Q3 2021 | Putnam Convertible Securities Fund Q&A

Convertibles retreat amid inflation and growth concerns

Anthony J. Daigle
Portfolio Manager, Analyst
Industry since 2004

Robert L. Salvin
Co-Head of Corporate and Tax-exempt Credit
Industry since 1986

Convertible securities retreated a bit as some caution crept into the financial markets during the final weeks of the quarter.

The delta, or equity sensitivity, of the U.S. convertibles market has declined recently due to the active new-issue market.

We believe it is important to strike a balance between the fund's exposure to growth and value stocks during this transition period.

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

Convertible securities delivered relatively flat performance as some caution crept into the financial markets during the final weeks of the quarter. The ICE BofA U.S. Convertible Index [the fund's benchmark] returned -0.49% for the quarter. The S&P 500 Index and the Bloomberg U.S. Aggregate Bond Index, a broad measure of U.S. fixed-income markets, returned 0.58% and 0.05%, respectively.

In July and August 2021, stocks marched higher despite a rise in Covid-19 cases due to the highly contagious Delta variant. Strong second-quarter 2021 earnings results and positive economic data, including a strong jobs report for July, helped fuel the rally. By mid-August, however, consumer and investor confidence began to wane due to concerns that the surging Delta variant might stall the economic recovery and prompt a return to pandemic restrictions. Other issues emerged. China's regulatory crackdown on some of its largest technology companies unnerved markets. Investors looked to the Federal Reserve for clues about the central bank's plans to begin tapering its bond-buying program. At the Fed's annual meeting in Jackson Hole, Wyoming, Chair Jerome Powell signaled the Fed may taper bond purchases this year but clarified that this did not signal its intention to raise short-term interest rates. Stock indexes rallied to new highs after his somewhat dovish comments.

After reaching an all-time high on September 2, 2021, the S&P 500 Index lost ground, closing the month with a return of -4.65% — its worst month since September 2020. Stock performance became more uneven in September following the disappointing August jobs report that suggested the Delta variant was weighing on the jobs recovery. The Fed's Beige Book survey showed U.S. economic activity had "downshifted" in July and August as Americans reduced spending on travel, dining, and other activities. Later in the month, the Fed sounded a slightly more hawkish tone, indicating it might begin tapering as early as November 2021. Half of the Fed's policymakers expected to raise interest rates in 2022.

Interest rates trended lower during the quarter before spiking in late September 2021. The prospect of higher prices due to supply chain disruptions, rising labor costs, and higher commodity prices stoked inflation fears. These fears weighed on stocks, especially technology and other growth stocks. Investors worried that the Fed, along with other central banks, might tighten monetary policy, which could stifle growth. The yield on the bellwether 10-year U.S. Treasury note, which began the period at 1.45% on June 30, 2021, fell to a low of 1.19% in July and August before closing the quarter at 1.52% on September 30, 2021. Longer-term, rate-sensitive, fixed-income assets also ended the period higher.

Five of the 12 sectors within the convertibles benchmark posted positive results for the quarter, with the best results in real estate [3.19%] and information technology [1.30%]. Consumer staples [-6.22%], materials [-4.59%], and communication services [-3.53%] struggled the most. In terms of style and market cap, growth-oriented convertible bonds outperformed value-oriented convertibles, while large-cap convertibles outperformed mid-cap and small-cap convertibles.

How did the fund perform?

For the three months ended September 30, 2021, the fund's class Y shares returned -0.35% [net of fees], edging out the benchmark return of -0.49%. On a gross basis, the fund returned -0.15%, outperforming the benchmark for the quarter.

On a relative basis, security selection within technology was the largest contributor to relative performance. Specifically, overweight positioning in select growth-oriented plays added to benchmark-relative performance. Security selection within communication services and consumer staples also aided relative performance.

On the other hand, underweight exposure and security selection within real estate was the largest detractor to the fund's relative returns during the quarter. However, real estate is a relatively small sector within the convertibles universe, and our decision to underweight the exposure was due to our preference to invest in securities outside the industry. Underweight exposure to consumer discretionary and security selection within industrials also detracted from relative returns.

What is your outlook?

Our near-term outlook for equities and corporate credit is constructive. Continued progress with vaccinations and the pace of the U.S. economy reopening provide a positive backdrop for risk assets in general, in our view. At the same time, we are mindful of certain risks that could lead to bouts of market volatility. The biggest unknown is how the Delta variant will evolve in the coming winter months. We are also keeping a close eye on supply chain disruptions, which are affecting a range of industries from technology to consumer products and could weigh on upcoming corporate earnings results. And, as we saw recently, inflation fears could push interest rates higher, which could be a headwind for the performance of long-duration assets, in our view.

Regarding the growth to value rotation we saw in the later part of the third quarter, uncertainty over a sustained pace of U.S. growth and vaccine proliferation may pause the rotation into the more value-oriented and cyclical companies — potentially causing growth companies to outperform. As such, we believe it is important to strike a balance between the fund's exposure to growth and value stocks during this transition period.

Our view of the convertibles market is also positive. The delta, or equity sensitivity, of the U.S. convertibles market has declined recently due to the active new-issue market. Lower-delta new issues are entering the market as higher-delta securities are converted into common stock. Furthermore, if economic growth continues to be robust and interest rates rise, history indicates that convertibles could perform well given the constructive backdrop for equities and the naturally low duration of the asset class. [Convertible securities tend to have lower duration, or price sensitivity, to rising rates than other fixed-income assets.] Ultimately, we believe U.S. convertibles offer a balanced vehicle for exposure to a variety of growth and value companies along with an attractive yield.

Putnam Convertible Securities Fund (PCGYX)

Annualized total return performance as of 9/30/21

	Class Y shares Inception 12/30/98	**ICE BofA U.S. Convertible Index**
Last quarter	−0.35%	−0.49%
1 year	21.59	27.30
3 years	19.50	20.21
5 years	16.39	17.37
10 years	13.10	14.37
Life of fund	10.42	—

Total expense ratio: 0.79%

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. You cannot invest directly in an index.

The views and opinions expressed are those of the portfolio managers as of September 30, 2021. They are subject to change with market conditions and are not meant as investment advice.

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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