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

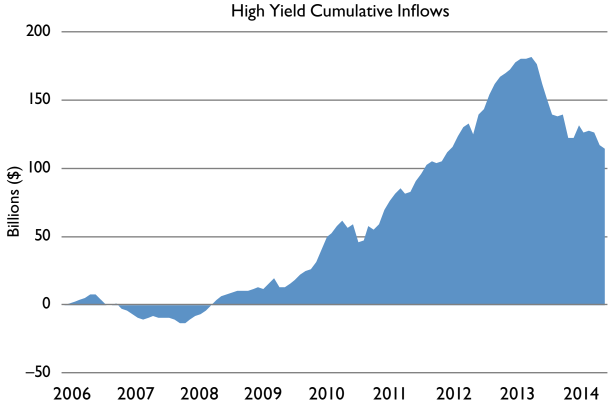
It's Not You, It's Your Liquidity

Recent market volatility has once again shed light on the diminished liquidity environment for corporate bonds. Regulatory uncertainty and evolving investor dynamics have resulted in some structural changes, with important implications for investors and active managers. In this commentary, we review these changes and their potential impact on investors.

Bank deleveraging and dealer liquidity

Since 2007, dealer consolidation, bank deleveraging, and a generally conservative risk appetite have led to tremendous reductions in primary dealer positions. Because bonds do not trade on exchanges like equity securities, bonds rely on a dealer network to make a market. Primary dealers are the designated firms that are the securities broker-dealers that are permitted to trade directly with the Federal Reserve System (the Federal Reserve). This occurred at the same time credit markets have expanded significantly (Chart 1), leading to less "two-way" markets across the wide breadth of corporate debt securities. Since peaking in 2007, primary dealer inventories have been reduced by 90% (Chart 2). Recent revisions to the Federal Reserve's Weekly Report of Dealer Positions, which removed non-agency mortgage-backed securities (MBS) from corporate securities, shows dealer positions are even lower than previously estimated. One impact of this structural change was seen this summer, as record mutual fund outflows led to increased trading costs (wider bid-ask spreads).

Chart 1: Credit markets have expanded rapidly over the past five years



Source: Investment Company Institute, as of July 31, 2015.

Beta?

Due to the difficulties of replication, trading costs, index turnover, fund flows, and the focus on the largest issuers—high yield ETF's have generally underperformed active managers over short and long term time periods.

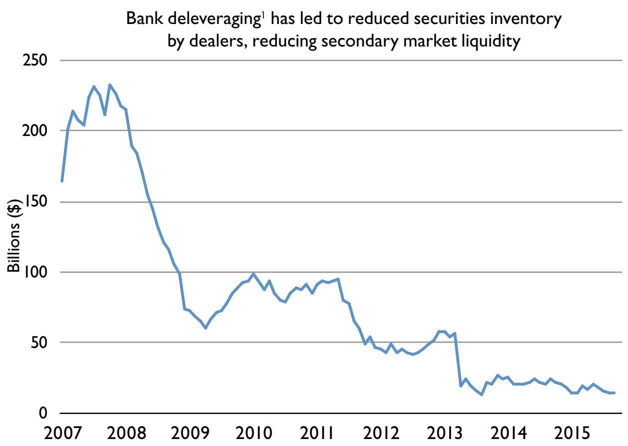
Table 1: High yield bond ETF's underperforming

Index	1 Year	3 Year	5 Year
iShares High Yield ETF (HYG)	–3.69%	3.72%	6.48%
SPDR High Yield ETF (JNK)	–5.38%	3.42%	6.28%
Markit iBoxx USD Liquid High Yield Index	–3.27%	3.94%	6.67%
Barclays High Yield Very Liquid Index	–3.91%	4.38%	7.32%
Barclays High Yield Index	–2.93%	4.91%	7.34%
Morningstar High Yield Peer Group Median	–3.23%	4.21%	6.37%

Source: Barclays, iShares, SPDR, Morningstar. Performance of the iShare, SPDR ETFs, Morningstar are shown as total return net of fees. All other performance measures are gross of fees. As of August 31, 2015.

