Q2 2018 | Putnam Convertible Securities Fund Q&A

Convertibles benefit from higher rates and tax reform

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Convertibles added to their gains earlier in the year and were among the better performing asset classes during the second quarter.

The fund's class Y share 2.08% quarterly return lagged that of its benchmark index, driven primarily by outperformance of securities not held in the portfolio.

A rising interest-rate cycle historically has supported outperformance by the convertibles asset class as tax reform and trade-war fears also made convertibles relatively more attractive.

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

The conditions were mostly supportive for convertibles. Historically, convertibles have benefited during periods of rising short-term interest rates, and rates rose significantly for two-year and five-year maturity Treasuries during the quarter. In addition, changes to the U.S. tax code that have made it more difficult for issuers to deduct interest costs has made convertible debt more attractive versus other types of debt from an issuer's perspective. Also, the equity market was a supportive backdrop. While volatility remained higher, one of the key factors in this volatility — the potential for a worsening trade war between the United States and its trading partners — helped small-cap stocks outperform large caps. The rising dollar was also positive for small companies and for issuers of convertibles more generally, as they tend to have greater dollar-based revenues. The economy remained solid as growth appeared to accelerate from the 2% rate achieved in the first quarter and employment gains continued. Meanwhile, technology stocks continued to perform quite well during the quarter.

For the quarter, the ICE BofAML U.S. Convertible Index returned 3.77%. Most of the advance occurred during May, as the yield curve flattened while small-cap equities appeared to benefit from being less exposed to trade war uncertainty. The index returned 3.54% for the month, led higher by strength in the technology and energy sectors, which had lagged the index in April on concerns over earnings in the technology sector. Small-cap convertibles underperformed large- and mid-cap convertibles, reversing the leadership pattern of April.

The convertibles market registered a modest gain during June. Media, consumer discretionary, and consumer staples were the clear outperformers, while materials and technology were the only negative performers. Convertibles of mid-cap companies were the leaders, outpacing issues of large and small caps. Viewing quarterly performance from a credit-quality basis, below-investment-grade and speculative-grade convertibles outperformed higher-quality issues in both May and June, reversing a preference for quality during April.

Meanwhile, issuance was consistently positive in each month of the quarter, and the new issues registered consistently positive returns as well. Key factors supporting issuance were higher interest rates, greater equity market volatility, and the impact of tax reform. Convertible new issuance is on pace to reach a 12-year high, and performance for new issues has outperformed the broad convertible market on a year-to-date basis.

Short-term yields rose more than longer-term yields during the quarter, reflecting market activity related to Federal Reserve policy. The Fed increased its target for short-term rates to 1.75%–2.00% at its June policy meeting, the second hike this year and the seventh in the past three years. The 10-year yield ended the quarter at 2.85%, only modestly higher than where it began the period, while the spread between 10-year and 2-year Treasuries fell to 35 basis points, the lowest level since the last recession.

What was your strategy for Putnam Convertible Securities Fund?

We have continued to trim exposure to securities in which the underlying equity valuations have become stretched, in our view. We offset that exposure with new issues where opportunities presented themselves.

The portfolio remained a "pure-play" on convertibles, with few holdings in common stocks or straight corporate bonds. We believe this sets the portfolio apart from its peers. The portfolio began the quarter with a delta — a measure of equity sensitivity — of 59, which was a bit higher than normal due to equity valuations. We generally keep the delta in the 50s range, to pursue a balanced profile of capital preservation and reduced volatility from the bond component and upside opportunity from the equity conversion option.

How did the fund perform?

For the three months ended June 30, 2018, the fund delivered positive performance but underperformed its benchmark, the ICE BofAML U.S. Convertible Index. Overall, much of the underperformance resulted from securities in the index that we did not hold in the portfolio because of their relatively high valuations. These included Sarepta Therapeutics, Restoration Hardware, and World Wrestling Entertainment. We also did not hold a position in Tesla due to our fundamental research view on the company. At the sector level, most of the underperformance resulted from positioning in three sectors: consumer cyclicals, health care, and capital goods. The portfolio held underweight positions in both the consumer cyclicals and health-care sectors, which had a negative impact on benchmark-relative returns. Security selection in each sector was also negative. In addition, the portfolio held an overweight position in the capital goods sector that was modestly positive for returns, but security selection fared poorly in this sector as well.

The portfolio continued to hold a significant overweight to the technology sector, which contributed positively to performance during the quarter, although stock selection in the sector modestly detracted. In other noteworthy decisions, the fund had a significant underweight to financials and utilities, and both sectors underperformed the index as a whole.

What is your outlook for the months ahead?

The U.S. convertibles market experienced a volatile June, driven by further political trade war noise and slowing economic growth in certain European and emerging-market countries. Investor confidence in the economy, coupled with solid underlying fundamentals and strong Q1 earnings, lead us to believe that the outlook for convertible securities remains constructive. Furthermore, outperformance of the U.S. convertibles market thus far in 2018 versus certain equity and credit markets demonstrates the relatively greater attractiveness of this hybrid asset class to investors during the later stages of the equity and credit cycles.

Convertibles continue to witness a standout new-issue market with YTD supply up 47% year over year. Increased supply has expanded the universe of investment options in the 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 levered companies.

Ultimately, with central banks beginning the process of normalizing monetary policy and the related potential for 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 6/30/18

Class Y shares Inception 12/30/98	**Net asset value**	**ICE BofAML U.S. Convertible Index**
Last quarter	2.08%	3.77%
1 year	10.73	11.98
3 years	6.27	7.71
5 years	8.26	9.99
10 years	7.32	8.46
Life of fund	9.84	—

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 June 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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