Q4 2016 | Putnam Diversified Income Trust Q&A

Multisector strategy fuels positive results amid supportive backdrop

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Despite rising interest rates, demand for credit risk remained strong amid improving U.S. economic growth and a positive post-election outlook.

The fund's interest-rate and yield-curve strategies, both domestically and overseas, and its active-currency strategy bolstered performance in the fourth quarter.

U.S. economic growth may accelerate in 2017 and could provide a potentially beneficial environment for the fund's strategies and overall positioning.

What was the fund's investment environment like during the fourth quarter of 2016?

Despite rising interest rates, the environment was generally favorable. Improving economic data fueled investors' appetite for risk, creating strong demand for securities across the risk spectrum.

Corporate credit spreads tightened, reflecting investor demand for credit risk amid improving U.S. economic growth and a positive post-election outlook for 2017. Credit spreads represent the yield advantage corporate bonds offer over comparable-maturity U.S. Treasuries. They tend to widen when investors become risk averse and narrow or tighten when investors are more comfortable taking on additional risk.

Internationally, the economic picture was less positive. Many economies outside the United States faced ongoing challenges, underscoring their sharp contrast with the strengthening U.S. data. The dichotomy was clear in monetary policies. Most foreign central banks continued on a path of easing, while the Federal Reserve remained steadfast in its stated plan to eventually normalize interest rates.

In fact, the Fed increased its target for short-term interest rates by a quarter percentage point at its December 14th meeting. The Fed also indicated that it may raise rates faster than previously indicated if U.S. economic growth shows signs of accelerating in 2017, which sent U.S. Treasury yields to a multiyear high. Despite higher rates and the Fed's marginally hawkish tone, investor risk appetite remained strong.

The benchmark 10-year Treasury yield trended gradually higher from midsummer through the end of October, then spiked in the week following the U.S. presidential election. It reached a high of 2.57% in mid-December and finished the period only slightly below that level.

The U.S. dollar strengthened during the quarter and reached a 14-year high shortly after the quarter ended. U.S. gross domestic product advanced at a seasonally adjusted annual rate of 3.5% in the third quarter, according to the Commerce Department — the strongest quarterly reading in two years after three straight quarters of growth below 2%. Stronger economic growth, a view that growth could benefit from a more robust fiscal policy, and indications from the Fed that it may take a more-aggressive approach toward monetary tightening, fueled the dollar's rise.

The fund generated a positive return for the quarter and outpaced its benchmark, the Bloomberg Barclays U.S. Aggregate Bond Index. Which holdings and strategies fueled performance?

Our interest-rate and yield-curve positioning in the United States and overseas was the biggest contributor to performance. We continued our efforts to de-emphasize interest-rate risk by keeping the portfolio's duration — a key measure of interest-rate sensitivity — below zero. This strategy was particularly helpful in November when intermediate- and long-term Treasury yields rose sharply in response to the U.S. presidential election outcome and President-elect Trump's proposed fiscal policy. We also positioned the portfolio to benefit from a potentially steeper U.S. Treasury yield curve, which also worked well as the curve steepened in November.

Internationally, our holdings of Greek government debt also contributed. The country's bonds rallied on increased investor optimism that they might eventually be included in the European Central Bank's bond purchase program. Additionally, maintaining negative duration strategies in various countries proved additive as interest rates rose.

On balance, active currency strategies also contributed for the period, as most major currencies weakened versus the U.S. dollar. Specifically, short positions in the British pound sterling and Japanese yen, along with tactical positioning in the Swedish krona, helped and more than offset negative results from long positions in the Australian dollar and the euro.

An out-of-benchmark stake in high-yield bonds was another bright spot. A variety of factors bolstered high-yield corporate credit, including stronger economic growth, expectations that growth in 2017 could benefit if the incoming Trump administration launches more-robust fiscal policy, a minimal 12-month default rate excluding commodity-related sectors, and reduced year-over-year new issuance.

How did mortgage credit influence performance?

Within mortgage credit, holdings of agency credit risk-transfer securities [CRTs] provided a further boost to performance. Launched in late 2013, CRTs are backed by a reference pool of agency mortgages. Unlike regular agency pass-throughs, the principal invested in CRTs is not backed by Fannie Mae or Freddie Mac. To compensate investors for this risk, CRTs offer higher yields than conventional pass-through securities. Similar to commercial mortgage-backed securities [CMBS], CRTs are structured into various tranches offering different levels of risk and yield based on the underlying reference pool.

During the quarter, the combination of relatively high yields and high-quality collateral continued to attract investors to CRTs. Furthermore, CRTs provided investors with a productive alternative to deploy their capital as other parts of the residential mortgage-backed securities [RMBS] market continued to shrink.

Holdings of pay-option adjustable-rate mortgage-backed securities also contributed. These positions benefited from the generally favorable risk environment during the period, as well as the fact that there was no new supply of these bonds coming to market.

On the downside, specific holdings of seasoned mezzanine CMBS backed by certain types of commercial properties underperformed and modestly offset the overall positive contribution from our mortgage credit investments.

