Q2 2020 | Putnam Convertible Securities Fund Q&A

Stellar quarter for convertibles

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Supported by their underlying equities, convertibles rebounded off their March lows and outperformed the S&P 500 Index for the second quarter.

Overweight positioning and security selection within the technology sector was the largest contributor to outperformance relative to the benchmark.

We remain somewhat cautious given recent equity highs following significant volatility earlier this year.

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

After a challenging first quarter, risk sentiment improved markedly in April 2020.

The spread of COVID-19 slowed in some countries and parts of the U.S. economy began to reopen after weeks of lockdowns. On the fiscal policy front, Congress passed a new $484 billion pandemic-relief package for small businesses and hospitals. The Federal Reserve authorized aid to state and local governments and emphasized that it stood ready to take further steps to address the economic fallout from the pandemic. Given these initiatives and positive supply/demand trends in the convertibles market, the ICE BofA U.S. Convertible Index [the fund's benchmark] rose 4.69% for the month.

The rally continued into May and June, with the momentum supported by the more equity-sensitive, large-cap, and/or growth names, along with cyclical companies that continued to rebound off their lows. By quarter-end, the fund's benchmark had climbed 24.15%, outperforming the S&P 500 Index's return of 20.54%. Given their equity sensitivity, convertibles captured 61% of the upside of their underlying equities, 118% of the upside of the S&P 500 Index, and 95% of the upside of the Russell 2000 Index for the quarter. All 12 sectors within the benchmark posted positive results, with the best results in technology, consumer cyclicals, and consumer staples. In terms of credit quality, below-investment-grade/speculative-grade convertibles bonds outperformed investment-grade convertibles. Finally, with valuations rising from their correction lows, the benchmark's delta, a measure of equity sensitivity, rose from the low 50s to the low 60s by quarter-end.

Fixed-income assets rallied in response to the Fed's aggressive monetary actions and demand from investors seeking safer harbors. The Bloomberg Barclays U.S. Aggregate Bond Index and the ICE BofA U.S. 3-Month Treasury Bill Index rose 2.90% and 0.02%, respectively, for the quarter.

The asset class experienced a surge of new issuance during the quarter. What was behind the increase?

As we have seen with other periods of market stress, the convertible bond market is sometimes used as a vehicle for companies to enter back into capital markets. This can create unique opportunities within the new issue market. In Q2, a record 94 new issues came to market worth $56.8 billion. In April and May, we were pleased to see more first-time issuers entering the market, which has broadened sector diversification across the asset class, in our view. We also saw issuers from industry sectors that have not been significantly active in the convertibles market for some time, including retail, gaming/leisure, and cruise lines. Many of these "rescue" financings were completed on attractive terms, with high coupons, low conversion premiums, and statistical cheapness to fair value, in our view. We believe this adds another layer of alpha, or excess return relative to that of the benchmark, and downside protection. Toward the end of the quarter, we also saw the return of more growth-oriented technology companies refinancing existing convertible issues that have experienced a significant rise in price. These deals, in our opinion, create an opportunity to swap into more balanced (priced at par and less equity-sensitive) securities. These are names that we already own, and we have favorable opinions of them.

With regard to demand, we believe the attractiveness of the convertible bond structures coming to market caught the attention of crossover equity and fixed-income investors, which helped to support prices.

How did the fund perform?

For the three months ended June 30, 2020, the fund's class Y shares returned 25.35%, outperforming the benchmark by a solid margin.

We had overweight positioning versus the benchmark to companies that had advantages in the crisis. These businesses are more accommodative to people working from home or social distancing, as well as names that benefited from reopening. Specifically, our overweight exposure and security selection within the technology sector was the largest contributor to outperformance relative to the benchmark. Security selection within health care also contributed to the fund's outperformance.

Underweight exposure and security selection in the consumer staples sector, along with overweight positioning and security selection within consumer cyclicals, were the largest detractors from the fund's relative returns. This was primarily due to underweight positioning in a few single names that outperformed during the quarter.

How are you positioning the fund as the third quarter begins?

We continue to trim winners, especially those trading with higher price to par and equity sensitivity, and redeploying proceeds to more balanced securities when appropriate. We believe this strategy is an effective way to manage the portfolio amid the economic uncertainty posed by the pandemic. As a result, the portfolio gained greater convexity, a tool we use to manage a portfolio's exposure to market risk.

We have also taken advantage of record new issue volume in order to make the portfolio more balanced. Ultimately, we believe convertibles will continue to be an attractive option for investors seeking current income and capital appreciation, and a good choice for reducing the volatility of an equity portfolio.

What is your outlook for convertibles in the coming months?

Looking into 2020, we expect a sharp economic slowdown due to the repercussions of the COVID-19 outbreak and oil price volatility. We continue to have a fairly constructive outlook on the convertibles market, although we remain somewhat cautious given recent equity highs following significant volatility this year.

In the aftermath of the March 2020 sell-off, we believe there were a few notable developments in the convertibles market that have implications for the asset class. With the markets rallying back and valuations approaching pre-COVID levels, we think it is important to keep in mind the potential for future downside if the economy does not experience a quick recovery. In February and March 2020, the convertibles market tracked about 60% of the downside of the equity market, while in April and May, the convertibles exhibited 95% of the upside of broader equity indices.* Overall, we think the asset class's convexity has proved to be favorable, providing support in volatile times and better risk-adjusted returns over the long term.

* Based on average returns of the S&P 500 Index and Russell 2000 Index.

Putnam Convertible Securities Fund (PCGYX)

Annualized total return performance as of 6/30/20

Class Y shares Inception 12/30/98	**Net asset value**	**ICE BofA U.S. Convertible Index**
Last quarter	25.35%	24.15%
1 year	17.23	15.34
3 years	12.40	11.71
5 years	9.01	9.24
10 years	10.37	10.91
Life of fund	9.98	—

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 Bloomberg (BBG) Barclays 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 Russell 2000 Index is an unmanaged index composed of approximately 2,000 of the smallest companies in the Russell 3000 Index as measured by their market capitalization.

The S&P 500 Index is an unmanaged index of common stock performance.

You cannot invest directly in an index.

The views and opinions expressed are those of the portfolio managers as of June 30, 2020. 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. Our investment techniques, analyses, and judgments may not produce the outcome we intend. The investments we select for the fund may not perform as well as other securities that we do not select for the fund. We, or the fund's other service providers, may experience disruptions or operating errors that could have a negative effect on the fund. You can lose money by investing in the fund.

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