The two ETFs (HYG and JNK) were chosen to represent high-yield ETFs because they are the two largest in their space.

Chart 2: Corporate Bond Positions of Primary Dealers

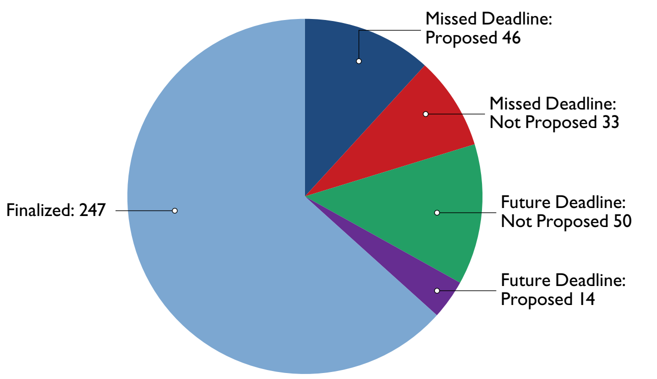


Source: Bloomberg, as of September 2015.
[1]Deleveraging refers to the reduction of the leverage ratio, which is a measure of the financial health of a company based on the amount of debt the company has.

Regulatory uncertainty

The uncertainty surrounding various reforms such as The Dodd-Frank Act, the Volcker Rule, and Basel III requirements are further constraining capital market liquidity and trading. The Dodd-Frank Act, signed into law in 2010 and containing more than 850 pages and 15 million words, is one of the most sweeping financial reforms in decades. However, implementation is proving difficult (Chart 3).

Chart 3: Dodd-Frank remains ambiguous and complex. Five years after signing into law, only 63% of the rulemaking legislation has been finalized.



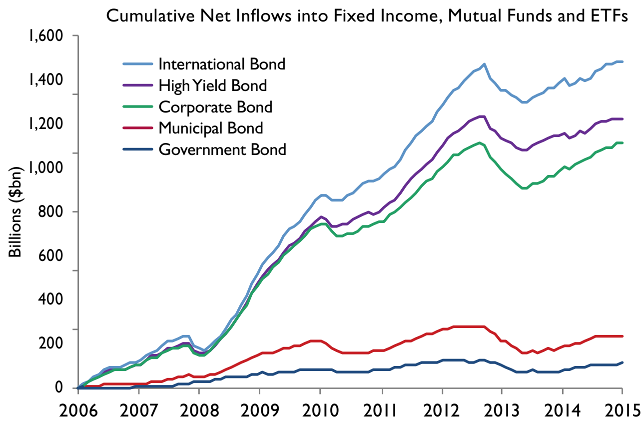
Source: Davis Polk, as of July 2015.

The uncertainty of the Dodd-Frank Act regarding capital requirements, derivatives, proprietary trading (Volcker Rule), and market making activities has and continues to constrain a bank's willingness to commit capital for trading. The results are inventory reductions, unwinding of proprietary trading desks, and decreasing human capital. While lawmakers recently agreed to various Basel III capital requirements, the progress on finalizing Dodd-Frank continues to be slow with final legislation highly uncertain.

Changing investor dynamics

While the uncertainty around regulatory reform has reduced liquidity, the growth of the retail investor is requiring more of it. ***Over the past five years, fixed income mutual funds and ETFs, excluding money market funds, have seen net inflows of over $1 trillion (Chart 4).*** Compared to traditional buyers of corporate debt, such as pension plans and insurance companies who frequently buy off-the-run or more seasoned securities, retail funds typically require higher degrees of liquidity.

Chart 4: The extraordinary growth of retail fixed-income mutual funds and ETFs has increased demand for liquidity, while structural and regulatory challenges constrain liquidity



Source: Investment Company Institute, as of July 31, 2015.