Did any other strategies help to build returns?

Within our prepayment strategies, holdings of agency interest-only collateralized mortgage obligations performed well and modestly aided performance. Rising interest rates provided a tailwind for these investments, helping to keep mortgage prepayment speeds below market expectations. Additionally, mortgage refinancing continued to be hampered by stringent bank-lending standards.

Investments in emerging-market debt [EMD] continued to be a productive part of the portfolio. This period, positions in Russia and Venezuela added the most, helped by higher oil prices and persistent investor demand for high-yielding securities.

What is your near-term outlook?

We think U.S. economic growth may accelerate in 2017, but the election of Donald Trump as president could lead to a struggle of competing forces influencing the economy. On the one hand, we believe President-elect Trump's policy pronouncements regarding lowering corporate and personal income tax rates, along with increasing spending on infrastructure and defense, could bolster growth. Of course, these initiatives will need to be financed at least partly by issuing new government debt, which would tend to push intermediate- and long-term interest rates higher.

Conversely, the President-elect's protectionist rhetoric regarding foreign trade, such as imposing substantial tariffs on imports from China and eliminating or weakening existing trade deals, would likely hamper growth, in our view. A more stringent immigration policy — another Trump proposal — could also dampen economic growth, since it would remove a source of consumer demand. It's also possible that a more protectionist approach to trade by the United States could hamper growth in emerging-market countries.

It will take some time for clarity on what the Trump administration's actual policy priorities will be, as well as which measures have the best chance of being approved by Congress. In the interim, we think some level of market volatility is likely due to increased uncertainty.

Given this outlook, how do you plan to position the fund?

In our view, the macroeconomic environment may be supportive for the fund's strategies and general positioning.

In terms of positioning, our non-U.S., quantitatively driven, negative-duration strategies moved the fund's total duration further below zero. We also extended our strategy of seeking to capitalize on potentially steeper global yield curves. We think this overall positioning could benefit the fund if interest rates continue to trend higher in 2017.

Putnam Diversified Income Trust (PDVYX)

Annualized total return performance as of 12/31/16

Class Y shares Inception 7/1/96	**Net asset value**	**Bloomberg Barclays U.S. Aggregate Bond Index**
Last quarter	3.60%	-2.98%
1 year	5.37	2.65
3 years	1.23	3.03
5 years	4.88	2.23
10 years	3.83	4.34
Life of fund	6.34	6.33

Total expense ratio: 0.73%

Returns for periods of less than one year are not annualized.

Current performance may be lower or higher than the quoted past performance, which cannot guarantee future results. Share price, principal value, and return will vary, and you may have a gain or a loss when you sell your shares. Performance assumes reinvestment of distributions and does not account for taxes. For the most recent month-end performance, please visit putnam.com. Class Y shares before their inception are derived from the historical performance of class A shares (inception 10/3/88), which have not been adjusted for the lower expenses; had they, returns would have been higher. For a portion of the periods, this fund may have had expense limitations, without which returns would have been lower. Class Y shares are generally only available for corporate and institutional clients and have no initial sales charge.

The Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities. You cannot invest directly in an index.

We plan to continue seeking opportunities in corporate and mortgage credit that we believe offer relative value. Within those market areas, we continue to have a constructive outlook for high-yield bonds, based on what we think is a generally favorable fundamental and technical backdrop for the asset class. We also continue to like CMBS due to the attractive spreads available there.

We plan to maintain the fund's exposure to select emerging-market countries, seeking to benefit from the relatively high income levels available in markets in which we believe we're being properly compensated for risk.

Lastly, we expect to maintain a sufficient cash allocation to provide a cushion against bouts of market volatility, as well as any disruptions in the market's supply/demand environment.

The views and opinions expressed are those of the portfolio managers as of December 31, 2016, are subject to change with market conditions, and are not meant as investment advice. All performance and economic information is historical and is not indicative of future results.

Consider these risks before investing: International investing involves currency, economic, and political risks. Emerging-market securities carry illiquidity and volatility risks. Lower-rated bonds may offer higher yields in return for more risk. Funds that invest in government securities are not guaranteed. Mortgage-backed securities are subject to prepayment risk and the risk that they may increase in value when interest rates decline and decline in value when interest rates rise. Bond investments are subject to interest-rate risk (the risk of bond prices falling if interest rates rise) and credit risk (the risk of an issuer defaulting on interest or principal payments). Interest-rate risk is greater for longer-term bonds, and credit risk is greater for below-investment-grade bonds. Risks associated with derivatives include increased investment exposure (which may be considered leverage) and, in the case of over-the-counter instruments, the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. Unlike bonds, funds that invest in bonds have fees and expenses. Bond prices may fall or fail to rise over time for several reasons, including general financial market conditions, changing market perceptions of the risk of default, changes in government intervention, and factors related to a specific issuer or industry. These factors may also lead to periods of high volatility and reduced liquidity in the bond markets. You can lose money by investing in the fund.

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