ticker

Best Credit Ideas Drive Returns

With a focus and expertise in domestic credit markets, Pacific Funds℠ Strategic Income represents a highly selective, multi-sector strategy that invests primarily in high yield bonds, investment grade bonds, and bank loans. Portfolio manager Brian Robertson relies on extensive fundamental research and the experience of his team to run a flexible and diversified best-idea portfolio, designed to perform throughout a 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.

How has the fund evolved since inception?

Pacific Asset Management was formed in 2007 with the intent to create a third-party asset management firm, primarily focusing on traditional US credit and driven by fundamental research. We initially anchored with three investment strategies totaling a little over $1 billion – high yield, investment grade and bank loans. Now, 13 years later, our assets under management crossed $12 billion as we've seen growth across a diversified mix of investment strategies. We began with six investment professionals and have grown to more than 20 today.

The Strategic Income Fund was launched at the end of 2011 as an extension of our expertise in the asset classes of high yield bonds, investment grade bonds, and bank loans. The multi-sector strategy is designed to represent our best ideas portfolio and capitalize on our team structure. Our analysts cover the traditional credit spectrum, from AAA rated bonds to distressed. We believe this lens provides an advantage in terms of relative value across the credit universe, so we created a fund that could utilize that advantage. This foundation has not changed.

While I have been a lead portfolio manager on the fund since inception, a few years ago we added David Weismiller and Michael Marzouk as portfolio managers to the fund. David is one of our investment grade portfolio managers and Michael is one of our loan portfolio managers. This helped formally bring their asset class expertise to the portfolio while also providing a more specialized approach to the individual positions.

How does the fund differ from its peers?

Our primary differentiator is our focus on U.S. Corporate Credit. It sounds surprisingly simple, but in the multi-sector universe, there are limited fund options with the focused asset class exposures we offer. A byproduct of this focus is our exposure to bank loans, where we have a strong stand-alone bank loan track record. Today, about 20% of the portfolio is in bank loans; it has been more than 30% in the past. Across the multi-sector universe, we tend to be among the largest users of bank loans and believe that they offer an important asset allocation role, especially during rising rate environments. Additionally, as opportunities appear through a cycle, we have the flexibility to invest smaller portions of the fund in structured credit, emerging market credit, and equities, but the core of what we do will remain traditional US credit.

A significant differentiator is that we build the portfolio around the best ideas and make sure that they are the drivers of return. We are highly selective as we invest in 125 to 175 issuers, which generally contrasts with the larger, more macro oriented funds that will invest across thousands of line items.

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Lastly, flexibility, in part from size, and in part from liquidity of the asset class, has enabled the fund to generate strong returns through the many rate and economic environments. With a firm size of $12 billion and strategy size of $750 million, we have flexibility and are able to move in and out of positions and between asset classes with manageable transaction costs. We can take shorter-term defensive or aggressive position as we feel necessary as maneuver the portfolio based on our team's outlook. Given fixed income liquidity has been challenged at times post-crisis, we believe this flexibility has been and will continue to be beneficial.

What core beliefs drive your investment philosophy?

Consistent with our differentiators, our philosophy focuses on credit fundamentals, selective portfolio construction, and flexible portfolio management. First, we focus on corporate credit and employ a bottom-up process that emphasizes downside protection to help generate strong risk-adjusted return. The second is selective construction. We make sure that individual positions make a difference, so limiting the number of names and issuers is a big part of what we do. The third pillar is managing a flexible strategy, which is especially important in a multi-sector approach.

We believe US credit offers strong relative value opportunities over a full cycle, but not every portion of the market is attractive at any point in time. It is a diverse universe and there are ways to protect investors' capital during expansion, early cycle, late cycle or a recession. Historically, US credit, especially the higher-quality portions of high yield, has provided some of the best risk-adjusted returns among the investable assets. The cross-over portion between investment grade and high yield has been the sweet spot over the years, though not always in favor.

Another core belief is that fixed income markets aren't always efficient, so being passive isn't an effective way to manage a credit portfolio. The universe is too diverse and is less liquid than the equity markets, so it is hard to replicate a benchmark, especially in leveraged credit. We believe some of the inefficiencies can come from less flexible mandates, which can create forced buyers or sellers in certain situations, and that managers with more flexible mandates can take advantage of these opportunities.

