Q4 2018 | Putnam High Yield Fund Q&A

High yield falters amid flight from risk

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High-yield bonds ended the year on a weak note as investors shifted away from riskier asset classes.

The fund benefited from underweighting consumer products and transportation, as well as favorable positioning in services. On the downside, security selection in financials and technology, along with positioning in gaming, lodging & leisure, hampered performance versus the benchmark.

As we enter 2019, we have a positive outlook for market fundamentals and think valuations are more attractive. We have a neutral view toward the supply-and-demand backdrop.

What was the market environment like for high-yield bonds during the fourth quarter of 2018?

High-yield bonds declined 4.65% for the quarter, as measured by the JPMorgan Developed High Yield Index, trailing high-yield bank loans as well as the broad investment-grade fixed-income market.

A variety of factors weighed on the asset class during the quarter, including uncertainty about the ultimate resolution of the trade dispute between the United States and China; concern that the Federal Reserve would raise policy rates too fast and choke off economic growth; flagging economic growth in Europe and China, leading to concern about a slowdown in growth globally; a precipitous decline in oil prices; some disappointments in third-quarter corporate earnings, particularly in the technology sector; weak stock market performance, particularly in December; and uncertainty about the ultimate resolution of the United Kingdom's exit from the European Union.

As of December 31, 2018, the energy sector accounted for about 15% of the JPMorgan Developed High Yield Index, the largest industry group in the benchmark. Consequently, oil prices have a major impact on the high-yield market. Despite production cuts by members of the Organization of Petroleum Exporting Countries [OPEC] and Russia, U.S. crude prices fell 38% in the fourth quarter, their biggest quarterly slide since the final months of 2014.

High-yield spreads — the yield advantage high-yield bonds offer over comparable-maturity U.S. Treasuries — increased by about two percentage points during the three months ended December 31, finishing the quarter at 567 basis points, the highest level since October 2016. For context, spreads peaked above 900 basis points in February 2016 during a period of substantial market turmoil. The average spread over the current market cycle is 545 basis points. [A basis point is 1/100th of one percent.]

Within the JPMorgan index, all cohorts posted losses, with energy (-9%), retail (-6%), and telecommunications (-6%) registering the weakest results. Groups outperforming the index included more defensive sectors such as utilities (-1%) and paper & packaging (-3%). Gaming, lodging & leisure (-3%) also held up relatively well. From a credit perspective, lower-quality CCC-rated and split B-rated bonds sold off as investors looked to shed risk, while BB-rated bonds outpaced the index.

For the quarter, the fund lagged its benchmark, the JPMorgan Developed High Yield Index. What factors had the biggest influence on relative performance?

On the plus side, we benefited from underweight exposure to consumer products and transportation, as well as favorable overall positioning in services. A roughly 5% allocation to bank loans also helped. Conversely, security selection in financials and technology, along with adverse positioning in gaming, lodging & leisure, hampered performance versus the benchmark.

What is your outlook for the high-yield market over the coming months?

We evaluate the high-yield market through three lenses: fundamentals, valuation, and “technicals,” or the balance of supply and demand. As of year-end, we thought the fundamental environment was positive, whereas we had a more neutral outlook toward technicals. We thought valuations were more attractive following the selling activity during the fourth quarter.

Despite global trade and political tensions, we think the fundamental backdrop for high yield remains supportive, led by corporate profit growth, a strong labor market, and rising employee wages. When distressed exchanges are included in calculating the U.S. high-yield default rate, the figure was 1.9% as of December 31. This is still well below the long-term historical average of about 3.5%. We think default rates could remain below average for the next year or two, and possibly longer. The two key reasons for our view are the relative financial health of high-yield issuers overall and that many have refinanced and extended bond maturities into the future.

Turning to valuation, we think the volatility and negative sentiment that resulted in materially wider spreads during the quarter created attractive investment opportunities in many areas of the market. As a result, we saw this period of volatility as a window of opportunity to add investments that may offer attractive total return potential.

As for technicals, gross high-yield new-issue activity totaled $187.4 billion for 2018. Due to heightened market volatility, there was no new primary market issuance at all in December, the first time that has occurred since November 2008. Net new volume totaled a meager $73.3 billion in 2018. Fund flows were negative for the year, with $45.1 billion leaving the asset class [mutual funds and exchange-traded funds combined]. In our view, the sizable outflows from high yield have not materially affected the market’s supply-and-demand environment due to the low amount of new issuance.

How have you positioned the fund in light of this outlook?

During the period, we reduced risk in the portfolio by increasing the fund’s allocation to higher-quality, BB-rated bonds while simultaneously shrinking our overweighting in CCC-rated credits. As of December 31, the fund’s duration — a key measure of interest-rate risk — was slightly below that of the benchmark.

At the industry level, we favored gaming, lodging & leisure and financials. Conversely, we had lower-than-benchmark exposure to food & beverages, consumer products, transportation, services, automotive, and health care.

Putnam High Yield Fund (PHAYX)

Annualized total return performance as of 12/31/18

Class Y shares Inception 12/31/98	**Net asset value**	**JPMorgan Developed High Yield Index**
Last quarter	–5.03%	–4.65%
1 year	–3.53	–2.36
3 years	6.09	7.56
5 years	2.96	3.95
10 years	9.60	11.45
Life of fund	7.22	—

Total expense ratio: 0.78%

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 December 31, 2018, are subject to change with market conditions, and are not meant as investment advice.

Consider these risks before investing: Bond prices may fall or fail to rise over time for several reasons, including general financial market conditions, changing market perceptions (including perceptions about the risk of default and expectations about monetary policy or interest rates), changes in government intervention in the financial markets, and factors related to a specific issuer or industry. These and other factors may also lead to increased volatility in the financial markets 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. 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. You can lose money by investing in the fund.

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