

Q3 2018 | Putnam Convertible Securities Fund Q&A

Equity sensitivity propels convertibles higher



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The new tax law increases the relative attractiveness of convertible market funding versus corporate debt, particularly for more highly leveraged companies.

The new issue market remains exceptionally strong, expanding the universe of investment options in the U.S. convertibles market.

Investor confidence in the economy, coupled with solid underlying fundamentals and strong earnings, leads us to believe that the outlook for convertible securities remains constructive.

Please describe conditions in the convertibles market in the third quarter.

With second-quarter total earnings for the S&P 500 Index up over 25% and revenue growth of nearly 10% from the same period in 2017, the U.S. equity market posted solid gains for the three months ended September 30, 2018. Most of the momentum came in July and August when investors appeared to shrug off concerns about trade tensions and a global growth slowdown. Investors became more cautious in September as the Trump administration threatened to escalate the trade war with China. Share prices of technology and multinational companies fell accordingly. In addition, the August jobs report showed wage gains, raising the likelihood that the Federal Reserve would raise its benchmark rate at its September meeting. With the probability of a rate hike in December 2018 increasing, the equity and fixed-income markets sold off. Treasury rates and the U.S. dollar closed out the quarter higher.

Short-term yields rose more than longer-term yields during the quarter, reflecting the market's anticipation of Fed monetary policy. The Fed raised its target for short-term rates to 2.00%–2.25% at its September policy meeting, the third increase this year. The benchmark 10-year Treasury crossed the 3% threshold and ended the quarter at 3.06%.

Given the equity market's momentum in July and August, the U.S. convertibles market delivered positive performance for the third quarter. August was an especially strong month for the underlying equities given easing trade concerns and a general risk-on environment. The ICE BofAML U.S. Convertible Index [the convertible index] returned 3.93%. Ten of the twelve sectors in the benchmark index delivered positive performance for the quarter, led by telecommunications [13.31%], health care [9.24%], and materials [8.06%]. Transportation [-3.49%] and consumer discretionary [-3.33%] were negative performers. Both small- and mid-cap convertibles underperformed large-cap convertibles. On a credit quality basis, investment-grade convertibles outperformed below-investment-grade convertibles for the quarter.

What was your strategy for Putnam Convertible Securities Fund?

We continued to maintain a balanced "pure play" convertibles portfolio, with few common stocks or straight corporate bonds, which we believe sets the portfolio apart from its peers. At quarter-end, the portfolio had a delta — a measure of equity sensitivity — of 59, which has climbed year to date due to appreciating equity values. 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 and upside opportunity from the equity conversion option. We believe this positioning will help the strategy weather potential volatility.

How did the fund perform?

The fund's focus on U.S. convertibles was beneficial, as emerging market and European convertibles struggled given concerns over a trade war, the strong U.S. dollar, and Brexit among other factors. For the three months ended September 30, 2018, the fund delivered positive performance but underperformed the convertible index.

On a relative basis, security selection within the consumer cyclicals sector was the largest contributor to the fund's performance, driven by our avoidance of companies with little to no free cash flow. Positive security selection within the consumer staples sector also added to relative performance.

Security selection and underweight positioning within the health-care and communication services sectors were the largest detractors to relative performance at the sector level. Much of this relative underperformance resulted from securities in the index that we did not hold because of their relatively high valuations and their tendency to be more sensitive to equity moves. Putnam seeks to take positions in securities in which the team, along with Putnam's equity and credit analysts, have strong conviction and can provide downside protection.

What is your outlook for the months ahead?

Investor confidence in the economy, coupled with solid underlying fundamentals and strong earnings, leads us to believe that the outlook for convertible securities remains constructive. Furthermore, outperformance of the U.S. convertible market thus far in 2018, versus certain equity and credit markets, demonstrates its relative attractiveness during the later parts of the equity and credit cycles.

The new-issue market continues to be exceptionally strong, with year-to-date supply up 45% year over year. Increased supply has expanded the universe of investment options in the U.S. convertibles market, creating attractive associated return opportunities, in our view. We expect this robust environment for new issues to continue in the face of rising interest rates, barring any short-term volatility. Additionally, the new tax law increases the relative attractiveness of convertible market funding versus corporate debt, particularly for more highly leveraged companies. Ultimately, with central banks beginning the process of normalizing monetary policy and potential equity market unease, we believe convertible securities continue to be an attractive option for investors whose investment objectives may include current income and capital appreciation, while also lowering portfolio volatility.

Putnam Convertible Securities Fund (PCGYX)

Annualized total return performance as of 9/30/18

Class Y shares Inception 12/30/98	Net asset value	ICE BofAML U.S. Convertible Index
Last quarter	3.31%	3.93%
1 year	9.53	12.15
3 years	10.75	11.83
5 years	7.75	9.31
10 years	9.47	11.00
Life of fund	9.86	—

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 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 September 30, 2018. 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 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 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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