Q4 2018 | Putnam Convertible Securities Fund Q&A

Hybrid nature of convertibles buffers sharp sell-off in stocks

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Convertibles experienced only 53% of the downside of their underlying equities during the quarter.

The fund retains its balanced "pure-play" convertible strategy, with few common stocks or straight corporate bonds, that we believe will help it weather market volatility.

We believe the outperformance of convertibles versus equity and credit markets in 2018 demonstrates their relative attractiveness during the later parts of the equity and credit cycles.

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

A cautious mood permeated the financial markets during the fourth quarter, sending the equity markets into a deep correction that was marked by extremely volatile moves. Worries about corporate earnings and global growth in light of the U.S. trade war with China, the pace of the Federal Reserve's monetary tightening, and geopolitical risks weighed heavily on equities and other higher-risk assets. While the fundamental backdrop presented a challenge for the equity and corporate credit markets, the Bloomberg Barclays U.S. Aggregate Bond Index closed out the quarter in positive territory. Amid the heightened volatility, a flight to safety ensued as investors sold higher-risk assets and generally moved into more conservative fixed-income investments and sanctuary assets like gold.

Short-term yields rose more than longer-term yields during the quarter, reflecting the market's anticipation of the Fed continuing down the path of normalizing interest rates. The Fed raised its target range for short-term rates to 2.00% to 2.25% at its December policy meeting, the fourth increase in 2018. The yield on the benchmark 10-year Treasury fell from previous highs above 3% in the third quarter to 2.68% by quarter-end.

The U.S. convertibles market posted solidly negative returns in October and December as a result of sharp price corrections in various sub-sectors — most notably biotechnology and semiconductors. Despite continued volatility in the equity markets, November offered a reprieve from the market's slide. Convertibles ended the month in positive territory, as investors welcomed news about the U.S. economy adding jobs in October and indications from the White House that progress was being made in trade talks with China.

In this environment, the U.S. convertibles market returned -9.31% for the quarter, as measured by the ICE BofAML U.S. Convertible Index [the convertibles index]. However, given their hybrid equity and fixed-income characteristics that help buffer the effects of market sell-offs, convertibles were more resilient than equities. Convertibles suffered only 53% of the downside experienced by their underlying equities during the quarter. Convertibles also outperformed most equity indices, as large-cap equities, represented by the S&P 500 Index, returned -13.52%, while small-cap equities, represented by the Russell 2000 Index, returned -20.20%. U.S. high-yield bonds fared better, although spreads widened, and the asset class returned -4.65%, as measured by the JPMorgan Developed High Yield Index. The broader fixed-income markets rose 1.64% for quarter.

Given the challenges during the quarter, sector returns within the benchmark index were negative across the board. Energy, materials, and health care were the clear underperformers, while the more defensive utilities sector held up relatively better. On a credit quality basis, investment-grade convertibles outperformed below-investment-grade/speculative grade convertibles, although returns were still negative on an absolute basis. In terms of the underlying equities, small- and mid-cap convertibles underperformed large-cap convertibles for the quarter. Meanwhile, new U.S. convertible issuance was over $52.8 billion in 2018, reflecting the largest supply in 10 years.

What was your strategy for Putnam Convertible Securities Fund?

We continue to maintain a balanced "pure-play" convertibles portfolio, holding few common stocks or straight corporate bonds, which we believe sets the portfolio apart from its peers. The portfolio maintains a delta, or equity sensitivity, in the mid-50s, which rose during 2018 as equities appreciated in value. It has recently fallen due to the market correction. 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 the fund weather potential volatility in the coming months.

How did the fund perform?

For the three months ended December 31, 2018, the fund underperformed the convertibles index. On a relative basis, security selection and overweight positioning in the capital goods sector, along with security selection in consumer cyclicals, were the largest detractors to relative performance at the sector level.

Meanwhile, security selection within the technology sector was the largest contributor to the fund's performance. This result was driven by our avoidance of companies that saw significant downward price corrections during the sell-off. Positive security selection and underweight positioning within the communication services sector also added to relative performance.

After such a challenging 2018, what is your outlook for convertibles in 2019?

Convertibles had significant relative outperformance versus equities in 2018, netting positive performance compared with negative returns for most major asset classes. By the end of the third quarter, the benchmark index was tracking 98% of the upside of the S&P 500 Index. It closed out the fourth quarter outperforming that benchmark by more than four percentage points. In other words, convertibles performed as expected: They tracked closely with the strong equity market during the first three quarters and then outperformed equities during the sell-off in the fourth quarter. Convertibles also outperformed most fixed-income indices in 2018. We believe the outperformance of the U.S. convertible market in 2018, versus certain equity and credit markets, demonstrates its relative attractiveness to investors during the later parts of the equity and credit cycles.

Putnam Convertibles Securities Fund experienced mixed performance during the course of 2018, finishing the year trailing the benchmark. However, we were very encouraged by the fund's performance in an extremely volatile December, when it outperformed the convertibles index. Looking back on 2018, the majority of our relative underperformance to the index occurred during strong equity rallies. This is mostly due to our practice of trimming winners, that is, selling securities after a period of outperformance. We practice this discipline to keep the portfolio balanced and protect shareholders on the downside. It is particularly helpful during volatile markets like we saw in 2018.

Looking ahead into 2019, we are excited for the asset class and believe the current market environment represents a timely buying opportunity for several reasons. First, the sell-off in equities since September 2018 has resulted in a more balanced convertible market than has been the case in several years. This is evidenced by the median convertible bond price ending 2018 only slightly above par after being higher most of 2018; the convertible market delta in the low 50s after being in the high 50s most of 2018; and the convertible market ending 2018 with what we view as an attractive current yield of 2.70%. Second, we saw positive growth in convertible new issuance in 2018 to a level that we have not seen in a number of years. Issuance by new companies also increased, leading to greater diversification. Finally, the sell-off resulted in more reasonable equity valuations, with the average price-to-earnings ratio for the S&P 500 Index near 14. This represents a discount to the long-term average valuation for this large-cap equity index.

Putnam Convertible Securities Fund (PCGYX)

Annualized total return performance as of 12/31/18

Class Y shares Inception 12/30/98	**Net asset value**	**ICE BofAML U.S. Convertible Index**
Last quarter	–9.83%	–9.31%
1 year	–3.05	0.15
3 years	7.05	7.94
5 years	4.26	5.95
10 years	11.64	12.21
Life of fund		—
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 S&P 500 Index is an unmanaged index of common stock performance.

The JPMorgan Developed High Yield Index is an unmanaged index of high-yield fixed-income securities issued in developed countries.

The Bloomberg (BBG) Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities.

The Russell 2000 Index is an unmanaged index of 2,000 small companies in the Russell 3000 Index.

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The views and opinions expressed are those of the portfolio managers as of December 31, 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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