Q1 2022 | Putnam Convertible Securities Fund Q&A

Convertibles decline in line with stocks, bonds amid volatility

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Amid rising market volatility, value stocks led growth stocks for much of the quarter before an abrupt reversal in mid-March.

Liquidity in the convertibles market evaporated during the quarter, and convertibles issuance fell sharply compared with the past two years.

After a difficult quarter, we believe the convertibles market offers investors greater balance and more attractive yield and mispricing opportunities.

What were the conditions in the U.S. convertibles market during the first quarter of 2022?

Convertibles experienced difficult conditions in the quarter. The Federal Reserve followed through on its intention to address rising inflation by approving a 0.25% hike in the federal funds rate. This was the first increase since December 2018. Fed Chair Jerome Powell signaled an aggressive approach going forward, indicating that additional hikes could occur at each of the remaining six policy meetings in 2022. Also during the quarter, Russia's invasion of Ukraine fueled a flight from risk and spurred volatility in energy and commodity prices.

The convertibles market, as represented by the ICE BofA U.S. Convertible Index [the fund's benchmark], registered a return of –5.41%. This was largely in line with both the broad bond and stock markets. The Bloomberg U.S. Aggregate Bond Index posted a –5.93% return for the period, among its worst results in recent decades. The Russell 3000 Index of large and small companies returned –5.28%. The yield on the benchmark 10-year U.S. Treasury rose from 1.63% on January 3 to 2.32% on March 31. Short-term yields rose by a greater amount, causing the yield curve to flatten.

We saw a few factors having a major impact on market performance. Leadership in the stock market shifted from growth to value equities, continuing a trend from previous quarters, before a powerful reversal in mid-March back in favor of growth stocks. Volatility, as measured by the VIX [CBOE Volatility Index], spiked above the important threshold of 35 in early March. In an abrupt change, investors showed little appetite for the zero-coupon and

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low-coupon deals that were prevalent in 2021. More than 70% of 2021 new issues are trading below par, especially those with new or unproven business models that were still scaling revenues and are essentially unprofitable. Market liquidity was and is low. Investors pursuing arbitrage strategies involving convertibles and their underlying equities usually supply liquidity to the market, but these participants have stepped back from activity.

How did technical conditions play out?

New issuance was down by a large amount. In the past two years, convertible issuance was near record highs. So far in 2022, we have seen only $5.9 billion of deals, which is down 86% versus last year. In the technology and health care sectors, which are typically big sources of issuance, totals are down by double-digit percentages. As spreads widen and borrowing costs increase, we are looking for higher-quality issuers to come forward.

Fund flows were negative during the quarter. They peaked during February and have slowed meaningfully since that time. It appears the driver was outflows from convertible bond ETFs, while convertible bond mutual funds were steadier, though still in net outflows.

How did the fund perform, and what were the pluses and minuses?

For the three months ended March 31, 2022, the fund's class Y shares returned –6.31% [net of fees], underperforming the benchmark. Relative to the benchmark, the position that contributed most to performance was a sector overweight in energy. Within the sector, our security selection also contributed positively. The energy sector in the convertibles universe is smaller than in the equity market, but it still benefited from higher oil prices. Our underweight exposure to the rate-sensitive real estate sector and security selection within consumer staples also aided relative performance.

The largest detractor from benchmark-relative results was overweight positioning and security selection within industrials. Earnings-related volatility was the problem. The industrials sector is only about 1% of the universe, and it consists of names that tend to be very sensitive to underlying equity and securities that are subject to risk from volatile commodity prices. Other detractors from relative returns were security selection within the health care sector, which tends to have high earnings variability, and overweight positioning to the consumer discretionary sector.

What is your outlook for the convertibles market?

As in other recent periods of market stress, the convertibles market has become more balanced. Due to the sharp sell-off in equities in late 2021 and into 2022, the equity sensitivity of convertibles has declined. The median price in the convertibles market is the lowest since 2018, and the performance difference between styles has narrowed. As a result, we see potential to add to convertibles from issuers we like but historically avoided due to previously high equity sensitivity.

Overall, market delta is down to the 50s [delta is a measure of equity sensitivity, or how much the prices of convertibles change with the prices of underlying equities]. As the dispersion between delta buckets narrows, we see opportunities in the lower delta cohorts. Convertibles with lower delta — below 50 — are performing in line with the index but outperforming on a risk-adjusted basis. This cohort has grown a lot in the last few months and is near a multi-year high.

Yields have become more tempting. Over 80% of the market now offers a positive yield to maturity. The market yield rose just above 2% during March, although it dipped again as the market shifted to risk on, as sentiment surrounding the Russia-Ukraine War improved. Yield opportunities in "busted" convertibles stand out as offering potential for greater downside protection and price appreciation.

The Russia-Ukraine War will create more uncertainty and inflation, we're afraid, which has us more cautious on expensive growth-style securities. The valuation of these securities is the sticking point for us. We are less worried on a fundamental basis. Growth style securities, if anything, are more insulated from volatility because their revenues are mostly contracted and recurring in nature.

We are trying to keep the portfolio balanced between growth- and value-style companies and across the delta buckets. We believe that achieving balance will help us with our ultimate goal of offering downside protection while tracking with the upside of the equity markets. The asset class allows exposure to companies of all sizes and styles, and we believe balance is important to us to weather these challenging market conditions.

At the end of the day, this market has a lot to offer, including yield, and real credit mispricings. Higher delta opportunities are still available and would be attractive if stocks rally. Compared with two years ago when Tesla represented 10% of the market and lifted its overall delta, the market today has a much more diversified issuer base with style and market-cap opportunities.

Putnam Convertible Securities Fund (PCGYX)

Annualized total return performance as of 3/31/22

	Class Y shares Inception 12/30/98	**ICE BofA U.S. Convertible Index**
Last quarter	–6.31%	–5.41%
1 year	–3.33	–2.21
3 years	16.49	18.00
5 years	13.43	14.39
10 years	10.82	12.16
Life of fund	10.16	—

Total expense ratio: 0.76%

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 6/29/72), 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 Bloomberg U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities. The ICE BofA U.S. Convertible Index tracks the performance of publicly issued U.S. dollar-denominated convertible securities of U.S. companies. The S&P 500® Index is an unmanaged index of common stock performance. The Russell 3000® Index is an unmanaged index of the 3,000 largest U.S. companies. You cannot invest directly in an index.

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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.

These risks are generally greater for convertible securities issued by small and/or midsize companies. Convertible securities' prices may be adversely affected by underlying common stock price changes. While convertible securities tend to provide higher yields than common stocks, the higher yield may not protect against the risk of loss or mitigate any loss associated with a convertible security's price decline. Convertible securities are subject to credit risk, which is the risk that an issuer of the fund's investments may default on payment of interest or principal. Credit risk is generally greater for below-investment-grade convertible securities. Convertible securities may be less sensitive to interest-rate changes than non-convertible bonds because of their structural features (e.g., convertibility, "put" features). Interest-rate risk is generally greater, however, for longer-term bonds and convertible securities whose underlying stock price has fallen significantly below the conversion price.

Our investment techniques, analyses, and judgments may not produce the intended outcome, and the investments we select for the fund may not perform as well as other securities that were not selected for the fund. We, or the fund's other service providers, may experience disruptions or operating errors that could negatively impact the fund. You can lose money by investing in the fund.

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