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Absolute return strategies offer modern diversification

Key takeaways

Absolute return strategies have a different return and risk profile than traditional funds that invest in stocks and bonds.

Independent from traditional benchmark indexes, absolute return strategies have flexibility to seek to protect capital during bear markets.

Putnam offers a suite of absolute return funds intended to give investors the opportunity to reduce long-term portfolio volatility.

Investors who have grown accustomed to investing in stocks and bonds for pursuing their long-term financial goals may be looking for something more. Over the past 15 years, stock markets have encountered high volatility more frequently, testing investors risk appetites. Similarly, bond yields have also been falling, reducing income potential. Together, these forces are driving investors to seek new ideas for generating returns while seeking to control risk.

Fortunately, there is an alternative that investors can explore to complement traditional investments in their portfolios — absolute return strategies. Different by philosophy, absolute return strategies offer an approach that addresses investors' concerns about both market volatility and reaching their performance objectives more consistently.

Unconstrained by benchmarks, absolute return strategies can flexibly adjust to changing market conditions and emerging risks, making them attractive choices to diversify traditional portfolios.

The key distinction of absolute return strategies is their focus on generating a positive risk-adjusted return stream over time, regardless of market conditions or direction. Absolute return performance is measured against a cash benchmark (Treasury bills), which is a significant point of differentiation versus more traditional mutual funds that are generally measured against an asset-class benchmark, like the S&P 500 Index for stocks or the Bloomberg Barclays U.S. Aggregate Bond Index for bonds. The focus on generating absolute returns can make these strategies valuable tools for portfolio construction by enhancing diversification, helping to reduce risk, and dampening overall portfolio volatility.

This paper describes how absolute return strategies provide modern diversification and how they are different from traditional funds. After outlining the attributes of traditional funds, the paper explores the following features of absolute return investing:

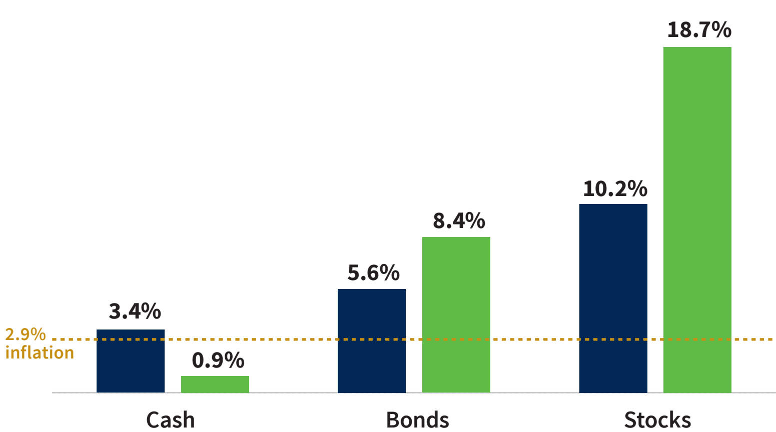
- Flexibility and independence from traditional benchmarks
- Downside protection in bear markets
- Risk reduction through diversification

Traditional funds are tied to the risks of asset class benchmarks

Investors turn to stocks and bonds as a way to build long-term wealth because these asset classes have a historical track record of positive performance over long-term periods. Investors can earn a greater return from owning stocks and bonds than they earn from short-term securities such as Treasury bills (also known as risk-free assets) because they carry a number of risks and their prices can change frequently. This additional return is called a risk premium. Over the long haul, the risk premium has given stocks and bonds a significant return advantage.

While the return advantage of stocks and bonds is attractive, it is important to remain aware that the risk of these investments, as measured by volatility, is much greater than the risk of owning cash. In other words, owning investments over a long time period can involve tolerating a number of ups and downs. Over the time period shown in the historical return example below, bonds were 9 times as volatile as cash, and stocks were 20 times as volatile. Investing in stocks or bonds as an asset class means accepting these higher levels of volatility in a portfolio.