Our approach in creating the firm was to develop a focused and specialized group, which would allow us to build expertise without being distracted by other asset classes. Our mix of asset classes allows us to position around different macro environments through a cycle. Investment grade, bank loans and high yield generally outperform at different points during a cycle. While investment grade is more correlated to interest rates and does better when rates are coming down, high yield tends to be more sensitive or correlated to the equity markets. This has led to higher returns historically for high yield but with more volatility and larger drawdowns over time. Bank loans, because of the floating rate nature, historically provide more protection when rates are rising. Our goal is to build diversified portfolios that can survive at different points in the cycle.

What are the key steps of your investment process?

The process starts with a macro assessment, which helps to frame our asset allocation decisions across the fund's main asset classes. In this macro assessment, we factor in broad corporate health, asset class technicals, and more specific relative value. Once this is determined, we then work with our experienced analyst team to screen the universe of potential investments. A big part of what we do is traditional underwriting and fundamental analysis. We are ultimately looking to narrow down the broad universe to the top 125-175 issuers that would provide a diversified portfolio of the best risk adjusted return ideas. The portfolio is then built name by name and monitored daily.

In Strategic Income, we combine our view about where we are in the cycle with where we see ideas from our analysts. Asset allocation decisions cannot be made in isolation and be based solely on either the macro view or the ideas of the analyst team. For instance, if we want to overweight high yield but there aren't sufficiently compelling individual risk/reward opportunities there, we won't force names into the portfolio just to have exposure from a macro standpoint.

Everyone on our team, including the portfolio managers, has a background in research. We all started in credit and it certainly helps that we speak the same investment language. Everyone can contribute to conversations and make sure ideas are vetted while being cognizant of the risks.

Would you describe your research process?

Our analyst team is industry focused and covers investment grade, bank loans and high yield. We have an experienced analyst team that plays a large role in the process. We place a lot of trust in their views and their recommendations, especially since many of our investment professionals have gone through full cycles and covered their sectors for a long time. Over time, they have built relationships across the industry from sell-side analysts, to buy-side peers and company contacts to continue to build out their knowledge base.

Our analysts have to construct their thesis about how an industry is going to evolve, what companies are going to survive and thrive, what the drivers are, how industries have changed over time, etc. Once they build this thesis and conclude that an investment opportunity is compelling, the analysts present their ideas to the portfolio management team. These ideas can come from the new issue market or can be secondary opportunities.

We discuss these prospects early on in the process with our analyst team to determine the potential for a portfolio fit. If we see an idea as worthwhile, we do the work to understand the company inside and out. Because we manage highly selective portfolios, we can easily cut companies if we aren't comfortable with the business model or some potential changes occurring in the respective industry. We focus on performing companies so we generally aren't looking to concentrate in loan to own opportunities or distressed situations.

An example illustrating one step in the information gathering phase of the process, our energy analyst recently participated in a group meeting with energy executives and other investors to gain insight into the rapidly evolving, and much discussed energy space. Shale energy companies have been a large component of the high-yield index, so it is important to know the changes in the business model and the investor views. The view of the industry has changed materially, and companies used to be rewarded for growing at all costs. Now, both equity and fixed income investors really want to see that the shale producers can grow within cash flow. That's a dramatic change and has had an impact on equity multiples and thus greatly impacted the debt trading levels of levered high-yield companies. Conversations like these help to frame our positioning. That is part of the mosaic that has led us to have a more conservative position in the energy exploration and production sector in high yield.

Overall, it is a collective effort, but the portfolio manager is responsible for the ultimate decisions. We utilize the insights from our analyst team and bring together a relative value perspective both across industries and asset classes.

Do you have an internal rating system or do you rely on external ratings?

We do not assign formal internal ratings. For core positions, our analysts do a full write-up, which involves a discussion on the industry, the company, its financials, and how it has evolved over time. Our focus is on how the business is going to perform over the medium term.

The credit ratings from the rating agencies are a data point in that process. We are all aware that sometimes they are spot on, sometimes they are not, but these ratings can be a driver for some investors. Even if you don't believe in all the ratings, they can affect the relative value of securities. Overall, ratings represent an input in our process, but they do not drive our decisions.

For us, it is important to evaluate how an investment opportunity compares at a particular point in time. These opportunities are evaluated relative to other comparable opportunities from an industry, rating category, or broad asset class. We form our opinion on where it should trade today on a spread basis versus other companies. This provides a framework for relative value that we can utilize over time.

