ticker

Flexibility in Corporate Credits

Corporate bonds are generally preferred for their attractive risk/reward profile in the investment-grade space. Moreover, the additional yield embedded in the second tier bonds can provide enhanced returns with relatively attractive risk, limiting the need to search in the very low end of the credit spectrum. David Weismiller, portfolio manager for Pacific Asset Management, the investment manager to Pacific Funds^{SM} Short Duration Income, and his team of seasoned research analysts seek to exploit opportunities in corporate credit, across investment grade, senior floating rate loans, and high yield bonds.

David Weismiller, CFA

Managing Director, Lead Portfolio Manager

David Weismiller is a Managing Director for Pacific Asset Management and the Lead Portfolio Manager on the Core Plus, Investment Grade, and Short Duration Bond Strategies. In addition, David has credit research responsibilities in the Chemicals and Utilities sectors. David has been with Pacific Asset Management since inception in 2007. Prior to this, he was part of Pacific Life's research team since June 2002.

Before joining Pacific Life, David was a corporate banking officer at Comerica Bank. He has over 17 years of investment and banking experience and holds a bachelor's degree from the University of California, Santa Barbara and an MBA from the University of California, Irvine. David is a CFA Charterholder and member of the CFA Society of Los Angeles.

What is the history of the fund?

The fund began in 2012 as an extension of what Pacific Asset Management had been doing in the corporate credit space since the group was founded in 2007. Pacific Asset Management's investment group was born out of members of its parent company's (Pacific Life Insurance Company) credit research and portfolio management staff that had been together since 2002. Pacific Asset Management's corporate credit expertise, which draws from a deep research bench and Pacific Life's extensive heritage in the sector, is utilized in implementing the investment strategy for the fund.

One of our fundamental beliefs about the corporate-credit space is that additional spread income provides more flexibility. This flexibility allows duration to move up and down versus the benchmark, while maintaining attractive income. Although the fund will invest, under normal circumstances, at least 70% of its assets in investment grade, the fund's investment strategy enables us to take advantage of opportunities in the upper end of the high yield space. Credit quality ranges from AAA down to B. The fund also allows us to use our senior floating rate loan expertise—something many of our competitors have not done.

At a very high level this is a flexible short-duration credit strategy; weighted average duration is generally expected to be less than three years. The portfolio also has a unique cornerstone of corporate credit—it has not employed a multi-sector strategy. Our research staff is industry focused. When looking across the credit quality spectrum, our analysts are able to see the relative value between investment grade bonds, high yield bonds, and floating rate loans. Those views are articulated in the portfolio.

Offering our strategy in a mutual fund provides investors with a high level of transparency and understandability, an important factor especially after the 2008 financial crisis. As a result, they can view the portfolio and know exactly what they own—it doesn't have much in derivatives, structured products, and the portfolio is 100% USD denominated.

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How do you define your investment philosophy?

We believe corporate bonds offer the best risk/reward opportunities in the investment-grade universe. The additional spread embedded in corporates, particularly in the BBB space, means we do

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not need to reach aggressively for yield. The research team's experience helps us avoid downgrades so we can capitalize on that additional spread, with the goal of providing higher income and better returns for investors over the long term. To complement investment-grade holdings, the fund includes higher quality, below-investment grade holdings as well as floating-rate loans. Compared to most short-duration peers, it typically holds more corporate credit and senior floating rate loans.

Because we are able to see where short-term investments lie within the maturity spectrum and understand cash flows, even in stressed environments, a clear pathway to payback for investments is visible. This gives us comfort, knowing companies will have the ability to pay us back.

What is your investment strategy and process?

Especially in a short-duration portfolio, there must be an identifiable path towards repayment for an individual issuer and investment. The keys to this are cash-flow analysis and the quality of cash flows. A quality asset base is also important, because during stressed periods a company can potentially use them as security or lever them up to ensure repayment of debt.

Additionally, a company's management must be committed to a strong balance sheet; this is paramount, particularly in the investment-grade space at this time in the credit cycle. It has become increasingly tempting for management teams to utilize the low-cost funding environment to benefit equity shareholders. As a result, we have seen less of a commitment across a few industries towards maintaining strong balances and retaining investment-grade ratings.

Within high yield and bank loans, the enterprise value is foremost. We want to see a loan-to-enterprise value that has a lot of cushion for a potential downtrend in the cycle and that the investment value is covered. In senior floating rate loans, the quality of asset bases becomes even more important. Assets or brands should not be cyclical in terms of value, and we desire ones with staying power and predictable values where the loan-to-value can be relied on.

Our research process begins with basic fundamental analysis. Ten analysts, five of whom are also portfolio managers, share these duties. To narrow the investable universe, we focus on larger issuers across the credit quality spectrum; this eliminates about half the names but still gives approximately 80% coverage on the indices.

The research team is organized by industry, giving them the ability to look up and down the spectrum of credit quality within an industry and evaluate capital structures within a company. Analysts also dig into a company's management, its board, and the sponsors behind the group to get a historical feel for how they have treated bondholders and their balance sheet in the past.