Traditional funds typically pursue returns from stocks and bonds, while absolute return objectives align with cash



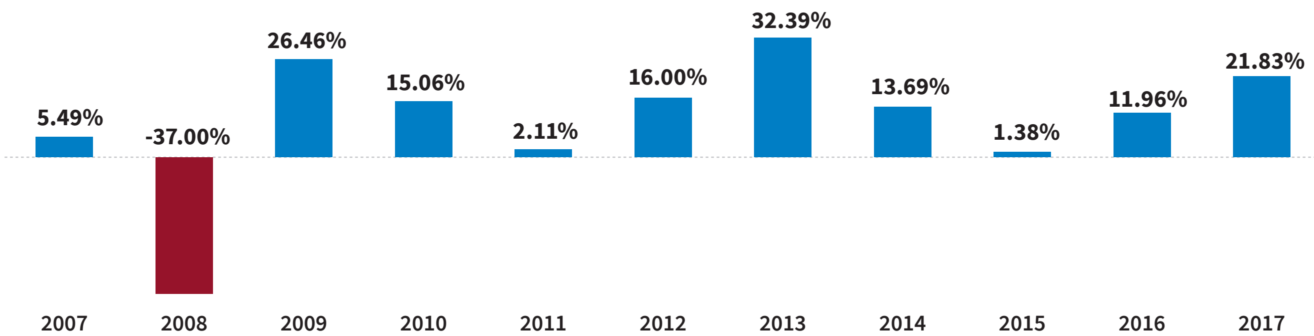
Stocks and bonds have outperformed cash, but with significantly more volatility

- Annualized returns (12/31/1925–12/31/2017)
- Annualized volatility (as of 12/31/2017)

Source: Ibbotson. Data for the period 12/31/1925–12/31/2017. Stocks are represented by the Ibbotson U.S. Large Stock Total Return Index, bonds by the Ibbotson U.S. Long-Term Government Bond Total Return Index, cash by the Ibbotson U.S. 30-day Treasury Bill Total Return Index, and inflation by the Consumer Price Index. The indexes are unmanaged and measure broad sectors of the stock and bond markets. You cannot invest directly in an index. Past performance is not indicative of future results.

The sharp decline in the S&P 500 during 2008's bear market caused a major setback for strategies constrained to invest in stocks

Annual returns of the S&P 500 Index



Source: Putnam.

Benchmarks create investment constraints

Most traditional mutual funds task the portfolio manager with outperforming a stock or bond benchmark such as the S&P 500 or the Bloomberg Barclays U.S. Aggregate Bond Index. In addition to providing a performance comparison, a benchmark also tends to constrain the investment universe. The manager is usually constrained to invest only in the domestic market or in a specific asset class. According to the ICI 2016 Fact Book, over 90% of mutual fund assets are in funds focused on a specific asset class — stocks, bonds, or money market securities. Hybrid funds are an exception. However, only 9% of industry assets are invested in hybrid funds. Furthermore, some traditional funds have even tighter constraints, such as bond funds that only invest in government bonds or high-yield bonds, or stock funds that can only invest in small companies or in value stocks. Such constraints may benefit investors in that they restrict a portfolio manager's investable universe and force deep security-level analysis.

Constraints limit flexibility to address bear market risk

However, putting constraints on a manager may limit flexibility and create disadvantages, such as leaving capital unprotected during market declines. A portfolio manager whose mandate is to stay fully invested in the asset class will, in all likelihood, not be able to avoid a negative result. In fact, a manager may "outperform" the benchmark but still lose money. This is an example of the limitations of a traditional, benchmark-oriented mutual fund.