What is your portfolio construction process?

Our benchmark is the Bloomberg Barclays U.S. Aggregate Bond Index, but we differ quite a bit from it. Our internal starting point over a full market cycle is a neutral asset allocation mix of 40% high yield, 40% investment grade and 20% bank loans, but we will use the portfolio's flexibility over time around these weights.

For example, today we have exposure of 25% in high yield, which is higher than the index, but is 15% underweight to our strategic allocation. This reflects our opinion that relative value is not as attractive in high yield as a neutral exposure would be. This internal neutral target provides a starting point for us to build the portfolio.

We target 125 to 175 names across all asset classes. For individual issuers, we usually start with position sizes of 40 to 50 basis points, so they are large enough to drive returns and warrant the work necessary to follow. On the higher end, our largest positions are 2% or 2.5% and often times represent less volatile holdings. To avoid adding too much incremental volatility, most of our larger holdings are either investment grade or higher-quality high yield bonds and bank loans. Currently, we have a slight overweight to the investment grade market and from an industry perspective, banking is our largest sector at about 10% to 12% of the fund.

Diversification is a key aspect of the portfolio construction as it is crucial to preserve investors' capital on the downside. Once we set up our preferred asset allocation mix which delivers that diversification, our focus is on picking the right names in the portfolio that can deliver strong returns with manageable downside.

What is your buy-and-sell discipline?

The buy-and-sell discipline is built in the construction process. The small number of issuers simplifies the buy and sell decisions. For each security, we need to understand the risk, the business and the sector. Everything that we own serves a purpose. It could be defensive yield or an expected catalyst such as an IPO or improving fundamentals. If the name doesn't have a place or serve a purpose, we have plenty of other names to choose from.

On the sell side, everything that we own competes against the investable universe. We make sure to move on when an investment no longer works for the portfolio. Typically, for a position is sold for two reasons. First, when our thesis has played out, the security has performed well and relative value is no longer attractive. The second reason is the opposite – if the company has performed poorly and we no longer feel as though the return potential warrants the downside risks. We aren't automatic sellers in situations where the borrower becomes troubled, but we do ensure through incremental underwriting that the risk/return opportunity is still compelling.

How do you define and manage risk?

Risk and reward are highly intertwined; they are part of the investment decisions and our job is the seek out opportunities where the equilibrium is in our favor. We know that any potential reward is not free and we need to balance the risk against that. At the individual security level, we lean into the experience of our analyst team as risk analysis is a large part of the standard bottom-up fundamental process.

On the portfolio level, our risks are reasonably simple. For many of our investors, it starts with the risk we rarely incur. The portfolio is almost entirely, and has almost always been, a USD based portfolio, and has very limited use of derivatives and mortgaged-backed securities.

Our three main risks are credit, duration and liquidity. Credit risk ultimately is the primary risk we are managing. We've built our firm and our processes in order to understand credit risk and we make sure to thoroughly underwrite our investments on the front end as well as monitor that risk. Through our analysis of relative value, we also look to ensure that there is adequate compensation for the credit risk that we take.

From a duration perspective, the benchmark typically has higher duration than our portfolio by virtue of the asset classes that we are involved in. Both the high yield and bank loan asset classes have lower durations than investment grade. The balance of these asset classes for our portfolio can change over time depending on our asset allocation decisions but for us has resulted in a portfolio duration generally between 3 and 4.5 for the fund. When we buy individual securities, the impact on the overall portfolio duration is one of many considerations.

We manage liquidity risk on an individual security and total portfolio basis. Some of our screens help us to manage the liquidity risk, because we screen out most middle market and smaller names. To run a flexible fund and move in and out of markets, we need to operate in securities that provide that flexibility. In bank loans and investment grade, where the upside is more limited compared to high yield, we need to be able to move on when the upside is realized. T

Pacific Funds Strategic Income Fund

Company	Pacific Funds
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	PLSFX (Advisor Class)
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Source: Company Documents

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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.

One **basis point** equals 0.01%.

Duration is often used to measure a bond's or fund's sensitivity to interest rates. The longer a fund's duration, the more sensitive it is to interest-rate risk. The shorter a fund's duration, the less sensitive it is to interest-rate risk.

About Principal Risks

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