PACIFIC FUNDS

PACIFIC FUNDS℠

ULTRA SHORT INCOME COMMENTARY

MARCH 31, 2022

SUB-ADVISED BY PACIFIC ASSET MANAGEMENT LLC

Advisor Class		Class I	
Ticker	**Fund Number**	**Ticker**	**Fund Number**
PLUDX	019	PLUIX	419

Market Overview

The "fog of war" has been used to describe the confusion, uncertainty, and unknown outcomes associated with an intense military battle. A version of this "fog" can be experienced in arenas, including today's markets. Opaqueness of geopolitical environments, health pandemics, central bank policy, and inflationary concerns need be navigated with fluidity and, tactical awareness through this volatility.

Globally, the war in the Ukraine will likely be a significant drag on growth worldwide. Per The Conference Board, "The deleterious effects will come from not just higher gasoline prices, but higher prices for food, metals, and intermediate inputs to manufacturing, and weaker GDP growth as consumers pull back spending." This, coupled with broken supply-chains, will likely fuel higher inflation prints. Global GDP estimates for 2022 and 2023 are now at 3.3% and 2.6%, respectively, both down from 5.9% in 2021. Given this backdrop, real economic growth slowed in the first quarter of 2022. The initial estimate of Q1 real U.S. GDP growth was -1.4%, down dramatically from the 7% for the previous quarter.

Stateside, both the ISM Services and Manufacturing indices have remained in expansionary territory, yet general trends warrant some concern. Month after month, respondents have continued to experience inventory and supply-chain constraints, higher input costs due to increased inflationary pressures, qualified-worker shortages, and the waterfall effect on pricing of fuel and various commodities directly related to the Ukrainian crisis. Despite pricing increases, demand has continued to outpace supply, and general activity has increased as most COVID-19-related restrictions have been lifted. However, inflation remains problematic with the Consumer Price Index's (CPI's) most recent print of 8.5% marking the fastest increase in over 40 years. That said, the Core Inflation Index (which measures prices, excluding more volatile food and energy costs) increased at a slower rate in March than it did in previous months, potentially indicating that the pace of inflation may be peaking. Notable was the difference in the pace of inflationary prints and the ability of prices to remain at elevated levels for some time. The argument for the former reaching peak pace over the latter may be easier to make now.

A key counter force to today's inflationary environment is the Federal Reserve. Historically, it has buffered periods of high inflation by increasing the federal funds rate, and this time has been no different. However, the pace and amount per hike combined with quantitative tightening may prove to be a very thin tightrope the Fed must balance or risk severe economic consequences. In March, the Fed increased the benchmark rate by 25 basis points to a range between 0.25% and 0.50%—the first hike in over three years.

Cementing the globalization of today's markets, several Fed officials have indicated they would have preferred a 50 basis points hike in March but for "great near-term uncertainty associated with Russia's invasion of Ukraine." Earlier this year, the Fed expected inflation to be reduced by spring as supply-chain bottlenecks improved, yet the war in Ukraine and recent COVID-related lockdowns in China appeared to have ended any expectation of near-term relief from a healing supply chain. "As we set policy, we will be looking to actual progress on these issues and not assuming significant near-term supply-side relief," Fed Chair Jerome Powell said. More aggressive rate hikes are also under consideration via 50-basis-points increments through the summer. Recent Federal Open Market Committee (FOMC) minutes noted that officials appeared close to finalizing a plan to shrink their asset portfolio, which nearly doubled in size over the past two years. Discussion of reducing assets at a considerably faster pace than last seen in 2019 may involve allowing up to $60 billion in Treasuries and $35 billion in mortgage-backed securities to mature each month. Chair Powell previously stated that the portfolio runoff may equate to an additional 25-basis-points rate increase. Suffice to say, the Fed is expected to move quickly and with purpose to combat inflation, while not stifling economic growth.

Accounting for the myriad of headwinds seen in the first three months of the year, the S&P 500 Index returned -4.61%. Rate

pressures translated broadly across various fixed-income asset classes over the first quarter. The investment-grade market (represented by the Bloomberg US Aggregate Index) was strongly negative, returning -5.93%. The high-yield market (represented by the Bloomberg US Corporate High Yield 2% Issuer Cap Index) was not exempt from external pressures, resulting in a first quarter total return of -4.82%. The short end of the yield curve, as represented by the two-year U.S. Treasury bond, experienced material steepening, rising 155 basis points, ending the period at 228 basis points. Meanwhile, the long end of the curve, as represented by the 30-year U.S. Treasury bond, steepened but not as much as the short end of the curve, moving 54 basis points higher, ending at 2.44%. The 10-year U.S. Treasury yield ended the quarter 80 basis higher at 2.32%.