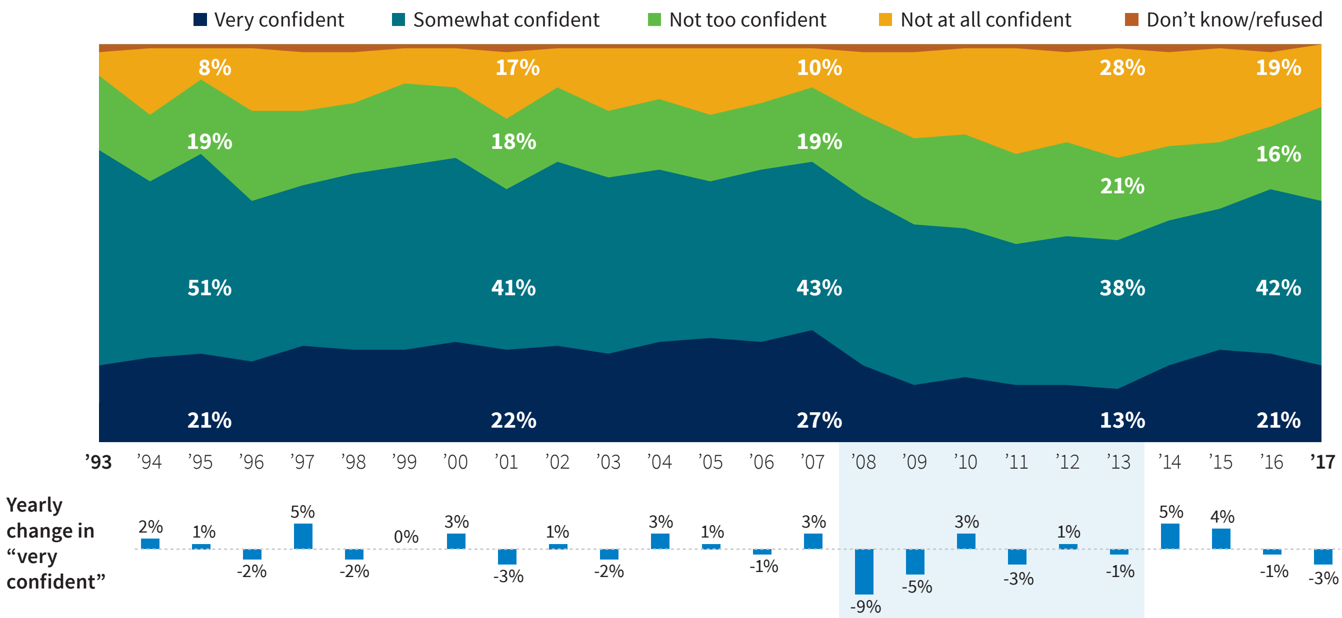
Traditional strategies may not perform well in declining markets. Over the course of a market cycle, prices can drop between 10% and 20% (a "market correction") or in excess of 20% (a "bear market"), and can significantly impair investors' ability to reach their financial goals. Since World War II, stocks have experienced 11 market corrections, in which the S&P 500 Index registered average results of -14.0% over a typical span of seven months. In the same post-war period, stocks have also experienced seven bear markets (the most recent being 2008), in which the S&P 500 registered average results of -31.7% over a typical span of 14 months.

Depending on an investor's age, goals, and time horizon, bear markets can expose investors to a type of risk called the sequence-of-returns risk. Specifically, investors who are at or nearing retirement must be conscious of the damage that a bear market may inflict on their assets and their ability to retire. After the 2008 bear market, for example, people experienced a big drop in their confidence about being able to retire, according to an annual survey by the Employee Benefit Research Institute. Workers' loss of confidence lasted for years.

Since World War II, stocks have experienced seven bear markets, in which stocks have lost an average of -31.7% over a typical span of 14 months.

The 2008 bear market sharply reduced workers' retirement confidence

Respondents were asked, "Overall, how confident are you that you (and your spouse) will have enough money to live comfortably throughout your retirement years?"



Source: Employee Benefit Research Institute and Greenwald & Associates, 1993–2017 Retirement Confidence Surveys.

Absolute return strategies are independent of traditional benchmarks

Absolute return strategies offer an alternative with more tools to counter a bear market. Unlike traditional funds, the performance of absolute return funds is not measured against traditional market indexes like the S&P 500 Index or the Bloomberg Barclays U.S. Aggregate Bond Index. Instead, absolute return funds align their performance with an asset that has lower volatility — cash (as tracked by a benchmark such as the Bank of America U.S. Treasury Bill Index). Absolute return strategies establish a return and volatility framework in excess of cash. This flexible mandate removes the constraints found in most traditional funds and paves the way for the portfolio managers to focus on generating superior risk-adjusted returns over time.

Indexes constrain traditional strategies but not absolute return strategies

One of the more distinctive tools available to absolute return managers is the freedom to invest in a wide range of asset classes. Absolute return strategies may have exposure to stocks, government bonds, cash, real estate, corporate bonds, currencies, and commodities. Investing across a wide range of asset classes with low or negative correlation can improve portfolio diversification.

