ticker

Selective Corporate Credits

When it comes to strategic income, investors tend to seek balance between well-researched selectivity and diversification. Brian M. Robertson and his team of analysts at Pacific Asset Management rely on a collaborative analysis of investment-grade, high-yield corporate bonds, and floating-rate loans to build a diversified portfolio that generates risk-adjusted returns over a market cycle.

Brian M. Robertson, CFA
Managing Director and Lead Portfolio Manager

Brian Robertson is a Managing Director for Pacific Asset Management. Brian is a Portfolio Manager on the Strategic Credit, High Yield, and Core Plus Strategies. In addition, Brian has credit research responsibilities across select sectors. Prior to being a founding member of Pacific Asset Management in 2007, from 2003-2006, Brian was a member of Pacific Life's securities division overseeing investments in corporate bonds, high yield, and bank loan securities.

Brian has over 12 years of investment experience. He holds a bachelor's degree from the University of Michigan. Brian is a CFA Charterholder and member of the CFA Society of Orange County.

What is the history of the fund?

Pacific Asset Management was founded in 2007, from parent company Pacific Life Insurance Company. Prior to this fund's launch in late 2011, we primarily managed portfolios dedicated to single asset classes, centering on investment-grade bonds, floating-rate loans, and high-yield bonds. Our investment strategies are focused around those three disciplines and this fund is an extension of this corporate-credit focus.

Broadly speaking, Pacific Asset Management manages about $5.5 billion across the firm, including separately managed accounts. This particular fund has about $250 million in assets under management.

The fund's broad based benchmark is the Barclays Capital U.S. Aggregate Bond Index.

What are the underlying principles behind your investment philosophy?

There are three main factors in our investment philosophy. First, we believe that corporate credit offers the best risk/reward opportunities in a fixed income landscape over a full cycle. Second, we believe the best approach to managing corporate debt is through fundamental security analysis. And, third, we believe a collaborative team-based approach, where all of the members of the investment team review and share ideas, is the best environment to generate portfolio alpha.

The Strategic Income Fund was structured to be the most flexible of our strategies, with the ability to capitalize on opportunities across credit and various asset classes, and to build on the firm's fundamental research and security selection. In addition to those three asset classes—investment-grade bonds, floating-rate loans, and high-yield bonds—we have a tactical bucket, which we have used for equity opportunities. .

We believe building a strategy around those three core asset classes can provide investors with attractive risk-adjusted returns over a full cycle while still providing sufficient asset class diversification. That philosophy and process has been constant over time. What differentiates us from some of our peers is our focus on credit and our selective portfolio construction.

How would you describe your investment strategy?

Our strategy is pretty straightforward. From a high level perspective, the fund is comprised of predominantly three fixed income asset classes, with high yield and investment grade bonds typically being the largest weighting, complemented with floating rate loans. Once we determine general guidelines around our risk appetite and asset allocation, the critical part begins, which is security selection. We construct a portfolio with 120 to 150 issuers built around the highest-conviction ideas generated through our research process. Our portfolio and firm assets under management size across the entire firm allows us to take meaningful positions and look for value across the credit market.

We generally focus on companies that we think will meet their debt obligations and whose underlying assets provide downside protection. We use derivatives sparingly, typically as a liquidity tool, and while the strategy can invest in non-U.S. dollar denominated assets, our focus is on U.S. dollar-denominated securities and mainly U.S.-centric companies.

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As for the beliefs that guide our thinking, while fixed income markets are reasonably efficient, there are certain elements we believe create attractive investment opportunities, and our team is positioned to capitalize on those opportunities.

We believe a selective portfolio construction process allows our analysts' best ideas to be magnified and drive alpha. Our focus on capital preservation through the underwriting process and downside protection is vital. Protecting investor capital in downside scenarios is an important aspect of generating strong performance over the long term.

What is your investment process?

Fundamental research is the cornerstone of our process. It begins with the team analyzing the macro landscape, the overall global macroeconomic drivers, corporate fundamentals, and market technicals.

An important part of that macro assessment is the feedback we solicit from management teams inside our coverage universe. At that point, we look at relative value across the asset classes we invest in and finalize our views in terms of the risk/reward profiles in each of those asset classes in order to determine asset allocation. We want to understand the risk metrics, both portfolio-wide and inside each asset class, to gauge where to take risk or diversify it by balancing it against that of our other asset classes.

The ultimate portfolio construction is done on a name-by-name basis through the work of our credit analysts and underwriting, in order to build those desired portfolio risk metrics. We underwrite the potential investment opportunities, assessing the risk/reward opportunity set by industry, company, and particular security.

How do you conduct research?

Our research starts with the screening process, then basic fundamental analysis. We perform sector reviews on a quarterly basis. Our analysts write up initial and quarterly reports and do relative value analysis across their investable universe. We capture all of our research in our research portal, which allows us to disseminate the information and pass it on to the appropriate portfolio managers.

We have 11 analysts on the team, five of which are also portfolio managers, and they share the research duties. Organized by industry, we look into a company's management team and sponsors, if any. The analysis we perform on the management teams help give us insight into their history running the business, how they have prioritized debtholders versus equity holders, how acquisitive they have been over time, and what their incentives may be in the future.

We analyze overall industry factors to identify the headwinds and tailwinds. We look at the company's cost positioning inside the industry, and we review the historical financial statements to form an opinion as to what direction we think the business is headed. Our analysts provide industry coverage up and down the credit spectrum, from AAA to CCC, as well as across bonds and loans. That structure enables our analysts to best understand industry dynamics and to analyze relative value across the entire credit spectrum.

Once we get a feel for the industry, company and security risks, we shift to the relative value side of the decision. We review relative value given the risk in the security and compare this to both current holdings as well as other potential investment ideas in order to determine whether the security will become a core holding.

