

Portfolio Manager Viewpoints

Bank loans have had a strong start in 2015. Positive technicals, improved risk sentiment, and a snapback 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 2015 outlook.

Start at the top, assess the capital market environment

Rosiak: Entering 2015, valuations for credit assets, notably bank loans and high yield, were attractive given the weakness seen in late 2014. An improvement in risk sentiment and technicals along with an energy market rebound have created above coupon returns thus far. As we enter the middle of 2015, focus remains on the Federal Reserve and the timing of a tightening cycle. Market sentiment would benefit from a slow and low path to policy hikes, which is conducive for credit risk given a “good enough” 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 |
| Int 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

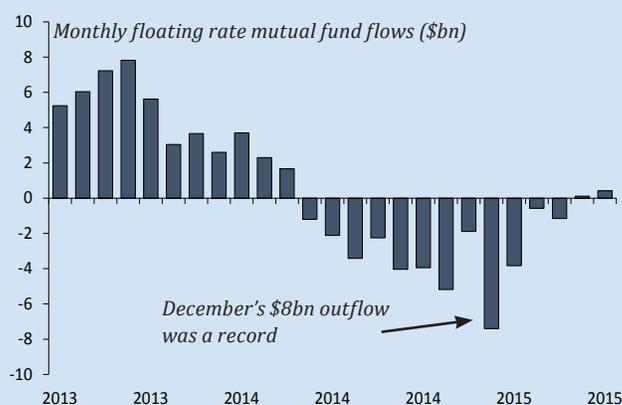
Describe the bank loan market performance over the past year

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, becoming tailwinds as bank loans have returned above coupon.

Going with the Flow

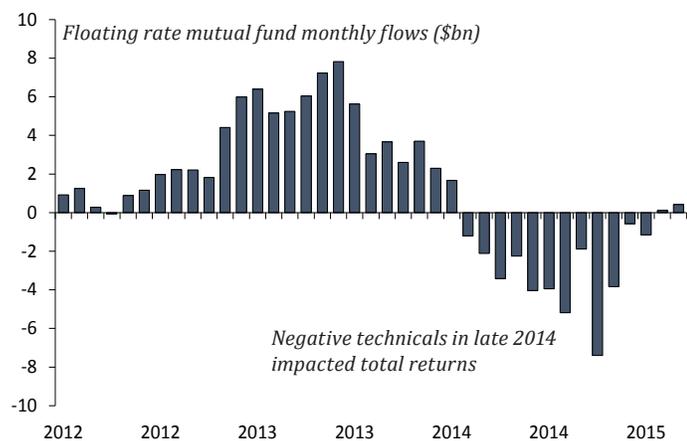
Recent fund flows and technicals have helped fuel above coupon returns for bank loans thus far in 2015.

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



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

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) |
| Repricing | (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) |

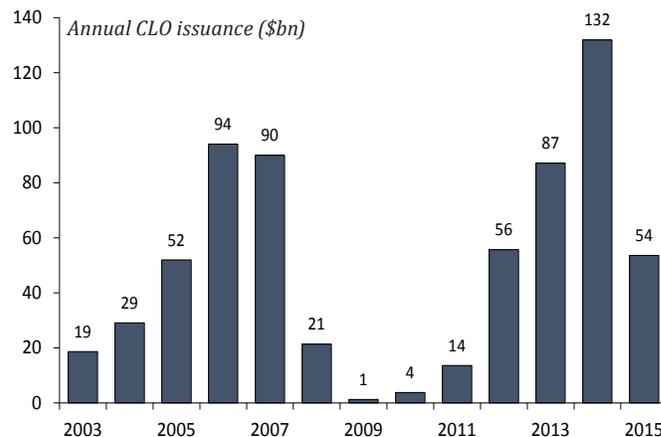
Source: JP Morgan, as of May 29, 2015. Surplus/shortfall takes net primary issuance and subtracts retail fund flows and CLO issuance to get a net demand. A positive number means supply outpaced demand.

