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The power of diversified alpha

Equity Insights offers research and perspectives from Putnam's equity team on market trends and opportunities.

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Equity markets are on track for a strong finish to the year, powered by mega-cap growth stocks — the equity MVPs of 2023. Continued strong earnings growth from these businesses, combined with an easing interest-rate regime, could help the S&P 500 Index grind through 5,000 in 2024. Along with these positive trends, however, there is enough uncertainty to make a more range-bound market possible. Lingering concerns about inflation, the labor market, or recession could stifle earnings growth.

In terms of valuation, rising interest rates put a lid on price/earnings multiples over the past year as bonds became more competitive with stocks. However, the recent retreat in the 10-year U.S. Treasury yield could support growth multiples going forward. Much of this year's market strength was concentrated in a narrow cohort of stocks. But these companies — high-quality businesses with above-average organic growth rates, high returns, strong cash flow, and resilient balance sheets — are deserving of higher p/e multiples.

We don't know what 2024 will deliver in terms of inflation, interest rates, bond yields, or growth and value performance. We do know that, as active managers, we can focus on delivering consistent benchmark outperformance regardless of the market environment.

Seeking a smooth performance journey

With equity portfolios, strong long-term returns come in many forms. Some are the result of steady, consistent performance year after year. Others take investors on a wilder ride. It's likely most investors prefer the smoother journey. And this, we believe, can be achieved with stock-driven portfolios that are less vulnerable to style shifts or other causes of market volatility. A portfolio that leans too heavily toward a particular style, sector, or macro view can result in greater fluctuations, sudden sharp downturns, or prolonged periods of underperformance.

Instead, we prefer a "diversified alpha" approach that seeks to avoid performance extremes. We use a stock-driven — rather than style-driven — process that gives us the chance to outperform our benchmarks in all market environments, regardless of whether indexes are rising or falling, or growth or value is leading. We don't take outsized bets on factors such as sector, style, or company size. Rather, we build portfolios one stock at a time, based on company-specific fundamentals. The goal is to create a portfolio of unique insights. Not every holding will outperform at the same time, but in aggregate, a broad and diverse mix of modestly sized uncorrelated holdings offers greater potential for consistent returns over time — that smoother performance journey.

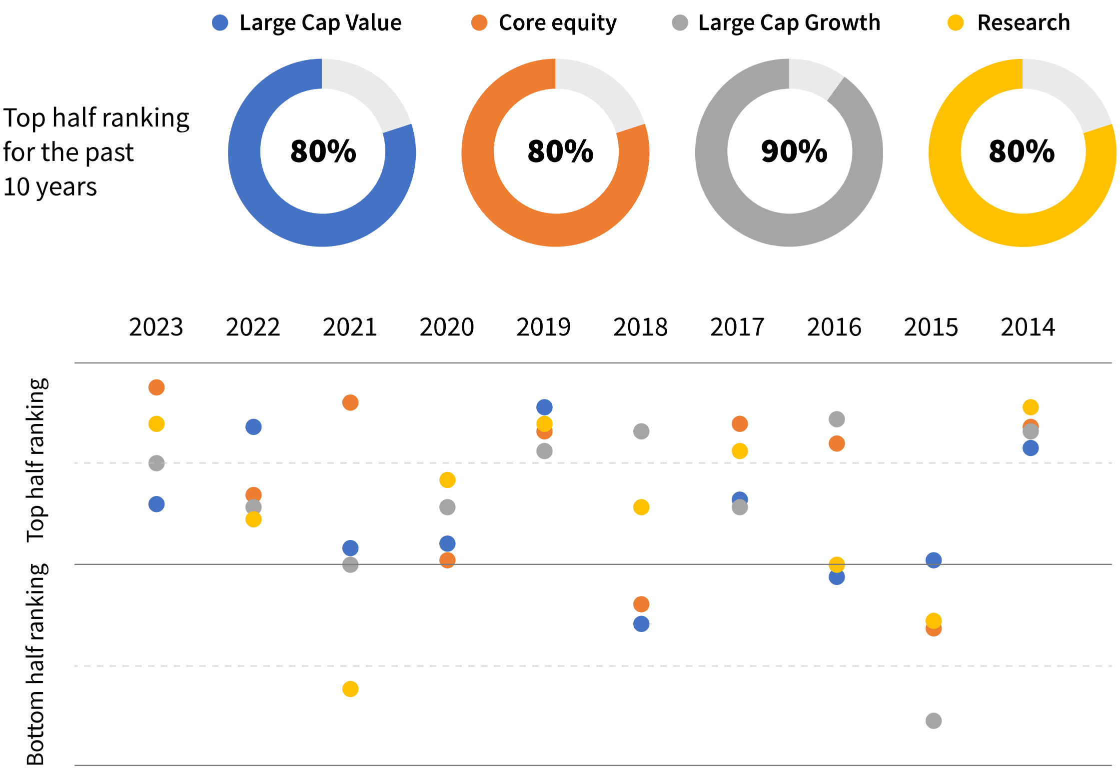
This approach can also reduce a portfolio's tracking error, which measures the consistency of its performance relative to its benchmark. Since we do not invest with a focus on common factors such as style or company size, our portfolios are less exposed to the risks associated with them, which all else equal, dampens tracking errors. But we believe the type of risk we are taking — with the emphasis on stock-specific risk — has the potential to deliver higher information ratios.