Can you provide an example of how your research process works?

When somebody presents a paper with data and logical conclusions, someone else has to examine and validate the presumptions. For example, if there is a claim that the CBOE Volatility Index (VIX) is going to get more business because people are starting to use it, then the primary research will involve meeting money managers and asking them if they know about the VIX index, what they think about it, if they are they interested in using it, what are the problems using it, etc.

A problem may be that custodians are not able to account for it yet. Then the next step would be to call custodians and ask them about that problem and if it is going to be solved. Is it insurmountable? They may say they are working on it, or have solved it already, or are planning a new system. Basically, you gather the information in a way to supplement the analysis, to look at the problem in a different way and gather information from different sources to see if the conclusion is valid.

Could you give us some examples of specific holdings to illustrate your thought process?

One sector we have had a lot of exposure to over the years is the packaging sector. Packaging companies tend to have pretty defensive end markets and perform better in a recession, in the mid-to-high, single-digit, top-line declines which compares relatively favorably. The companies typically don't have much in the way of commodity risk given a contract structure that allows for a pass-through of most input costs. Although there tends to be some delay in that pass-through mechanism, it does ultimately pass through to the end consumer.

We also like the sector from the standpoint of relative value. It's a sector that has seen a lot of M&A (mergers and acquisitions) activity over the years. Because we've followed it closely for a long time, we feel comfortable with certain companies' management teams, their businesses, and prospects. There have been many companies that took on incremental debt to complete M&A in order to consolidate the space and we have used that as an opportunity to invest incrementally in the industry.

Despite the higher levels of leverage, we are comfortable that the enterprise value of these businesses will remain stable over time, and when the acquisitions inevitably slow, they should be able to generate strong amounts of free cash flow and deleverage the balance sheets.

The packaging space is an example of some of the opportunities we have had in the portfolio across high yield, bank loans and investment grade asset classes. It has been an investment opportunity in the portfolio that has paid off over time.

One additional factor in our research process that is important, especially as it relates to bank loans, is a review of covenants. Although covenants have generally been weaker across all of fixed income, the loan asset class still provides better investment protection through covenants than investment grade and high yield. While covenant structures are not what they were 10 years ago, they can still play an important role if the company gets into trouble or when we go through a recession. Because of this, when we consider companies in the bank loan space, an analysis of the covenants does play a more important role in our review process.

How do you construct your portfolio?

We have about 120 to 150 issuers, and the typical issuer size, as far as holdings are concerned, ranges anywhere from 50 to 200 basis points. Typically, names that we think provide superior attributes from a risk-adjusted return perspective would be up to 2%.

Our strategic asset allocation target over time is 40% high yield, 40% investment grade, and 20% bank loans. That's where we expect the averages to be over an entire cycle. Obviously, that mix would be quite dynamic over time, depending on where we are in the economy and the business cycle, and where we see relative value opportunities.

Right now we are pretty neutral to that 40-40-20 mix. The maximum we can go in high-yield-rated securities, which includes high-yield bonds and high-yield-rated bank loans, is 70%. The highest we can go as far as investment grade-rated securities is 65%. So, we do have a decent amount of flexibility when it comes to increasing and decreasing risk tolerance.

There is, similarly, a reasonably wide band as far as the duration of the fund over time. The duration band is one to seven years. Based on the duration of our asset classes, our neutral asset allocation mix over time of 40-40-20 would lead to a duration of around four years. In the last several quarters we have been within half a year that duration figure.

For a security to become a core position, we must feel comfortable that we understand the risks we're taking and that we're being paid sufficiently to take those risks. We will develop a thesis on how the investment or business will progress, the motivations of the management team, and the direction they want to take the business. If we progress through those steps and believe we'll be compensated for the risks, the position will find its way into the portfolio.

What do you do to address diversification?

Some of it is inherent in the asset allocation mix we develop over time. Obviously, diversification plays a pretty big role as a risk mitigant in the portfolio. Historically, our investment-grade holdings have demonstrated relatively strong downside protection.

When the US went through the recent crisis, higher-quality investment grade holdings held up pretty well and certainly provided a risk diversifier in multi-sector portfolios.

Additionally, our exposure to bank loans provides diversification to interest rate risk. Bank loans tend to be around a quarter of a year in duration, give or take, depending on whether or not they have a LIBOR floor. They are a low-duration asset class that, in a rising rate environment, should provide protection against one of fixed income's greater risks.

How do you define and manage risk?

Well, I'll start with what we don't do: little to no securitized debt, not much non-USD currency exposure, and not much in the way of derivatives. The main risk in this portfolio, broadly speaking, comes through general downside credit risk, duration risk, and liquidity risk. Those are our three main risk factors.

In mitigating credit risk, the first line of defense is to focus on downside protection with our analysts and through our underwriting process. That's why we spend as much time as we do trying to understand the credit risk of each security, the recovery prospect when a company in the portfolio is struggling, and calculating how to minimize such risk when we do our credit underwriting.

We also monitor our duration exposures, credit quality exposures (using external credit rating services), and sector concentration security limits. We actively monitor the portfolio's liquidity to make sure the portfolio is constructed properly and there aren't any unintended risks in that process.

The overriding asset allocation mix does provide some risk mitigation through a variety of economic environments. While high yield has been the anchor for the strategy, investment grade and bank loans provides diversification in times of rising rates or economic slowdowns essentially acting as a diversifier through the entire economic cycle. T

Pacific Funds Strategic Income Fund

Company	Pacific Funds
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The Barclays U.S. Aggregate Bond Index is composed of approximately 7,000 asset-based, corporate, government, and mortgage-backed bonds; commonly used to track the performance of U.S. investment grade bonds.

About Risk

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