Q2 2019 | Putnam Convertible Securities Fund Q&A

# June equity rally closes solid quarter for convertibles

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***Convertibles tracked 90% of the upside of the S&P 500 Index and outperformed fixed-income indices for the quarter.***

***The fund had strong absolute and relative performance for the quarter, helped by overweight positioning and security selection in the outperforming technology sector and security selection and underweight positioning in the underperforming energy sector.***

***We believe convertibles will continue to be an attractive option for investors seeking current income and capital appreciation and to reduce portfolio volatility.***

**Please describe conditions in the U.S. convertibles market in the second quarter.**

Market volatility picked up during the quarter. However, due to its hybrid characteristics, the convertible asset class performed as it is designed to do — capturing much of the upside of equities and some degree of support from its fixed-income attributes.

Convertibles performed well in April, along with other risk assets, on hopes for a U.S.–China trade deal, dovish central bank statements, solid preliminary earnings results, and the 3.1% first-quarter 2019 gross domestic product [GDP] announcement. Investor sentiment changed course in May, as escalating U.S.–China tensions and mixed U.S. economic data stalled the rally. With trade talks breaking down, both countries imposed a new round of tariffs. The sell-off was sharp, with economically sensitive and lower-quality investments leading the decline. Fortunately, convertibles demonstrated their downside protection features, succumbing to only about 55% of the equity market's downside as measured by the S&P 500 Index. As a result, the asset class broadly outperformed U.S. equity indices during the month.

The markets recovered dramatically in June in response to investor optimism about interest-rate cuts and a U.S.–China trade deal. The Federal Reserve held its benchmark short-term rate steady throughout the quarter, and its communication became increasingly dovish. At the Fed's June 2019 meeting, policy makers removed "patience" from their statement and acknowledged that "uncertainties" have increased in the economic outlook. With economic data softening, Fed Chair Jerome Powell indicated that the next rate move would likely be a cut. Interest rates fell further after his statement, pushing yields on the benchmark 10-year U.S. Treasury bond below 2% for the first time since 2016.

In addition to optimism about the direction of Fed policy, which provided a tailwind for both the equity and fixed-income markets, the United States and China agreed, at the Group of 20 summit in Japan at the end of June, to suspend new tariffs and resume trade negotiations. Although the meeting did not produce a comprehensive deal, President Trump delayed additional tariffs and eased restrictions on Huawei Technologies, and President Xi Jinping agreed to unspecified new purchases of U.S. farm products.

With interest-rate expectations lowered, fixed-income markets also moved higher. [Bond prices rise as yields fall.] Returns were not as striking as those in the equity markets but still noteworthy, with the Bloomberg Barclays U.S. Aggregate Bond Index and the JPMorgan Developed High Yield Index returning 3.08% and 2.60%, respectively, for the quarter. Outside of the short end of the yield curve, U.S. Treasury yields fell 28 to 50 basis points, or 0.28% to 0.50% percentage points, reflecting the market's anticipation of the Fed's hiatus in normalizing interest rates. The yield on the 10-year Treasury fell from 2.39% at the beginning of the quarter to 2.00% at quarter-end.

The ICE BofAML U.S. Convertible Index [the convertibles index] eclipsed these fixed-income benchmarks with a return of 3.85%. Due to its hybrid characteristics, the convertible asset class performed as it is designed to do — capturing much of the upside of equities and some degree of support from its fixed-income attributes. Convertibles tracked approximately 90% of the upside of the S&P 500 Index and outperformed most fixed-income indices for the quarter.

The S&P 500 Index closed out the month of June with a return of 7.05% — reaching an all-time high and enjoying the best first half of a year since 1997. Fueled by the momentum of June's strong performance, the ICE BofAML U.S. Convertible Index [the convertibles index] closed out the quarter with a return of 3.85%. Nine of the twelve sectors within the convertibles index delivered positive performance for the quarter, led by sector media [5.87%], financials [5.51%], and technology [4.97%]. Energy [-9.87%], consumer staples [-7.86%], and transportation [-1.71%] were negative performers. In terms of underlying equities, large- and mid-cap convertibles outperformed small-cap convertibles. On a credit quality basis, below-investment-grade/speculative-grade convertibles outperformed investment-grade convertible bonds for the quarter.

## What was your strategy for Putnam Convertible Securities Fund?

We continue to maintain a "pure-play" balanced convertibles portfolio, holding few common stocks or straight corporate bonds, which we believe sets the fund apart from its peers. The portfolio maintains a delta, or equity sensitivity, in the mid-50s, which rose during the past year as equities appreciated in value. In our opinion, keeping the delta in the 50s range represents a more balanced profile of capital preservation and reduced volatility from the bond component, as well as upside opportunity from the equity conversion option. We believe this positioning will help cushion the fund from potential volatility.

## How did the fund perform?

For the three months ended June 30, 2019, the fund's class Y shares outperformed the convertibles index, the S&P 500 Index, and the Bloomberg Barclays U.S. Aggregate Bond Index. On a relative basis, overweight positioning and security selection within the technology sector was the largest contributor to the fund's performance, driven by strength in the sector and holding specific names that posted positive earnings. Positive security selection within the health-care sector also added to relative performance, as did security selection and an underweight exposure to the energy sector. With crude oil prices down 3.3% over the quarter, energy-related companies struggled. In addition, we avoided a major oil-field services company that announced it was filing for bankruptcy protection.

Underweight positioning and security selection within the financials sector were the largest detractors to relative performance. During the risk-off sentiment in May, financials was the only sector that posted positive returns. The sector has relatively less equity sensitivity and therefore did not suffer as much of a downturn as other sectors.

## What is your outlook for convertibles in 2019?

Convertible securities performed well during the first half of 2019, due in large part to the strong appreciation of their underlying equity prices. With a dovish Fed and stable economic growth, we believe equities may continue to rise, barring further trade concerns. Therefore, we continue to trim winners, especially those trading with higher price to par and heightened equity sensitivity. We are deploying the proceeds into more balanced securities when appropriate. New issuance for the year started off strongly, and we expect steady new issuance trends for the balance of the year. Ultimately, we believe convertibles will continue to be an attractive option for investors seeking current income and capital appreciation, and seeking to reduce portfolio volatility.

## Putnam Convertible Securities Fund (PCGYX)

Annualized total return performance as of 6/30/19

| **Class Y shares** Inception 12/30/98 | **Net asset value** | **ICE BofAML U.S. Convertible Index** |
|---|---|---|
| Last quarter | 4.89% | 3.85% |
| 1 year | 9.40 | 7.93 |
| 3 years | 12.29 | 12.17 |
| 5 years | 6.17 | 6.90 |
| 10 years | 10.91 | 11.60 |
| Life of fund | 9.83 | — |
| Total expense ratio: 0.80% | | |

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 ICE BofAML U.S. Convertible Index tracks the performance of publicly issued U.S. dollar denominated convertible securities of U.S. companies. You cannot invest directly in an index.

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The views and opinions expressed are those of the portfolio managers as of June 30, 2019. They are subject to change with market conditions and are not meant as investment advice.

**Consider these risks before investing:** Convertible securities 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 and reduced liquidity in 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 do 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 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. You can lose money by investing in the fund.

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