The value in avoiding performance extremes

In analyzing our approach, we looked at Lipper rankings of four Putnam equity funds since 2014. Their solid 10-year rankings come from a history of moderate and consistent annual performance. By avoiding performance extremes, three of the funds were in the top half of their peer groups 80% of the time, and Putnam Large Cap Growth landed in the top half 90% of the time. We also found that not all competitors' funds with strong 10-year rankings have offered a smooth ride. Many delivered outsized one-year results and then struggled against style headwinds.

Emphasizing consistency over extremes

Putnam equity fund Lipper rankings, 2014–2023

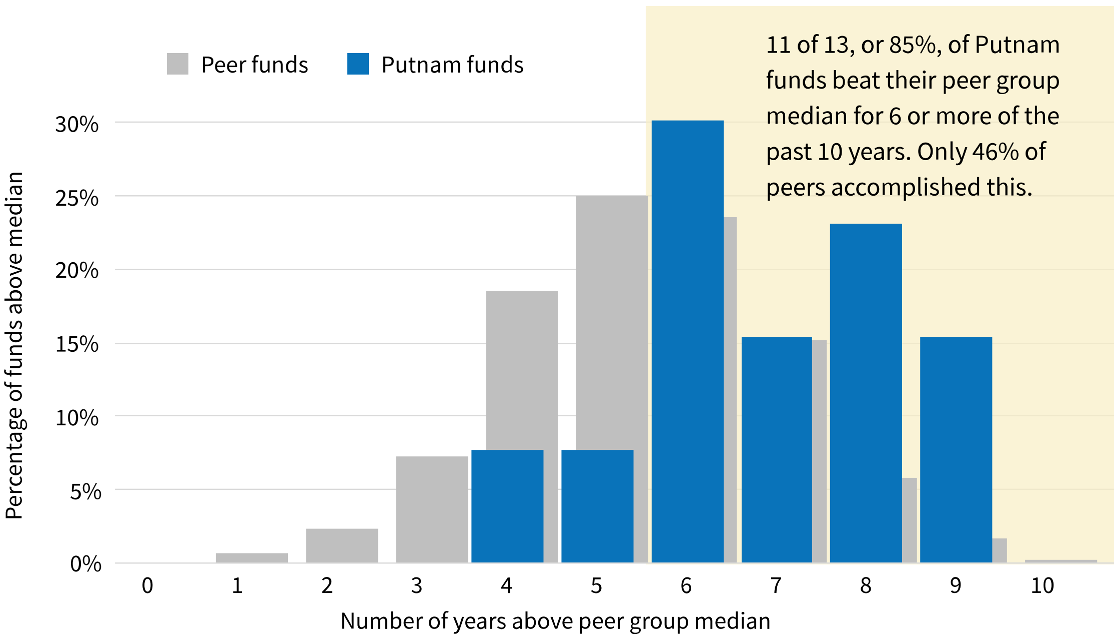


Source: Lipper. 2023 data represents year to date as of 11/30/23.

We also looked at above-median performance for all Morningstar active diversified equity funds. Over the past 10 calendar years, 85% of Putnam funds beat their peer group median for six or more of those years. This puts Putnam at number one in this category versus other fund family competitors. Only 46% of peer funds accomplished this.