What will be the impact of Dodd-Frank and the risk retention for CLO issuance?

Marzouk: As part of Dodd-Frank legislation, sponsors (aka asset managers) of any structured product (CMBS, CLO, CDO, RMBS), will be required to retain 5% of each tranche 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 LSTA fought hard against the ruling, CLO’s were not given an exemption. The capital requirements could be onerous for smaller or independent asset managers, potentially impacting 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 CLO’s reach refinancing windows, we may see a tapering of issuance given the concerns towards retention requirements.

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

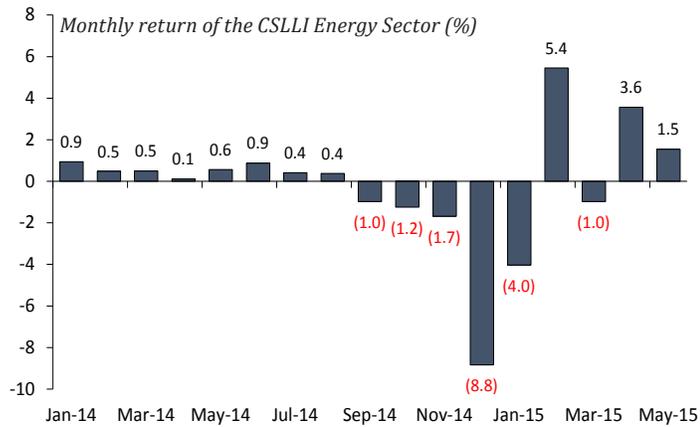


Source: JP Morgan, as of May 29, 2015

How do you articulate 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, coinciding with oil reaching \$44 per barrel (Chart 3). Since late January, 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.

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 sufficiently appealing to increase our energy exposure. First, while we have selective energy issuers in the portfolio, 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

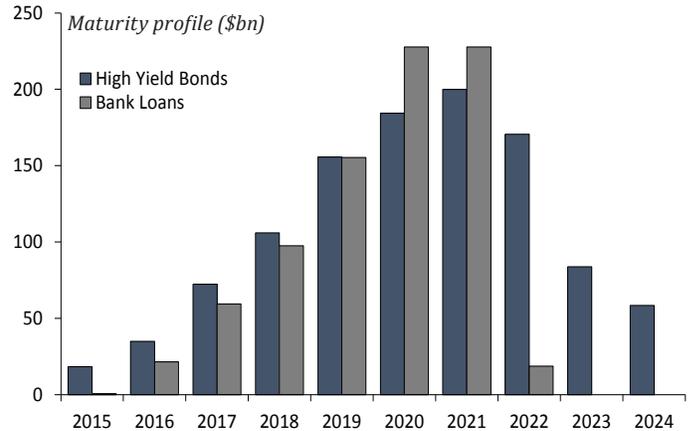
Marzouk: We have seen a reversal in technicals and risk sentiment help propel bank loans to above coupon returns year-to-date. We viewed the total return profile for 2015 as coupon plus, perhaps 5-6%. With such a strong first half, income and yield are likely to drive total returns for the remainder 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 the valuations and technicals. What about the fundamental outlook?

Leasure: Our theme in loans over the past few years has been limited refinancing risk, right sizing of corporate balance sheets, and slow but positive U.S. GDP growth extending the credit cycle, creating a favorable fundamental backdrop. U.S. corporate profits are continuing to generate free cash flow and provide the 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 ma-

terialize 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: ML/BOA 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 negates the income advantage for bonds over loans. We believe second lien loans are a more attractive way to capitalize on higher returns.

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 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 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 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 snapback in performance as technicals and risk sentiment have improved. A combination of stable fundamentals, “good enough” economic growth, and low absolute yield levels on traditional fixed income 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.

Pacific Asset Management
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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. As of March 31, 2015 Pacific Asset Management managed approximately \$4.8bn.

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