While markets attempt to navigate these roads, we would like to pause here and highlight that aside from the economic impacts associated with the Ukrainian invasion, it is the tragic humanitarian emergency that remains at the forefront. We hope for resolution and peace, and our thoughts are with those suffering.

Asset Class Overview

Short-duration investment-grade bonds (measured by the Bloomberg 1-3 Year US Government/Credit Bond Index) returned -2.49% in the first quarter of 2022. The negative return seen in the first quarter has not been worse on a quarterly basis since the first quarter return of 1980 (-2.55%). The primary driver resulting in such a challenged total return was the market's pricing in of current and anticipated rate increases by the Federal Reserve. The 3-month Treasury note moved 46 basis points higher, the 2-year Treasury moved 155 basis points higher, and the 3-year Treasury moved 148 basis points higher in the span of only three months. Such a prolific move higher in rates in such a short time is nearly unheard of. The Bloomberg 1–3 Year US Government/Credit Bond Index ended the quarter with an average price of $98.55, down from $101.52 to start 2022. Over the quarter, the yield-to-worst of the index moved materially higher by 161 basis points, ending at 2.42%. Spreads widened by 5 basis points to end the quarter at 15 basis points. As of late, the short end of the curve may now appear interesting to targeted investors seeking shorter-term, high-yielding, investment-grade-rated debt to complement their fixed-income portfolio. The short end of the fixed-rate market has significantly less duration than the intermediate or longer portion of the market thus allowing it to outperform credits further extended on the curve. With a duration of 1.92 years, the index provided some insulation from the move higher in rates.

Fund Performance

Pacific Funds Ultra Short Income (Advisor Class) returned -0.63% versus the Bloomberg Short Treasury Total Return Index return of -0.13%.

Portfolio Review

Sharply higher interest rates led to negative returns for short- and intermediate-duration, fixed-rate, fixed-income securities. Corporate spreads in the 1-3-year range widened from 42 to 59 basis points, adding to the challenging environment for short-duration credit assets. The Bloomberg US 1-3 Year Corporate Index and the Bloomberg ABS fixed index returned -2.47%, and -2.88% respectively. Floating-rate bank loans as measured by the Credit Suisse Leveraged Loan Index returned -0.10%. The fund's corporate-credit exposure totaled approximately 70%, which was allocated across investment-grade corporate bonds (63.8%) and floating-rate bank loans (6.2%). Investment-grade corporate-credit exposure detracted from quarterly performance due to impact from both duration and spread widening. Floating-rate bank loans continue to serve as a source of low-rate duration with attractive yield and were a positive relative return contributor. On a sector basis, the fund's media and entertainment, independent exploration and production (E&P), and cable and satellite positions contributed to relative returns, while its electric utility, automotive, and finance-company positions detracted from performance. The fund continues to maintain an overweight to the banking sector with exposure of approximately 25%. Banking holdings are primarily focused on U.S.-centric top banks. The allocation to securitized assets of approximately 23% detracted from

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performance. Securitized holdings were focused primarily on senior collateralized loan obligations (CLOs) floating-rate securities (15.8%), fixed-rate auto asset-backed securities (1.5%) and student loan asset-backed securities (5.5%). The fund's AAA CLOs outperformed corporates due to their floating-rate nature, but fixed-rate asset-backed securities positions detracted from performance due to Treasury curve steepening and credit-spread widening. The fund's longer-than-index duration of .58 years versus .36 years also detracted. The fund held an average cash position of 4.98%.

Manager Outlook

The first quarter saw the Fed follow through with its forecasted approach of tighter monetary policy as it seeks to fight a persistent inflationary environment. The Fed increased short-term rates by 25 basis points in March and continues to support additional hikes in 2022 (approximated at 200 basis points), thereby altering the shape of the curve. The front to intermediate portion of the curve steepened materially, while the back end of the curve (while still higher) flattened due to growth concerns and the war in Ukraine. Unlike early 2021, where spreads helped cushion rate volatility, U.S. credit spreads ended the quarter 21 basis points higher than where they started the year. The extent to which the curve has priced in current and anticipated rate hikes (coupled with unknown effect of quantitative tightening) remains to be seen. However, dislocations are being created across risk markets, creating both valuation stress and opportunities for market participants.

For the most part, corporate fundamentals entered the year strong and are currently in a good spot. Overall leverage is back to pre-pandemic levels with cash generation near all-time highs. However, we are beginning to see economic pressures build on many fronts. The first is the impact of inflation on corporate margins. Whether it be from higher food, energy or labor costs, more and more sectors are struggling to keep up with higher costs. Secondly, we are starting to see consumer sentiment negatively impacted by the recent spike in food and energy costs, which could hurt overall demand for corporate goods and services. Also, in its quest to slow inflation, the Fed's more hawkish policy will most certainly have a negative impact on overall domestic growth (we are already seeing mortgage rates spike). Finally, the Russian/Ukraine conflict is pressuring growth in Europe, which will impact multi-national corporate earnings. While we expect the current net upgrade trend to continue in the near term, we are becoming more cautious on overall fundamentals and how that may play through to longer-term ratings.

