INVESTMENT COMMENTARY

This third quarter was a rough one on several fronts. Yet in the face of escalating tensions with North Korea, muted Federal Reserve (Fed) economic optimism, another failed pass at Affordable Care Act (ACA) repeal, and three hurricanes hitting the US and its territories, the ever-optimistic investors chose to focus on the prospect of tax cuts; however, we believe passage of any meaningful legislation also appears doubtful. Against this background, the 2-year treasury yield climbed 10 basis points (bps) in the third quarter, while the 10-year yield rose 3bps. We continue to remain skeptical that we have the correct fiscal and monetary policies to sustain future economic growth. The Fed announced that they will gradually reduce the size of their balance sheet by not reinvesting the paydowns of mortgage-backed securities. However, with the reported unemployment rate below the 5% Fed target and inflation under control, market expectations are for the Federal Reserve to either continue or even accelerate the pace of rate hikes. We believe that the fragility of the financial system and the massive amounts of debt caused by years of zero interest rate policy and multiple rounds of quantitative easing cannot be simply undone without caution. As a result, we expect a more measured pace of rate hikes for 2017 and beyond, coupled with a slow decrease in the size of the Fed balance sheet.

We believe the rate trajectory uncertainty, along with all the other factors that have created more bond market volatility should persist for some time. This volatility continues to create opportunities in several high quality corporate names. We are invested in several credits that we believe are undervalued on a risk-adjusted basis and should continue to provide value added as markets normalize and investors become more selective and risk-reward sensitive. We think any future rate hikes by the Federal Reserve should cause spreads to tighten even further and provide investors with excess returns, although not without the occasional reversals.

Our strategy remains more defensive, electing to add value to our portfolios by investing in high quality corporate bonds, while maintaining the risk of our portfolios at acceptable levels. Because our process emphasizes risk-adjusted yields, we believe our portfolios will tend to have more yield than the benchmark (BofA Merrill Lynch 1-Year US Treasury Note Index), which should also benefit returns. We are however, selective in the names we purchase, and we emphasize stable credits, that are undervalued on a risk-adjusted basis, which are sold when reach their fair values.

Given the future growth uncertainties, our portfolio duration has remained neutral relative to the benchmark, while we also maintained our barbell yield curve positioning with greater emphasis on longer corporate bonds and shorter government securities. Over the next few quarters we anticipate a further flattening of the credit curve and expect our longer maturity corporate bonds will continue to outperform their shorter maturity counterparts.

We maintain our overweight in industrial bonds, which provide our portfolios with additional yield. We selectively invest in finance names whose yields we believe more than fairly compensate for their risk, as we think the spreads offered by the sector overall, still only fairly compensate for the sector volatility. We are modestly overweight agency mortgage backed securities, as sector valuations remained at fair values on a risk-adjusted basis.

Evangelos Karagiannis
Managing Director,
Senior Portfolio Manager

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Mutual Fund investing involves risk. Principal loss is possible. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in Asset Backed and Mortgage Backed Securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. The Fund may invest in derivatives, which may involve risks greater than the risks presented by more traditional investments. The risk of owning an ETF or mutual fund generally reflects the risks of owning the underlying securities that the ETF or mutual fund holds. It will also bear additional expenses, including operating expenses, brokerage costs and the potential duplication of management fees. These risks are fully disclosed in the Prospectus.

Fiscal Policy - The means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy.

Monetary policy - consists of the actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Zero Rate Policy - a method used, by the United States Federal Reserve, Japan and several EU memeber nations, for stimulating growth while keeping interest rates close to zero.

Yield Curve - A line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt.

Spread - The difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

Yield - The income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost.

Basis point (bp)- A unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument.

Duration - A commonly used measure of the potential volatility of the price of a debt security, or the aggregate market value of a portfolio of debt securities, prior to maturity. Securities with a longer duration generally have more volatile prices than securities of comparable quality with a shorter duration.

Barbell - An investment strategy primarily applicable to fixed-income investing, in which half the portfolio is made up of long-term bonds and the other half comprises very short-term bonds.

The BofA Merrill Lynch 1-Year US Treasury Note Index is comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month that issue is sold and rolled into a newly selected issue. The issue selected at each month-end rebalancing is the outstanding Treasury note that matures closest to, but not beyond, one year from the rebalancing date. To qualify for selection, an issue must have settled on or before the month-end rebalancing date. You cannot invest directly in an index.

Past performance is not a guarantee of future results.

P I A
Pacific Income Advisers

1299 Ocean Avenue Second Floor Santa Monica California 90401

telephone 310.255.4488 facsimile 310.434. 0100

www.pacificincome.com