Above-median performance from Putnam funds

Morningstar active diversified equity funds, 2013–2022



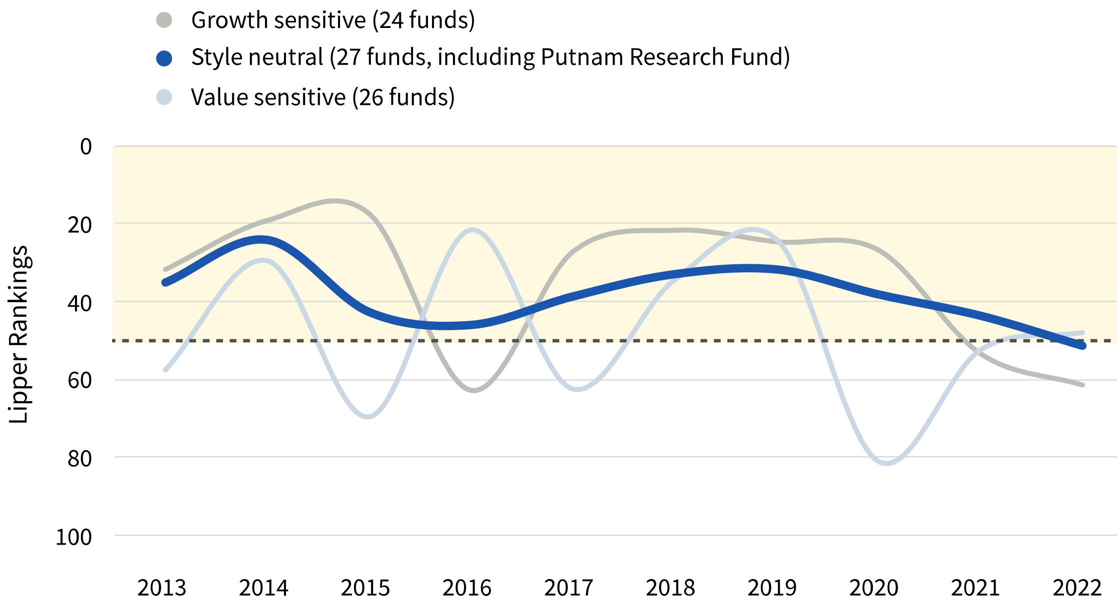
Source: Putnam and Morningstar. We measured all Morningstar listed active diversified equity funds with 10 years of results through year-end 2022. Calendar annual gross return ranking is calculated within peer group for each year of the analysis. Index funds are not included in the ranking or analysis.

Plotting a steadier course by avoiding a strong style bias

We looked at all funds that were in the top quintile of the Lipper U.S. Large Core universe for the 10 years ended 12/31/22. While these funds all delivered strong performance over the long term, those with a notable style bias tended to fluctuate more, testing investors' conviction in the funds with rougher performance rides. Those with neutral style sensitivity, including Putnam Research Fund, offered much more consistent performance.

Style-sensitive funds had greater fluctuations

Lipper U.S. Large Core Funds in top quintile for 10 years ended 12/31/22



Source: Putnam and Lipper. Style sensitivity groups are assigned based on correlation between a 10-year series of Lipper annual percentile ranks and annual return spreads between Russell 1000 Growth and Russell 1000 Value.

An unwavering focus on our active strategies

We are closing out a year of surprises in the financial markets — a robust and resilient U.S. economy, a sharp rally in mega-cap growth stocks, and unprecedented excitement around artificial intelligence, to name a few. But surprises are not the goal when managing portfolios for investors. We look forward to seeking a smooth and better-than-index performance journey for investors in the coming year.

The views and opinions expressed are those of the authors, are subject to change with market conditions, and are not meant as investment advice.

Diversification does not guarantee a profit or ensure against loss. It is possible to lose money in a diversified portfolio.

All investments involve risk, including the loss of principal. Investments in small and/or midsize companies increase the risk of greater price fluctuations. You can lose money by investing.

Consider these risks before investing: Growth stocks may be more susceptible to earnings disappointments, and the market may not favor growth-style investing. The value of investments in the fund's portfolio may fall or fail to rise over extended periods of time for a variety of reasons, including general economic, political, or financial market conditions; investor sentiment and market perceptions; government actions; geopolitical events or changes; and factors related to a specific issuer, geography, industry, or sector. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings. From time to time, the fund may invest a significant portion of its assets in companies in one or more related industries or sectors, which would make the fund more vulnerable to adverse developments affecting those industries or sectors.

The fund may invest a significant portion of its assets in companies in the information technology sector. The information technology sector may be significantly affected by technological obsolescence or innovation, short product cycles, falling prices and profits, competitive pressures, and general market conditions. The fund is considered non-diversified and can invest a greater portion of its assets in securities of individual issuers than can a diversified fund. As a result, changes in the market value of a single investment could cause greater fluctuations in share price than would occur in a more diversified fund.

Our investment techniques, analyses, and judgments may not produce the outcome we intend. The investments we select for the fund may not perform as well as other securities that we do not select for the fund. We, or the fund's other service providers, may experience disruptions or operating errors that could have a negative effect on the fund. You can lose money by investing in the fund.

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