The substantial asset growth of fixed income ETFs also has important influences on secondary market trading. The ETF focus on larger issuers has led to tighter spreads during periods of ETF inflows and, conversely, wider spreads during periods of ETF outflows. While these ETFs have substantially underperformed relative to major market indexes over the long term (see table 1 on page 1), the ease of entry and exit for investors means that ETF growth is likely to continue its influence on secondary market trading.

Results of these forces on secondary market liquidity

Reduced dealer inventories and increasing liquidity demands have led to a concentration of trading into a narrower number of issuers. These issuers, typically called "flow-names," now account for the majority of trading in corporate bonds. The concentration of liquidity has led to greater price volatility across larger issuers. In times of credit weakness, larger issuers will usually underperform, in many cases because they were the most readily available to meet redemptions.

Another result of the changing liquidity dynamic is the development of an order driven market, which had in the past been used predominantly by the less liquid asset-backed securities (ABS) and non-Agency MBS sectors. In an order driven market, a seller/buyer of bonds sends out a list of securities and sizes in which they wish to transact, usually several days in advance. A dealer would then work to fill the order with counterparty.

Frequently called BWIC (Bids Wanted in Competition) or OWIC (Offers Wanted In Competition), the benefit of this type of transaction is greater price transparency and the ability for a dealer to act only as broker, without having to take inventory onto their diminished balance sheets. The negative is that it reinforces the idea that, in some cases, there may not be enough bonds to meet demand. This forces many asset managers, notably those with significant assets under management, to increase their number of holdings across strategies in order to be fully invested.

The structural, regulatory, and investor dynamics discussed are in our view part of a longer term trend of diminishing liquidity. For asset managers focused on credit, understanding the inter-relationships of these forces on secondary market trading is an important part of portfolio management. In many cases the opportunities lie in identifying how these structural trends affect individual capital structures and sectors. For example, due to the concentration of liquidity into the largest issuers, this provides an opportunity of evaluating smaller issuers, which may have sound credit fundamentals, but are passed over by many ETF and mutual fund investors. The influence of ETFs may also lead to arbitrage opportunities where those parts of the issuing company's capital structure owned by ETFs may be more volatile than those that are not.

Selectivity leads to outperformance

For many large firms, the ability to employ bottom-up security selection in a constrained liquidity environment can be hindered. These asset managers are often forced to hold hundreds, and sometimes thousands, of individual bonds in order to be fully invested and maintain liquidity. This has been shown empirically to minimize the effect of security selection in attribution. For bond focused strategies, we believe selectivity is a key to outperformance, and manageable assets under management are key to selectivity. At Pacific Asset Management, our size continues to be a competitive advantage in navigating today's liquidity environment.

iShares High Yield ETF (HYG) refers to the iShares iBoxx High Yield Corporate Bond ETF which tracks a market-weighted index of U.S. high-yield/high-risk corporate debt.

SPDR High Yield ETF (JNK) refers to the SPDR® Barclays High Yield Bond ETF which seeks to provide investment results that, before fees and expenses, correspond generally to the price and yield performance of the Barclays High Yield Very Liquid Index.

Barclays High Yield Index refers to the Barclays U.S. High-Yield Index, which covers the universe of fixed rate, non-investment-grade debt.

Barclays High Yield Very Liquid Index includes publicly issued U.S. dollar denominated, non-investment grade, fixed-rate, taxable corporate bonds that have a remaining maturity of at least one year, are rated high-yield, and have $600 million or more of outstanding face value.

Markit iBoxx USD Liquid High Yield Index includes liquid U.S. dollar-denominated, high yield corporate bonds for sale in the United States.

The **Morningstar High Yield** category includes funds with at least 65% of assets in bonds rated below BBB.

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 September 30, 2015, Pacific Asset Management managed approximately $5.59 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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Pacific Life Fund Advisors LLC (PLFA), a wholly owned subsidiary of Pacific Life Insurance Company, is the investment advisor to the Pacific Funds. PLFA also does business under the name Pacific Asset Management and manages certain funds under that name.

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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