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Q3 2021 | Putnam High Yield Fund Q&A

High yield generates modest gain amid Fed tapering signals

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High-yield bonds posted a moderate advance for the quarter, driven predominantly by income returns.

Security selection in energy contributed the most versus the benchmark, while picks in cable & satellite and gaming, lodging & leisure detracted.

We have a generally positive outlook for the market's fundamental environment and supply-and-demand backdrop, but are more neutral toward valuation.

How did the fund perform for the three months ended September 30, 2021?

The fund's class Y shares rose 0.73%, trailing the 0.96% return of the benchmark JPMorgan Developed High Yield Index.

What was the market environment like for high-yield bonds during the third quarter of 2021?

High-yield corporate credit posted a modest rise for the quarter, driven predominantly by income returns. Relative to other asset classes, high-yield bonds outperformed the broad investment-grade [IG] fixed income market and IG corporate credit, but slightly lagged high-yield bank loans.

High-yield credit spreads widened in July amid increased concern about the Covid-19 Delta variant. [Spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity U.S. Treasuries. Bond prices fall as spreads widen and rise as spreads tighten.] The market pullback continued during the first three weeks of August. A strong July employment report — released on the first Friday in August — along with hawkish comments from U.S. Federal Reserve officials fueled speculation about when the Fed would announce the beginning of the end of its bond-buying program. However, in a much-anticipated late-August speech, Fed Chair Jerome Powell reiterated the central bank's expectation that it would begin tapering bond purchases by year-end without making a firm commitment as to timing. Anticipating this outcome, and also boosted by a strong report on second-quarter corporate earnings growth, the high-yield market rallied during the last week of the month.

Longer-term U.S. Treasury yields jumped higher in late September, dampening the performance of high yield for the month. While the Fed's signal to begin tapering later in the year was expected, investors were surprised when Fed Chair Powell indicated the board intended to conclude all of its bond buying around the middle of next year. Additionally, a fairly aggressive tone by Bank of England policymakers led to a sell-off of government bonds and a sharp rise in yields across Europe.

Within the fund's benchmark, every cohort generated a positive result with returns in a tight range. Energy, utilities, diversified media, paper & packaging, and technology slightly outperformed the benchmark, with each group gaining about 1%. The weakest relative performers included cable & satellite, automotive, and consumer products. From a credit-rating perspective, lower-quality debt delivered the best relative returns, signaling a comfort level with risk as investors sought higher yields.

What factors had the biggest influence on the fund's relative performance?

Security selection in energy added the most value on a relative basis, driven by greater-than-benchmark positions in several top-performing index members. On the downside, picks in cable & satellite and gaming, lodging & leisure dampened performance versus the benchmark.

What is the team's near-term outlook?

We have a positive outlook for high-yield market fundamentals and the overall supply-and-demand backdrop. Our view on valuation is more neutral, given the relative tightness of yield spreads in the market as of quarter-end.

Our optimism is driven by the sizable percentage of Americans who have received Covid-19 vaccines, along with continued government stimulus. We were encouraged that, as of September 30, U.S. cases of, and hospitalizations from, Covid continued to steadily decline, as the country seems to be moving past a July surge caused by the highly transmissible Delta variant.

Within this environment, we remain focused on the health of issuers' balance sheets and liquidity metrics, with an eye toward default risk or a credit-rating downgrade.

Expectations for defaults have meaningfully improved this year, given the liquidity in the market. In our view, many troubled issuers have been given the lifeline they need to continue operating. Including distressed exchanges, the U.S. high-yield default rate ended the quarter at 0.99%, meaningfully below the long-term average of 3% to 3.5%, and down from nearly 7% at the beginning of the year. The departure of large default/distressed totals from September 2020 helped lower the rolling 12-month default rate calculation.

As for supply/demand dynamics, new issuance of high-yield debt totaled $409.7 billion on a year-to-date [YTD] basis through September 2021, a 17% increase over the same period last year. Roughly two thirds of this year's new issuance has been used to refinance existing debt. On the demand side, high-yield funds [mutual funds and exchange-traded funds] experienced outflows of $11.9 billion for the YTD period compared with inflows of $35.9 billion during the same period in 2020. However, the asset class experienced two consecutive months of inflows in August and September 2021. Overall, we think demand from institutional investors for newly issued bonds, along with an uptick in demand from retail investors, supports our positive view of market technicals.

From a valuation standpoint, the average spread of the fund's benchmark widened slightly during the quarter and was at 3.85 percentage points over U.S. Treasuries as of quarter-end, below the long-term average of 6 percentage points. The benchmark's yield was at 4.5% as of September 30, close to a record low. Despite tight spreads and relatively low yields, we think the market's income potential remains attractive in the face of much lower global yields.

How was the fund positioned as of September 30?

Relative to the benchmark, the portfolio had overweight exposure to the higher-quality segment of the market and an underweight allocation in lower-quality bonds. From an industry perspective, we favored broadcasting, diversified media, and housing/building products.

Putnam High Yield Fund (PHAYX)

Annualized total return performance as of 9/30/21

	Class Y shares Inception 12/31/98	**JPMorgan Developed High Yield Index**
Last quarter	0.73%	0.96%
1 year	10.37	11.94
3 years	6.23	6.57
5 years	5.75	6.48
10 years	6.71	7.46
Life of fund	7.35	—

Total expense ratio: 0.79%

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 3/25/86), 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 JPMorgan Developed High Yield Index is an unmanaged index of high-yield fixed-income securities issued in developed countries. You cannot invest directly in an index.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed are those of the portfolio managers as of September 30, 2021, are subject to change with market conditions, and are not meant as investment advice.

Consider these risks before 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.

Lower-rated bonds may offer higher yields in return for more risk. 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 generally greater for longer-term bonds, and credit risk is generally greater for below-investment-grade bonds (a significant part of the fund's investments). 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.

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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Request a prospectus or summary prospectus from your financial representative or by calling 1-800-225-1581. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

Putnam Retail Management

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