The technical picture has been quite negative over the past quarter. With the Fed on a more-aggressive-expected monetary policy path, rates have moved significantly higher. This has led to historic negative returns across the investment-grade landscape and has led to significant retail outflows for investment-grade funds. Investment-grade corporate supply has also been unexpectedly high, with first-quarter primary issuance one of the highest on record. Corporate borrowers are trying to get ahead of rate increase and use the primary issuance market to refinance higher cost debt, create liquidity for share buybacks or help fund merger-and-acquisition activity.

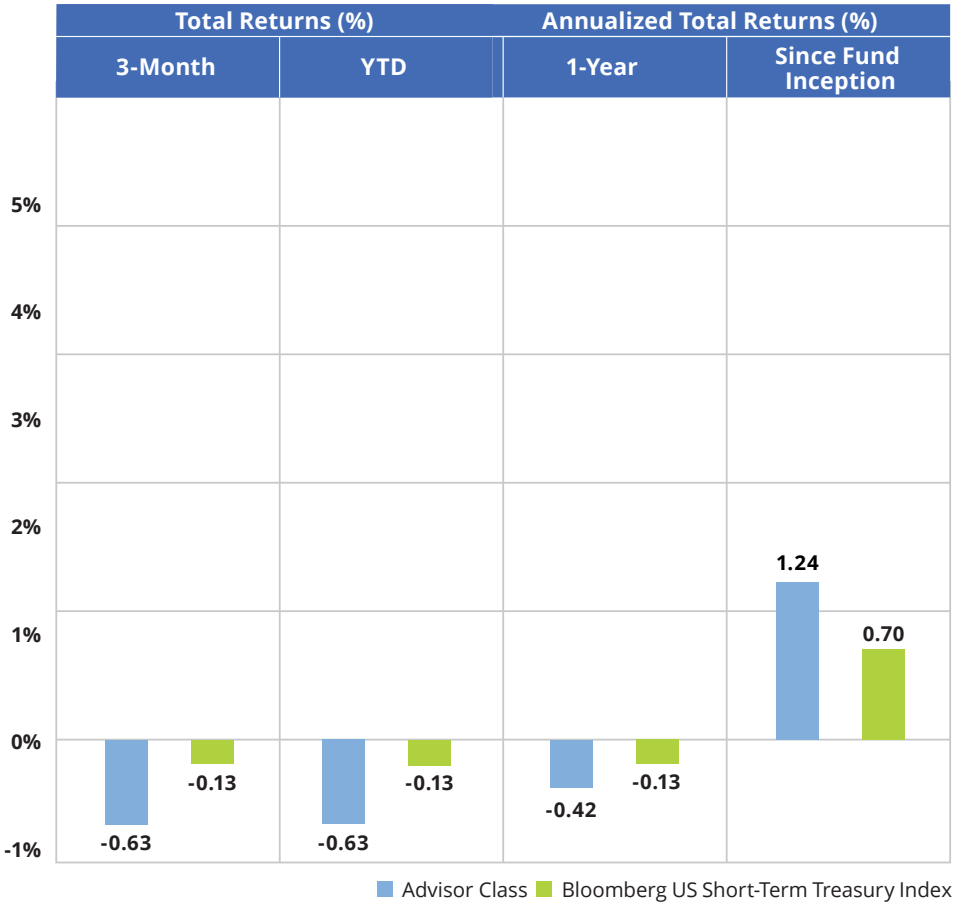
The relative value picture for investment-grade credit is mixed. U.S. credit spreads have reacted to interest-rate volatility by widening 21 basis points in the first quarter after widening 7 basis points in the prior quarter. While this creates a more attractive entry point, heightened rate volatility and concerns around future growth could create further upside pressure on spreads, as we saw in the last monetary policy tightening environment in 2018. While the spread outlook is less certain, what is certain is that all in investment-grade yields are much more attractive than where they were at the beginning of the year and where they were a year ago. The yield-to-worst on the U.S. credit index as of March 31, 2022 was 3.52%, which is 127 basis points higher than when we started the year and 184 basis points higher than where we started 2021.

Where do we still see value in this environment? We still like some re-opening trade sectors that have continued to see strong demand, despite inflation and growth concerns, such as airlines, aircraft leasing, leisure/lodging and domestic gaming. Large U.S. banks should continue to be fundamentally sound as net-interest margins improve with higher rates. Other sectors will face tougher inflationary and supply-chain disruptions, including technology, consumer products and certain retailers. We remain cautious on the technology and healthcare sectors due to valuations and increasing shareholder friendly activities.

