion (bn) versus $43bn in 2010 (Source: Lipper), fund flows appear to be influencing short term performance. This was particularly true in December 2014 as fund outflows accelerated into a seasonally weak liquidity environment (Chart 1). Given the strength of institutional demand for bank loans through collateralized loan obligations (CLOs) issuance and limited net supply, the technicals became a tailwind in the beginning of 2015 (Table 2). Also, since bottoming in March, floating rate loan fund flows have turned mildly positive as duration has become a performance detractor.

Chart 1: Ending a streak of twelve consecutive months of outflows, fund flows have turned positive in the past two months



Source: Lipper, as of May 24, 2015.

Table 2: Demand has outpaced supply thus far in 2015, helping to buoy prices and create a positive tailwind

$bn	2012	2013	2014	2015
Gross Issuance	301	670	467	146
Paydowns	(200)	(260)	(188)	(59)
Repricings	(37)	(242)	(91)	(43)
Total Net Supply	**64**	**169**	**188**	**44**
Retail Inflows	12	63	(24)	(5)
CLO Issuance	56	87	132	54
Total Demand	**68**	**150**	**108**	**49**
Surplus/(Shortfall)	**(4)**	**19**	**80**	**(5)**

Surplus/shortfall takes net primary issuance and subtracts retail fund flows and CLO issuance to get a net demand. A positive number means supply outpaced demand.

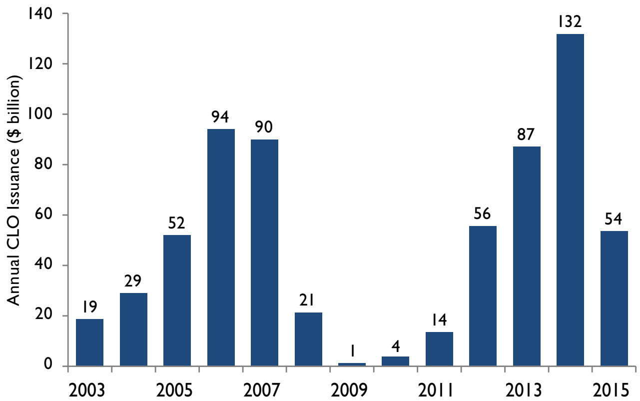
Source: JP Morgan, as of May 29, 2015.

What Will Be The Impact of Dodd-Frank and Risk Retention for CLO Issuance?

Marzouk: As part of Dodd-Frank legislation, sponsors (asset managers) of any structured product (commercial mortgage-backed securities, collateralized loan obligations, collateralized debt obligations, residential mortgage-backed security), will be required to retain 5% of each tranche or portion of the capital structure beginning in 2017. The goal is to incentivize better collateral management and deal structures by requiring sponsors to have "skin in the game." While loan managers and the Loan Syndications & Trading Association fought hard against the ruling, CLOs were not given an exemption. The capital requirements could be onerous for smaller or independent asset managers, potentially depressing CLO issuance in the future.

Rosiak: In the immediate term, we believe we will see a pulling forward of demand, which will continue to support the technical picture in 2015. However, into 2016, as some CLOs reach refinancing windows, we may see a tapering of issuance given the concern about the 5% retention requirement.

Chart 2: While CLO issuance is expected to remain high in 2015, concerns towards refinancing risk and retention requirements may curtail 2016 issuance

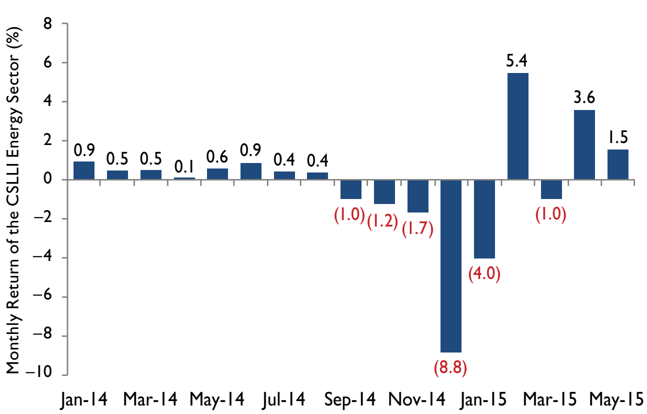


Source: JP Morgan, as of May 29, 2015.

What Are Your Views on Energy-Related Volatility and Its Impact on Bank Loans?

Leasure: While only 4% of the Credit Suisse Leveraged Loan Index is energy-related versus 14% for the Barclays High Yield Index, volatility has been significant, impacting returns. Negative price action for energy issuers hit its peak in late January (Chart 3), coinciding with oil reaching $44 per barrel. Since late January 2015, however, the stabilization in oil prices along with a positive risk environment has led to an improvement for energy credits. We have seen high quality energy issuers improve the most in price. This is indicative of a market evaluating issuers on underlying fundamentals versus the highly correlated selloff seen in late December 2014.

