Q4 2017 | Putnam High Yield Fund Q&A

Positive performance lifts market to levels that may constrain upside

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

Norman P. Boucher
Portfolio Manager
Industry since 1985

Robert L. Salvin
Portfolio Manager
Industry since 1986

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 retail, as well as positioning in gaming, lodging & leisure. Conversely, selection in health care and consumer products, along with positioning in energy, dampened relative results.

We have a positive outlook for market fundamentals and the supply-and-demand backdrop, but a neutral view toward valuation.

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

High-yield bonds returned 0.75% for the quarter, as measured by the JPMorgan Developed High Yield Index, trailing high-yield bank loans, but outpacing the broad investment-grade fixed-income market.

Strong investor confidence, which sent U.S. stock indexes to a series of new highs throughout the quarter, provided a supportive backdrop for high-yield debt. The high-yield market also benefited from reduced new issuance, rallying oil prices, and optimism surrounding a tax plan presented by Congressional Republicans.

Within the index, the energy sector was the top performer for the quarter. Crude oil prices rose steadily during the period, bolstered by improving global demand, an agreement between the Organization of Petroleum Exporting Countries [OPEC] and Russia to extend supply cuts through 2018, and supply disruptions in Libya. By quarter-end, the price of oil reached $60.42 per barrel, its highest level since June 2015 and up from $51.67 at the end of the third quarter.

Improving economic growth and the continuation of a positive trend for corporate profits bolstered investor sentiment in the fourth quarter. U.S. gross domestic product [GDP] registered two consecutive quarters of 3% or better annualized growth in the second and third quarters of 2017. Consumer spending was solid overall, as was business investment, and exports grew, reflecting a strengthening global economy. The unemployment rate reached a 17-year low of 4.1%. A closely watched measure of corporate profits — after-tax profits, without inventory valuation and capital consumption adjustments — increased 9.8% compared with a year earlier. All told, we think these trends point to a steadily growing economy ahead of the $1.5 trillion tax cut that was approved by Congress in late December, with a portion of that amount likely to influence the economy this year.

The most recent data on U.S. inflation showed that the personal-consumption expenditures price index — the price gauge the Federal Reserve prefers — had risen at a 1.8% annual rate, still below the central bank's long-elusive 2% target. Despite the continuing trend of low inflation, the Fed hiked its benchmark rate by a quarter percentage point to a range of 1.25% to 1.5%, the fifth such increase in the past two years, citing indications of accelerating economic growth. The Fed also reiterated its forecast for raising rates potentially three times in 2018.

Gains were modest but broad-based across high-yield industry groups. Besides energy, utilities and metals & mining notably outperformed the index. By contrast, more defensive cohorts, such as cable & satellite, consumer products, and telecommunications, posted negative returns. From a credit-quality perspective, lower-quality bonds outperformed the market, fueled by positive sentiment and a rally in commodities. Higher-quality BB-rated and split BBB-rated bonds lagged the JPMorgan index.

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. Historically, during periods when market gains are led by lower-quality securities — as was the case in the fourth quarter — the fund has generated a solid absolute return but has tended to lag the benchmark.

At the sector/industry level, the fund benefited from security selection in financials and retail, along with favorable overall positioning in gaming, lodging & leisure. On the downside, selections in health care and consumer products, coupled with adverse positioning in energy, worked against 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," or the balance of supply and demand. As of quarter-end, we thought the fundamental environment and technical backdrop were positive and valuation was neutral.

Looking at fundamentals, we think corporate fundamentals are likely to remain strong. Issuer defaults have begun to creep higher, with forecasts for a 2% to 2.5% total default rate in 2018, which is still low based on longer-term history. At the same time, recovery rates have also risen.

Regarding valuation, high-yield credit spreads — the yield advantage high-yield bonds offer over comparable-maturity U.S. Treasuries — compressed throughout 2017. Also, the average bond price within the index was close to par [face value]. As a result, the asset class is not compellingly cheap, but is in a range of fair value, in our view, given corporate fundamental strength. Against this backdrop, we think performance in 2018 will be driven by coupon income with limited capital appreciation potential.

As for technicals, we are not anticipating a significant spike in new supply. In light of new provisions governing corporate interest deductibility passed as part of U.S. tax reform, it's possible that new-issue supply could sharply decline. If this happens, we think it could be beneficial for existing bonds, assuming the demand for yield persists.

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 period-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 select CCC-rated credits where we had high conviction in the issuer's prospects.

At the sector/industry level, we favored gaming, lodging & leisure; housing; chemicals; utilities; and financials. Conversely, 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 continue our underweight exposure there. The fund also had lighter-than-benchmark exposure to services, technology, food & beverages, transportation, health care, consumer products, and telecommunications.

We modestly reduced the fund's allocation to bank loans to about 5% by the end of the period. Due to the large volume of refinancing occurring in the bank-loan market, loan credit spreads tightened during the past 12 months. As a result, while loans can provide the fund with a degree of ballast against market volatility, and their coupons may adjust higher as market interest rates rise, we thought their value relative to high-yield bonds had diminished.

Putnam High Yield Fund (PHAYX)

Annualized total return performance as of 12/31/17

Class Y shares Inception 12/31/98	**Net asset value**	**JPMorgan Developed High Yield Index**
Last quarter	0.89%	0.75%
1 year	7.16	7.80
3 years	5.48	6.76
5 years	5.14	6.15
10 years	6.99	8.29
Life of fund	7.58	—

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 December 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 (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.

This material is for informational and educational purposes only. It is not a recommendation of any specific investment product, strategy, or decision, and is not intended to suggest taking or refraining from any course of action. It is not intended to address the needs, circumstances, and objectives of any specific investor. Putnam, which earns fees when clients select its products and services, is not offering impartial advice in a fiduciary capacity in providing this sales and marketing material. This information is not meant as tax or legal advice. Investors should consult a professional advisor before making investment and financial decisions and for more information on tax rules and other laws, which are complex and subject to change.

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 308395 1/18