Similarly, accessing non-directional sources of alpha, which are investments that can move independently of the market's direction, may create a return stream that is less sensitive to and less correlated with traditional indexes. These advanced methods of diversification offer greater flexibility to the manager in pursuit of positive, risk-adjusted returns over time.

The strategies can seek reduced market risk

Unlike traditional funds that compete on the basis of returns relative to a benchmark by seeking out the securities within an asset class that will have above-average returns, absolute return products rely on asset allocation, diversification, and risk-mitigation strategies in an attempt to produce positive returns versus cash, over market cycles. Additionally, absolute return managers are not solely reliant on, or held hostage to, the overall direction of markets. Consequently, an absolute return strategy can be added to a portfolio of traditional funds and improve overall diversification. In turn, this further diversification may allow for an overall reduction in risk at the portfolio level.

Free from constraints of benchmark measurement, the absolute return portfolio manager has the ability to invest globally, to invest across multiple asset classes, and to seek positive returns regardless of market direction.

Flexibility to respond to bear markets

While traditional funds and traditional diversification methods are vulnerable to bear markets, absolute return strategies have greater flexibility and can adapt to market conditions with strategies seeking to stabilize performance. Additionally, the ability to generate returns independent of market direction is critical to pursuing positive, risk-adjusted returns over time. Free from constraints of benchmark measurement, the absolute return portfolio manager has the ability to invest globally, to invest across multiple asset classes, and to seek to generate positive returns regardless of the market's direction. The manager can also use cash as a tool for pursuing better risk-adjusted returns, unlike a manager of a traditional strategy who views cash as an unwanted drag on performance. In an absolute return strategy, the investment team is free to invest in ways that reflect their active views and convictions. This is a critical point of differentiation versus traditional managers who are essentially mandated to be invested (and, most of the time, fully invested) in a specific asset class.

Absolute return funds combine many tools to manage risk

Taking advantage of the broadest possible toolkit, an absolute return approach can seek to mitigate volatility and capture a portion of the upside potential of any market rally.

	ABSOLUTE RETURN FUNDS	TRADITIONAL BOND FUNDS	TRADITIONAL BALANCED FUNDS	U.S. STOCK FUNDS	INTERNATIONAL STOCK FUNDS
Absolute flexibility	●				
Defines positive return targets	●				
AVAILABLE STRATEGIES					
U.S. bonds	●	●	●		
U.S. stocks	●		●	●	
Foreign bonds	●	●	●		
Foreign stocks	●		●		●
Emerging markets	●				●
Commodities	●				
Hedging strategies	●	●			●
REITs	●				
Long/short strategies	●				
Cash	●				

All funds involve different levels of risk, have different fees and expenses, and have different objectives that you should consider before investing. Absolute return funds have fewer limitations on where they can invest as compared with traditional funds. They have the ability to move among security types (i.e., stocks, bonds, cash, and alternatives), capitalization ranges, styles, durations, credit qualities, and geographic regions. This flexibility in terms of asset allocation offers the advantage of improved portfolio diversification as compared with many traditional funds. Absolute return funds also may have additional risks that traditional funds might not incur such as investing in derivatives and commodities, and from the use of leverage.

Putnam's approach to absolute return investing

In 2008, Putnam launched a suite of four absolute return funds to give investors access to non-traditional strategies geared toward generating positive, better risk-adjusted returns and to enhance portfolio diversification. The funds employ strategies that may reduce volatility over time, using modern tools such as derivatives to enhance diversification and mitigate risk. We believe that using absolute return strategies can be valuable in portfolio construction. Investors' reliance on traditional, benchmark-driven strategies may benefit from adding a strategy that seeks improved risk-adjusted returns and increases diversification.

Putnam Absolute Return 100 Fund

Seeks 1% above U.S. T-bills

Putnam Absolute Return 300 Fund

Seeks 3% above U.S. T-bills

FUND STRATEGIES

The 100 Fund and 300 Fund are diversified across fixed-income investments.