Chart 3: Energy issuers have seen a strong improvement in prices following the December/January volatility



Source: Credit Suisse, as of May 29, 2015.

Do You Look at The Energy Sector as An Attractive Opportunity?

Rosiak: We do not find valuations in the energy sector sufficiently appealing to increase our energy exposure. First, while we have selective energy issuers in the portfolios we manage, it is not our preference to have issuers with equity like volatility in our strategy. Second, a lot of the short term volatility around energy is being driven by the price of oil, which is very difficult to forecast. Third, energy issuers have seen strong price improvement since February, removing some relative value opportunities for many credits.

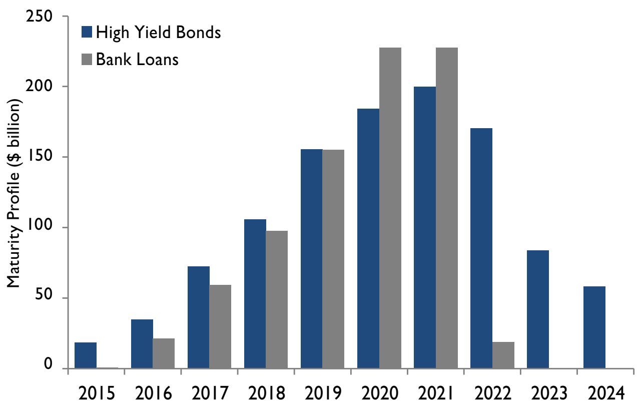
Describe The Outlook for The Second Half of 2015

Marzouk: We have seen a reversal in technicals and risk sentiment help propel bank loans to above coupon returns year-to-date. We viewed the total return profile for 2015 as coupon plus, perhaps in the range of 5–6%. With such a strong first half, income and yield are likely to drive total returns for the remainder of the year versus the price performance seen thus far. The wild cards will be energy and metals/mining sectors, which have the ability to impact the coupon-like return profile.

We Have Discussed Valuations and Technicals. What About The Fundamental Outlook?

Leasure: Our theme in bank loans over the past few years has been limited refinancing risk, right sizing of corporate balance sheets, and slow but positive U.S. Gross Domestic Product growth extending the credit cycle, creating a favorable fundamental backdrop. U.S. corporate profits are continuing to generate free cash flow and provide an ability to service debt. Refinancing risk remains minimal, reducing the risk of a maturity wall or surge in defaults due to lack of access to capital markets (Chart 4). Excluding energy and metals/mining companies, there remain a limited number of default candidates in the near term. Meaningful defaults for energy issuers may not materialize until 2016, given the stabilization in oil and production hedges. The amount of defaults will be dependent upon a combination of the price of oil, asset valuations, capital market conditions, and refinancing risk.

Chart 4: The lack of refinancing risk supports a below average default rate



Source: Merrill Lynch/Bank of America as of April 30, 2015.

What Are Your Portfolio Positioning and Themes for The Second Half of 2015?

Rosiak: As is our style, we are focused on the larger companies within the bank loan universe. We are overweight B vs. BB rated issues given the favorable fundamental backdrop. We are overweight housing, retail, and service sectors and underweight healthcare, utility, and technology. We seek to minimize exposure to euro-centric companies due to weak profit growth and systemic risks.

We hold limited high yield bonds (less than 2%), favoring an overweight to second lien bank loans. It is our opinion that the volatility profile of high yield bonds negates the income advantage for bonds over loans. We believe second lien loans are a more attractive way to capitalize on higher returns of the asset class.

How Would You Articulate The Value Proposition for Loans?

Leasure: We have seen non-CLO demand for bank loans over the past three years driven by the ebbs and flows around concerns of higher interest rates. We view the asset class as a strong diversifier to traditional fixed income given the lack of duration, focused credit risk, yield advantages, and the limited correlation to other traditional fixed income portfolios asset classes. Regardless of one's view on interest rates, the low absolute yield levels of traditional fixed income combined with stable credit fundamentals paints a favorable relative value picture for floating rate loans.

Should Rates Move Higher, or a Taper Tantrum Similar to 2013 Develop, Bank Loans Have The Added Benefit of Being a Potential Hedge Against That Volatility.

Summary: Following a weak 2014, bank loans have seen a rebound in performance as technicals and risk sentiment have improved. A combination of stable fundamentals, sufficient economic growth, and low absolute yield levels on traditional fixed income asset classes all paint a favorable relative value picture. Given a coupon-like return profile of 5-6% with a lack of duration risk, bank loans continue to serve as an excellent diversifier for traditional fixed income portfolios.

Pacific Asset Management
June 2015

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.

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.

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.

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.

Indexes are unmanaged and cannot be invested in directly.

About Pacific Asset Management

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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.

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