We are a small, focused, and experienced team. We draw on this experience before making investments. Ideas can come from either analysts or portfolio managers, but it is important to gather together as a team when talking about a credit. As the portfolio manager for the fund, I determine whether an investment will have a role in its portfolio—does it have a steady carry-play story, offer diversification, or provide a catalyst that will benefit the yield or return?

Can you discuss some examples of investment opportunities?

Over the years, we have liked investment-grade corporate debt at publicly traded REITs. This asset class is not widely known in the investment-grade universe, and it is appealing because the companies within it have strong asset bases and controls around what they can do with those assets. Covenants determine whether they can sell off assets and whether they can secure debt against them. It is one of the few investment-grade areas where covenants can be found.

Another attractive area is found in Enhanced Equipment Trust Certificates (EETCs), where corporate debt is secured by aircraft. Even though the industry is more cyclical, it has been consolidating with favorable fundamentals and the issues have the benefit of security offered by those aircrafts.

To add nice, stable spread and yield into the portfolio, we seek BBB floaters that are not widely issued. But given our size and concentration on corporate credit, we are able to find attractive opportunities.

What is your portfolio construction process?

On December 31, 2015, there were 155 issues in the portfolio, which is just a little higher than the 125 to 150 credits we have normally held in the strategy. Also know that we will hold multiple issues of particular issuers. The majority of the fund's investments are currently on the credit side with the balance being largely government exposure. From a firm level, we realize there is a heavy bias to credit, so we look essentially at underlying credit performance with a little risk premium to incorporate high yield and loans.

Exposure in a name is generally 50 to 200 basis points. When constructing the portfolio, higher weightings are obviously given to investment-grade issuers, which are more stable and predictable. On average, these higher weights have 1% positions in the portfolio; a high yield or bank loan may be just 25 to 50 basis points.

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The fund's benchmark is the Barclays 1–3 Year U.S. Government/Credit Bond Index. The benchmark is primarily a guidepost for yield and duration, not for sectors or credits. Though small variations in duration are allowed, we try to find most of our alpha outside of duration, primarily from sector and security selection.

How do you define and manage risk?

Many of the standard risk factors that larger shops face do not affect our strategy or the fund. We invest in U.S. dollar denominated holdings, with limited-to-no securitized debt, and do not really have derivatives. Our risk management centers on duration, credit quality, sector concentration, security limits, and liquidity. There are firm rules around each of these factors.

We start with overall portfolio risk, the option adjusted spread (OAS) and yield relative to our longer-term targets. Typically there is a higher overall spread in yield than the stated benchmark's—but from both duration and industry standpoints the benchmark remains a guidepost.

The fund's portfolio has a lot of spread duration versus pure interest-rate duration, and is the core behind why we believe in corporate credit, especially investment grade. If the belief is that rates are going to either stay low or move up, that belief makes the argument for corporate credit or spread instruments.

Especially in this volatile period, there is a benefit from having BBB floaters and bank loans as a part of the portfolio. The flexibility to do so allows us to maintain an attractive yield while at the same time limiting duration and its impacts.

Diversification plays an important role in managing risk and is built into the portfolio in several ways. We create dispersion across sectors and industries as well across underlying business catalysts. T

Pacific Funds Short Duration Income Fund

Company	Pacific Funds
Symbols	PLADX (Class A) PLDSX (Advisor Class)
Address	700 Newport Center Drive Newport Beach, CA 92660
Phone	800-722-2333
Website	www.PacificFunds.com

Source: Company Documents

About Ticker Q&A

Our research staff analyzes and selects funds based on their consistency in performance and durability of investment style.

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Pacific Asset Management receives credit quality ratings on underlying securities of the Fund from major rating agencies—S&P®, Moody's, and/or Fitch. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest). When the rating agencies rate a security differently, Pacific Asset Management uses the higher rating. Below investment grade is represented by a rating of BB and below. Ratings and portfolio credit quality may change over time.

Barclays 1-3 Year U.S. Government/Credit Bond Index is the 1–3 year component of the U.S. Government/Credit Index. The U.S. Government/Credit Bond Index is the non-securitized component of the U.S. Aggregate Bond Index. The U.S. Government/Credit Bond Index includes Treasuries, government-related issues, and corporates.

About Risk

As with any mutual fund, the value of the funds' holdings will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Interest rate changes, or expectations about such changes, may cause the value of debt securities to fluctuate. 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. Floating rate loans are usually rated below investment grade and thus are subject to greater risk of default than higher-rated securities. In addition, their extended trade settlement periods may result in cash not being immediately available to the fund, thus subjecting the fund to greater liquidity risk. High-yield/high-risk bonds (also known as "junk bonds") have greater risk of default than higher-quality bonds that may have a lower yield. The Funds are also subject to liquidity risk (the risk that certain investments may be difficult to purchase and sell in adverse market conditions) and credit risk (the risk an issuer may be unable or unwilling to meet its financial obligations). Actively managed funds could be adversely impacted and under perform relative to other funds with similar investment goals if the manager's judgments about the value or potential appreciation of an investment proves to be incorrect or fails to have the intended results. Not all U.S. securities are backed or guaranteed by the U.S. government and different U.S. government securities are subject to varying degrees of credit risk. Diversification does not guarantee future results, ensure a profit, or protect against loss.

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