Many areas of the fixed-income markets have provided long-term returns near the level of returns pursued by Putnam Absolute Return 100 Fund and 300 Fund. With that as the case, these two funds can pursue their objectives by investing in a diversified mix of fixed-income securities, and they have full flexibility to adjust the mix as market conditions change over time.

Both funds can invest across a wide range of fixed-income securities.

To pursue the higher return objective of the 300 Fund, the portfolio managers have greater latitude to favor strategies with greater return expectations.

VETERAN MANAGEMENT

Putnam's Fixed Income leadership

D. William Kohli
Chief Investment Officer, Fixed Income
Industry since 1988

Michael V. Salm
Co-Head of Fixed Income
Industry since 1989

Paul D. Scanlon, CFA
Co-Head of Fixed Income
Industry since 1986

Albert Chan, CFA
Portfolio Manager
Industry since 2002

- 16 years of experience working together on the fixed income team
- Manage absolute return strategies for institutional investors
- Continuity in fund strategy since 2008 inception

We invest across a wide range of fixed-income securities, chosen for their risk-adjusted return expectations.

The funds offer an alternative to investments aligned with traditional indexes

The four funds share a commitment to pursuing a level of returns that is proportional to their level of risk, as measured by volatility. Each one offers flexible diversification and an alternative to the goal of outperforming common stock or bond market benchmarks. With these attributes, the funds can complement traditional investments in a portfolio to enhance overall diversification.

Putnam Absolute Return 500 Fund

Seeks 5% above U.S. T-bills

Putnam Absolute Return 700 Fund

Seeks 7% above U.S. T-bills

FUND STRATEGIES

The 500 Fund and 700 Fund are diversified across multiple investment asset classes.

With higher return objectives, Putnam Absolute Return 500 Fund and 700 Fund have the flexibility to invest in equities, commodities, and related derivatives. In addition, like the 100 Fund and 300 Fund, they can invest in fixed-income securities. The funds strive to keep performance volatility low by combining a wide range of strategies and assets that do not move in lockstep with each other.

Both funds can invest across multiple asset classes, including stocks, commodities, and currencies.

To pursue the higher return objective of the 700 Fund, the portfolio managers have greater latitude to favor a mix of investments with greater return expectations.

VETERAN MANAGEMENT

Putnam's Global Asset Allocation leadership

Robert J. Schoen
Chief Investment Officer, GAA
Industry since 1990

James A. Fetch
Co-Head of GAA
Industry since 1994

Jason R. Vaillancourt, CFA
Co-Head of GAA
Industry since 1993

- Managed portfolios together at Putnam for 17 years
- Manage absolute return strategies for institutional investors
- Continuity in fund strategy since 2008 inception

We use a variety of tools to implement our investment process as we seek to manage various global risks.

Consider these risks before investing: Allocation of assets among asset classes may hurt performance. 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. These factors may also lead to periods of high volatility and reduced liquidity in the bond markets. 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. Unlike bonds, funds that invest in bonds have fees and expenses. 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 less when interest rates decline and decline in value more when interest rates rise. International investing involves currency, economic, and political risks. Emerging-market securities have illiquidity and volatility risks. The funds may not achieve their goals and are not intended to be a complete investment program. 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. The funds' efforts to produce lower-volatility returns may not be successful and may make it more difficult at times for the funds to achieve their targeted returns. Under certain market conditions, the funds may accept greater-than-typical volatility to seek their targeted return. You can lose money by investing in the funds. The funds' prospectus lists additional risks. **For the 500 Fund and 700 Fund, these risks also apply:** Growth stocks may be more susceptible to earnings disappointments, and value stocks may fail to rebound. Our alpha strategy may lose money or not earn a return sufficient to cover associated trading and other costs. Our use of leverage obtained through derivatives increases these risks by increasing investment exposure.

Absolute return funds are not intended to outperform stocks and bonds during strong market rallies.

A world of investing.®

Putnam INVESTMENTS

Your clients should carefully consider the investment objectives, risks, charges, and expenses of a fund before investing. For a prospectus, or a summary prospectus if available, containing this and other information for any Putnam fund or product, call the Putnam Client Engagement Center at 1-800-354-4000. Your clients should read the prospectus carefully before investing.

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Putnam Retail Management

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