History tells us that an aggressively hawkish Fed can create significant volatility across risk markets and that policy can create downward revisions to potential growth. With this in

mind, we believe starting to add higher-quality duration makes sense, especially on the front end of the curve for shorter-duration portfolios where coupons have grown the most. And while we remain cautious, all-in yields for the asset class will continue to improve as interest rates move higher. Higher-quality investment-grade that can withstand higher inflation should do well in the near term. We see value in asset-backed securities and AAA/AA collateralized loan obligations (CLOs) as sound structures and diversification should help limit fundamental deterioration. We believe floating-rate loans continue to be a good place to be as fundamentals are sound, defaults minimal and technicals strong. We are also allocating to a number of rising-star candidates within high yield as upward rating migration continues.

Advisor Class



Top-10 Holdings	Maturity	Weight (%)
Mitsubishi UFJ Financial Group, Inc. 3.455%	3/02/2023	2.96
JPMorgan Chase & Co.	2/24/2026	2.61
MAGNE 2015-16A	1/18/2028	1.82
DTE Energy Company 2.25%	11/01/2022	1.55
Morgan Stanley	5/08/2024	1.55
Siemens Financiering-smaatschappij NV	3/11/2024	1.53
Daimler Trucks Finance North America LLC	4/05/2024	1.53
Skandinaviska Enskilda Banken AB	9/01/2023	1.53
US Treasury 0.125%	6/30/2022	1.53
NextEra Energy Capital Holdings, Inc.	2/22/2023	1.53
Total		**18.16**

Net annual operating expenses for Advisor Class are 0.33% and total (gross annual) expenses are 0.68%. Returns reflect reinvestment of dividends and distributions. The Fund's annual operating expenses shown above are effective 8/1/21 through 7/31/22. Gross Expense Ratio reflects the total annual operating expenses paid by the Fund. **Net Expense Ratio** reflects waivers, reductions, reimbursements, and the limitation of certain "Other Expenses." Expense caps and/or fee waivers are reevaluated annually. There is no guarantee that the investment adviser will continue to cap expenses after the expiration date. Please see the current prospectus for detailed information.

Indexes are unmanaged and cannot be invested in directly. Further, they hold no cash and incur no expenses. All share classes may not be available at all firms and not all investors may be eligible for all share classes.

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Definitions

One **basis point** equals 0.01%.

The **Bloomberg 1–3 Year US Government/Credit Bond Index** is a performance benchmark of U.S. investment-grade government and corporate bonds with maturities of one to three years.

The **Bloomberg Asset-Backed Securities (ABS) Index** is the ABS component of the Bloomberg Barclays U.S. Aggregate Index that measures the performance of ABS with the following collateral types: credit and charge card, auto and utility loans. All securities have an average life of at least one year.

The **Bloomberg Short Treasury Total Return Index** is a performance benchmark of all U.S. Treasuries that have a remaining maturity between one and twelve months.

The **Bloomberg US Aggregate Bond Index** is composed of investment-grade U.S. government bonds, investment-grade corporate bonds, mortgage pass-through securities, and asset-backed securities, and is commonly used to track the performance of U.S. investment-grade bonds.

The **Bloomberg US Corporate Bond Index** includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements.

The **Bloomberg US Corporate High Yield Bond Index** measures the USD-denominated, high yield, fixed-rate corporate bond market

The **Consumer Price Index (CPI)** is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Changes in the CPI are used to assess price changes associated with the cost of living.

The **Credit Suisse Leveraged Loan Index** is designed to mirror the investable universe of the U.S. senior secure-credit (leveraged-loan) market.

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.

The **ISM Manufacturing index** is also known as the Purchasing Managers' index (PMI) and is an indicator of the economic health of the manufacturing sector and is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

The **S&P 500 index** is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the U.S. stock market.

Yield to worst is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

About Principal Risks

All investing involves risks including the possible loss of the principal amount invested. Corporate bonds are subject to issuer risk in that their value may decline for reasons directly related to the issuer of the security. Not all U.S. government securities are checked or guaranteed by the U.S. government, and different government securities are subject to varying degrees of credit risk. Mortgage-related and other asset-backed securities are subject to certain rules affecting the housing market or the market for the assets underlying such securities. The Fund is subject to liquidity risk (the risk that an investment may be difficult to purchase, value, and sell particularly during adverse market conditions, because there is a limited market for the investment, or there are restrictions on resale) and credit risk (the risk an issuer may be unable or unwilling to meet its financial obligations, risking default). High-yield/high-risk bonds ("junk bonds") and floating-rate loans (usually rated below investment grade) have greater risk of default than higher-rated securities/higher-quality bonds that may have a lower yield. The Fund is also subject to foreign-markets risk.

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Diversification does not assure a profit, nor does it protect against a loss in a declining market.

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