Q3 2017 | Putnam High Yield Fund Q&A

Fund outperforms as emphasis on quality helps returns

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For the quarter, Putnam High Yield Fund modestly outpaced its benchmark, the JPMorgan Developed High Yield Index.

The fund benefited from security selection in financials and technology, whereas selection in food & beverages and underweight exposure to transportation dampened relative results.

Our outlook for market fundamentals remains positive, but we are neutral on valuation and the technical backdrop.

Note: During the second quarter of 2017, Putnam High Yield Trust merged into Putnam High Yield Advantage Fund, and on May 8, 2017, Putnam High Yield Advantage Fund was renamed Putnam High Yield Fund.

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

High-yield bonds returned 2.05% for the quarter, as measured by the JPMorgan Developed High Yield Index, outpacing high-yield bank loans, as well as the broad investment-grade fixed-income market.

The asset class posted a strong gain in July, alongside a sharp climb in oil prices, positive second-quarter corporate earnings, a benign interest-rate backdrop, fresh record highs for stocks, and light new issuance. In August, high-yield bond prices recovered from an early-month slide fueled by geopolitical tension to finish the month essentially flat. In September, the asset class benefited from receding macro stress, optimism surrounding the release of a tax plan by Congressional Republicans, continued equity market strength, and a firmer backdrop for energy bonds.

U.S. crude oil prices rebounded in the third quarter, fueled by unexpected strong demand, signs of ebbing U.S. production, and refinery disruptions resulting from Hurricane Harvey. The price for a barrel of West Texas Intermediate, the U.S. crude benchmark, ended the period at $51.67, representing a 10.5% advance for the quarter.

U.S. stocks continued to advance in the quarter, with the bellwether S&P 500 Index gaining 4% and notching its eighth consecutive quarterly advance. Small-cap stocks outpaced their large- and mid-cap counterparts, with the Russell 2000 Index of smaller-company shares returning 5.67%.

For the quarter overall, investors grappled with geopolitical risk, highlighted by heated rhetoric surrounding North Korea's nuclear program. In the United States, Hurricanes Harvey and Irma caused suffering and economic disruption in Texas and Florida, respectively. Despite these developments, investors focused on a broader macro landscape that revealed a rising trajectory, with second-quarter U.S. gross domestic product revised upward to 3.1% and a labor market that continued to register reasonably positive gains.

The benchmark 10-year U.S. Treasury yield ended the quarter about where it started, at 2.33%. The yield declined during August into early September amid heightened U.S.–North Korea tension. The yield moved higher during the remainder of September, however, as the Federal Reserve indicated that it still saw the potential for raising rates once more this year and three times in 2018.

At its mid-September policy meeting, the Fed left the target for short-term interest rates unchanged at a range of 1% to 1.25%. The central bank announced that it would begin in October to shrink its massive portfolio of Treasuries and agency mortgage-backed securities [MBS] that it accumulated after the 2008 financial crisis.

Gains were broad-based across industry groups, led by utilities, energy, and transportation. By contrast, retail, telecommunications, and consumer products were the weakest performers. Retail was the only group to post a negative return, hampered by weak earnings trends and longer-term concerns about brick-and-mortar versus online sales. From a credit-quality perspective, split B-rated bonds — which occupy the lower end of the credit-quality spectrum — delivered the best performance, as investors were willing to assume greater risk to access higher yields. Higher-quality BB-rated and split BB-rated bonds also outperformed the JPMorgan index, but not by as much as their split B-rated counterparts.

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

Generally speaking, we take a fairly conservative approach to credit risk, and our emphasis on higher-quality bonds aided relative performance for the third quarter.

At the sector/industry level, the fund benefited from security selection in financials and technology, along with an overweight allocation to housing. On the downside, selection in food & beverages, coupled with underweight exposure to transportation and services, dampened relative results.

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, the latter meaning the balance of supply and demand. As of quarter-end, we have a positive fundamental outlook and generally have a neutral view on valuation and technicals.

Looking at fundamentals, economic expansion in the United States, as well as abroad, and solid U.S. corporate earnings, have helped risk-based assets across the board. Recently — and for the first time since 2011 — companies in the S&P 500® Index posted two consecutive quarters of double-digit-percentage earnings growth from the year-earlier period, according to data provider FactSet.

Default trends are another factor in our favorable fundamental outlook. The high-yield default rate was 1.07% at quarter-end, down sharply from 3.57% at the beginning of the year. A major reason for the steep decline this year is the removal of $41.5 billion of debt from the calculation that defaulted during the first nine months of 2016, while adding just $10.3 billion in defaults for the year to date in 2017.* Energy and other commodity-related issuers, the companies that were at greatest risk of defaulting, have either already done so or have improved their balance sheets by selling assets and refinancing debt. Given the supportive fundamental backdrop, we think the default rate may remain below long-term historical averages for the remainder of this year and into 2018.

Turning to valuation, high-yield credit spreads are near their post-financial-crisis lows. At about four percentage points over comparable-maturity U.S. Treasuries as of September 30, spreads appear rich by historical standards. The 20-year median is a spread of about 5.25 points. At the same time, spreads are not at the extreme levels we saw in the first half of 2007, when they tightened below three percentage points.

It is not surprising that credit spreads would be relatively tight — stocks have hit several new highs this year, interest rates are low around the world, and volatility has been muted. High yield has moved in step with other risk-based asset classes. History has shown that relatively tight spreads and low volatility can persist for extended periods of time. Furthermore, we have not yet seen the kind of exuberance you would normally see when the market is about to go through a severe downturn.

As for technicals, demand remains strong — from both U.S. and foreign investors — and net new issuance has been modest. New issuance of high-yield bonds totaled $255.6 billion for the year-to-date period through September 30, 2017, which was 9% higher than the same period in 2016. However, 62% of newly issued bonds year to date were used to refinance existing debt, as corporations sought to capitalize on tight spread levels to refinance and extend their maturities.* According to data from J.P. Morgan, the amount of new issuance excluding refinancing is at its lowest level since 2011.

How are you positioning the fund in light of this outlook?

As always, we plan to maintain broad diversification across market sectors. From a credit-quality perspective, the majority of the fund's holdings at quarter-end were in split BB-rated or B-rated bonds, which occupy the middle tier of high-yield credit quality. We increased the fund's allocation to CCC-rated credits to bring the portfolio's overall risk level closer to that of the benchmark.

At the sector/industry level, we favor housing, gaming, lodging & leisure, paper & packaging, chemicals, and financials. By contrast, we had a relatively negative view toward retail and plan to maintain underweight exposure there. The fund also had lighter-than-benchmark exposure to technology, services, and transportation.

*Source: J.P. Morgan.

Putnam High Yield Fund (PHAYX)

Annualized total return performance as of 9/30/17

Class Y shares Inception 12/31/98	**Net asset value**	**JPMorgan Developed High Yield Index**
Last quarter	2.19%	2.05%
1 year	7.69	9.65
3 years	4.81	5.93
5 years	5.55	6.63
10 years	6.80	8.11
Life of fund	7.61	—

Total expense ratio: 0.82%

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.

The views and opinions expressed are those of the portfolio managers as of September 30, 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 (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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