Q4 2020 | Putnam Convertible Securities Fund Q&A

Convertibles surge on vaccine optimism and economic recovery

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Convertibles closed another stellar quarter, strongly outperforming the S&P 500 Index and fixed-income markets.

Performance was driven by the strength of the underlying equities of the asset class.

Our near-term outlook for equities and corporate credit is constructive, though we expect economic uncertainty to remain.

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

Powered by the performance of their underlying equities, convertibles added to their strong second- and third-quarter gains. The ICE BofA U.S. Convertible Index [the convertible benchmark] rose 19.67% for the quarter, outperforming the 12.15% and 0.67% return of the S&P 500 Index and the Bloomberg Barclays U.S. Aggregate Bond Index, respectively.

The quarter began with heightened uncertainty surrounding the U.S. elections, the lack of a new stimulus package, and a resurgence of COVID-19 cases, which raised fears of renewed lockdowns to stem the spread. Equities and other higher-risk assets struggled in October as a result. Due to their hybrid characteristics, however, convertibles held up better than equities for the month, with the convertible benchmark experiencing about a third of the decline of the S&P 500 Index for the month.

Sentiment rebounded in November with the Biden presidential victory and the announcement by Pfizer/BioNTech and Moderna regarding the high efficacy of their vaccines. The vaccine news encouraged many investors to look beyond the 2020–2021 winter to the possibility of a full reopening of the U.S. economy by mid to late 2021. President-elect Biden's nomination of Janet Yellen as Treasury Secretary and his decision to keep Federal Reserve Chairman Jerome Powell as head of the central bank reassured investors that this administration was focused on the recovery from the pandemic. Given the positive momentum, November proved to be the best month for the S&P 500 Index since April 2020, rising 10.95%. Market leadership shifted away from high-technology growth stocks to more economically sensitive cyclical stocks and those poised to benefit from the reopening of the U.S. economy. In an especially noteworthy move, investors shifted into value and small-cap stocks. The Russell 2000 Index, a measure of small-cap stock performance, rose 31.37% for the month, its best month ever. U.S. convertible securities experienced their second-best monthly return in November, with the convertible benchmark climbing 12.72%.

The rally continued into December with many equity benchmarks notching new highs. The rollout of COVID-19 vaccines and hopes of federal stimulus buoyed investor expectations despite a surge in U.S. infection rates. In its final policy meeting of 2020, the Federal Reserve held its key interest rate near zero and remained committed to its bond-buying program to support the credit markets. Just before quarter-end, Congress and the White House finalized a $900 billion COVID-19 aid bill and a $1.4 trillion budget package to fund government agencies through September 2021 — averting a federal government shutdown.

All 12 sectors within the convertible benchmark posted positive results for the quarter, with the best results in materials, consumer discretionary, and industrials. In terms of credit quality, below-investment-grade/speculative-grade convertibles bonds outperformed investment-grade convertibles.

How did the fund perform?

For the three months ended December 31, 2020, the fund's class Y shares returned 16.37% [net of fees], underperforming the convertibles benchmark.

Security selection within technology and consumer discretionary was the largest detractor to relative performance, although both sectors were among the fund's top contributors on an absolute total return basis. Specifically, within consumer discretionary, underweight positioning in a couple of single names that outperformed during the quarter weighed on relative performance.

On the other hand, underweight exposure to the financials sector was the largest contributor to the fund's relative returns. This was due to higher interest rates during the period, which were a headwind for rate-sensitive convertible preferred securities.

How were technicals in the convertibles market?

Market technicals were healthy in terms of both supply and demand dynamics. November saw record-breaking issuance for the month, which helped to bring the total for 2020 to $113.6 billion. This surpassed the one-year record of $106.4 billion in new issuance in 2001, according to Merrill Lynch. In addition, with valuations increasing, the market size of the U.S. convertibles market rose to a record $348 billion.

We also saw more new names and first-time issuers entering the convertibles market. New issuance from existing issuers provided the opportunity for us to trade out of highly appreciated issues and replace them with more balanced new issues at par value.

Demand also continued to be robust, with increased interest from crossover equity and fixed-income investors as well as convertible arbitrage hedge funds. As a result, companies were able to issue convertible bonds with lower coupons and higher premiums compared with those in recent years.

How is the fund positioned as we head into 2021?

The fund's exceptional performance in November had two drivers, in our view. Convertible securities tied to the reopening of the economy and positive vaccine news and securities that are beneficiaries of work-from-home and/or social distancing measures did well. The outperformance of both of these investment themes in the short term gives us confidence that a balanced portfolio across all investment styles and market caps should perform relatively well as investors digest potential outcomes and news.

What is your outlook as we head into 2021?

Fueled by its strong finish in the fourth quarter, the convertible benchmark rose 46.22% in 2020. This result was primarily driven by a combination of the asset class's more defensive characteristics during the spring sell-off and the rebound of their underlying equities during the recovery. In February and March, the convertibles market tracked about 70% of the downside of the equity market. Since then, convertibles have exhibited roughly 100% of the upside of the broader market indices, as measured by the average of the S&P 500 Index and Russell 2000 Index. With valuations at or above pre-COVID-19 levels, we think it is important to keep in mind the potential for further downside if the economy experiences a correction.

Our near-term outlook for equities and corporate credit is constructive, however, though we expect economic uncertainty to remain. In this environment, we believe there could be a continued rotation from growth companies to more value and cyclical companies.

Our view of the convertibles market is also positive. Though growth companies constitute a significant portion of the convertibles market, we believe many of these companies may continue to perform very well in the post-COVID-19 period. Additionally, the constitution of the market has become more balanced, with securities in value-oriented sectors, or beneficiaries of economic reopening, becoming a larger portion of the market. We believe this makes the U.S. convertibles market a more balanced vehicle for exposure to a variety of growth and value companies with attractive yields.

Putnam Convertible Securities Fund (PCGYX)

Annualized total return performance as of 12/31/20

Class Y shares Inception 12/30/98	**Net asset value**	**ICE BofA U.S. Convertible Index**
Last quarter	16.37%	19.67%
1 year	45.33	46.22
3 years	20.65	21.72
5 years	17.31	17.76
10 years	11.43	12.59
Life of fund	10.49	—

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.

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As of December 31, 2020, the fund did not have any exposure to Pfizer, BioNTech, or Moderna. Holdings will vary over time.

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