Q1 2017 | Putnam High Yield Advantage Fund and High Yield Trust Q&A

Funds post positive returns amid risk-driven environment

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

Norman P. Boucher
Industry since 1985

Robert L. Salvin
Industry since 1986

For the quarter, Putnam High Yield Advantage Fund and Putnam High Yield Trust trailed their benchmark, the JPMorgan Developed High Yield Index.

Overweight allocations to gaming, lodging & leisure, and housing aided the funds' relative performance. Conversely, lighter-than-benchmark exposure to technology and health care detracted.

Given historical patterns, it is possible that high-yield credit could potentially outperform most other types of fixed-rate bonds in an environment of rising rates and inflation.

What was the market environment like for high-yield bonds during the first quarter of 2017?

After ending 2016 on a strong note, the high-yield rally continued in January and February, fueled by investor optimism despite few specifics on the Trump administration's plans for tax reform, deregulation, and infrastructure spending. Rising stock prices, solid economic data, strong earnings, plateauing U.S. Treasury yields, and modest net new issuance also aided the asset class.

March was a volatile period for high yield, as the asset class declined for most of the month before recovering in the final week. The market was buffeted by hawkish rhetoric from the Federal Reserve, a sharp decline in oil prices, rising stock market volatility, heavy new supply, and a failed effort by the U.S. House of Representatives to repeal the Affordable Care Act. Later in the month, however, oil prices rebounded to a three-week high amid signs of growing U.S. demand, a supply disruption in Libya, and speculation that the Organization of Petroleum Exporting Countries might extend its supply cuts into May. Additionally, stock market volatility receded, a near-record stretch of new supply subsided, and retail fund outflows abated.

As expected, the Fed increased its target for short-term interest rates by a quarter percentage point to a range of 0.75% to 1% at its mid-March policy meeting. Fed Chair Janet Yellen expressed confidence in the economy and reaffirmed that the central bank may implement two more increases this year.

Gains were broad-based across industries, led by health care, chemicals, and cable & satellite. Conversely, retail, metals & mining, and consumer products were the weakest performers. Retail was the only industry to post a negative return, as many store operators continued to struggle with declining sales at brick-and-mortar locations. From a credit-quality perspective, lower-quality bonds delivered the best performance, reflecting continued investor appetite for risk.

What factors had the biggest influence on the funds' relative performance during the quarter?

Generally speaking, we take a fairly conservative approach to credit risk. Historically, during periods when market gains are led by lower-quality securities — as was the case this quarter — the funds have generated solid absolute returns but have tended to lag the benchmark.

At the sector/industry level, the funds' benefited from overweights in gaming, lodging & leisure, and housing, along with overall positioning in financials. On the downside, lighter-than-benchmark allocations to technology and health care, as well as positioning in energy, worked against benchmark-relative performance.

What is your current assessment of market fundamentals?

We think fundamentals remain supportive. Fourth-quarter U.S. gross domestic product [GDP] was revised upward from a 1.9% to a 2.1% annual rate, according to the Commerce Department. This follows growth of 3.5% in the third quarter.

The government also reported that corporate profits grew at a 2.3% annual rate in the fourth quarter, down from 6.7% in the third quarter. The downtrend, however, was largely attributable to the impact of a nearly $5 billion settlement between the U.S. subsidiary of Volkswagen AG and U.S. federal and state governments for violation of environmental regulations. The Commerce Department also reported that a measure of after-tax corporate profits jumped 22.3% in the fourth quarter compared with a year earlier.

In our view, the Trump administration's pro-business agenda — reduced regulation, lower corporate tax rates, and increased infrastructure spending — may lead to accelerating economic growth as well as stronger revenue and earnings growth for high-yield companies. That said, with valuations of credit-sensitive bonds appearing elevated, any significant disappointments regarding actual policy implementation may result in periods of volatility.

Tell us more about high-yield valuation at the end of the quarter.

High-yield spreads — the yield advantage high-yield bonds offer over comparable maturity U.S. Treasuries — have compressed significantly, and the average bond price within the index was close to par [face value]. As a result, valuations were not as attractive as they were in 2016.

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

Historically in the high-yield market, spreads have tended to tighten when interest rates and inflation are rising, since the primary determinant of return is credit risk. And tightening spreads have generally served as a positive offset to the negative impact of rising rates on bond prices.

The historical performance of high-yield bonds is negatively correlated with the performance of U.S. Treasuries and investment-grade corporate bonds during periods of rising rates. For example, recent industry research showed that high-yield bonds returned an average of 4.77% during the 15 periods since 1998 when U.S. government bond yields rose by at least a half a percentage point. Investment-grade credit returned -0.66%, on average, over those periods, and 10-year Treasuries returned -5.48%.

Based on historical patterns, we think high-yield credit can potentially outperform most other types of fixed-rate bonds in an environment of rising rates and inflation. That said, returns may be subdued because higher rates could encourage investors to shift to other areas of the bond market offering rising yields.

How do you plan to position the funds in light of this outlook?

Overall, we plan to maintain broad diversification across market sectors. At period-end, the majority of the funds' holdings were in split Ba-rated or B-rated bonds, which occupy the middle tier of high-yield credit quality. In terms of sectors, we favor gaming, lodging & leisure, housing, utilities, and automotive. The funds' biggest underweights were in technology, health care, and retail.

At the end of the period, we had a relatively negative view toward retail, given weak earnings trends and longer-term issues related to brick-and-mortar versus online sales. Consequently, we plan to maintain under-weight exposure there.

We are closely monitoring developments in health care. Headline risk has risen in this sector, due to policy uncertainty regarding the new administration's stance on drug pricing and whether the Affordable Care Act will be overhauled.

We had about 6% of the portfolios invested in floating-rate bank loans and plan to maintain this allocation. We think this allocation provides the funds with a degree of ballast against market volatility. Moreover, if market interest rates continue to move higher, we think demand for bank loans may continue to build since loan coupons will continue adjusting upward.

Putnam High Yield Advantage Fund (PHAYX)

Annualized total return performance as of 3/31/17

Class Y shares Inception 12/31/98	**Net asset value**	**JPMorgan Developed High Yield Index**
Last quarter	2.04%	2.59%
1 year	14.05	17.68
3 years	3.55	4.64
5 years	5.97	7.06
10 years	6.46	7.73
Life of fund	7.60	—

Total expense ratio: 0.82%

Putnam High Yield Trust (PHYYX)

Annualized total return performance as of 3/31/17

Class Y shares Inception 12/31/98	**Net asset value**	**JPMorgan Developed High Yield Index**
Last quarter	2.26%	2.59%
1 year	14.64	17.68
3 years	3.71	4.64
5 years	6.25	7.06
10 years	6.45	7.73
Life of fund	8.54	—

Total expense ratio: 0.77%

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 (High Yield Advantage Fund class A inception, 3/25/86, and High Yield Trust class A inception, 2/14/78), which have not been adjusted for the lower expenses; had they, returns would have been higher. For a portion of the periods, these funds 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.

The views and opinions expressed are those of the portfolio managers as of March 31, 2017, 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 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. 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.

A world of investing.®

Putnam INVESTMENTS

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

Putnam Investments | One Post Office Square | Boston, MA 02109 | putnam.com

TL007 305815 4/17