Q3 2020 | Putnam Convertible Securities Fund Q&A

Convertibles gain with strong back-to-back quarters

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Convertibles and their underlying equities closed another robust quarter, outperforming the S&P 500 Index and fixed-income markets.

With more new names and first-time issuers entering the market, we have broadened sector diversification within the portfolio.

Convertible securities have historically performed best during periods of moderately rising inflation.

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

Fueled by gains from their underlying equities, convertibles added to their stellar second-quarter rebound off pandemic lows and posted double-digit gains for the third quarter. The ICE BofA U.S. Convertible Index [the fund's benchmark] rose 13.93% for the third quarter, outperforming the 8.93% and 4.93% return, respectively, of the S&P 500 Index and the Russell 2000 Index (a measure of small-cap stock performance). Improving prospects for a COVID-19 vaccine, better-than-expected earnings, and the Federal Reserve's accommodative monetary policy underpinned the rally through August 2020. September brought a change in sentiment as the market tried to digest the upcoming election, delays on another fiscal package to date, an unclear outlook for a COVID-19 vaccine, and rising cases across the globe that resulted in discussions about further economic shutdowns at home and abroad. In this environment, convertible bonds saw increased demand from crossover equity and fixed-income investors as well as convertible arbitrage hedge funds. The heightened demand helped to support prices.

The Fed remains committed to providing liquidity in the credit markets at an unprecedented scale. However, while the Fed expects to keep interest rates near zero toward the end of 2023, policy makers outlined a more tolerant stance on inflation in August and September 2020. Acknowledging the difficult road to recovery, Fed Chair Jerome Powell communicated that the Fed "will likely aim to achieve inflation moderately above two percent for some time."

With the Fed's policy shift on inflation, the rally in fixed-income assets stalled. The Bloomberg Barclays U.S. Aggregate Bond Index and the ICE BofA U.S. 3-Month Treasury Bill Index closed the third quarter with returns of 0.62% and 0.04%, respectively. Equities also reversed course in September. After reaching an all-time high on September 2, 2020, the S&P 500 Index declined -3.80% in September, led by a sell-off in technology stocks. Due to their hybrid characteristics, however, convertible securities held up better than equities for the month. The fund's benchmark experienced about half of the decline of the S&P 500 Index for the month.

Given their equity sensitivity, convertibles captured 104% of the upside of their underlying equities and 156% of the upside of the S&P 500 Index. All 12 sectors within the benchmark posted positive results, with the best results in consumer discretionary, telecommunications, and technology. 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, was in the low 60s at quarter-end.

How did the fund perform?

For the three months ended September 30, 2020, the fund's class Y shares returned 13.06%, underperforming the benchmark.

On a relative basis, security selection within health care was the largest contributor to relative performance, particularly positioning in a health-care company and a telemedicine company that merged in August 2020. Overweight positioning and security selection within technology also contributed to the fund's performance. Companies that are more accommodative of people working from home or social distancing performed especially well.

Underweight exposure and security selection in the consumer discretionary sector was the largest detractor from the fund's relative returns. This was primarily due to underweight positioning in a couple single names that outperformed during the quarter.

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

We continue to trim winners, especially those trading with higher price to par and equity sensitivity, and redeploy proceeds to more balanced (priced at par and less equity-sensitive) securities when appropriate. As we saw in the second quarter of 2020, the convertibles market is sometimes used as a vehicle for companies to enter back into the capital markets. Year to date through September 30, 2020, new issuance is up 87% year over year, with more new names and first-time issuers entering the market. This has allowed us to broaden sector diversification within the portfolio. Many of these financings were completed on attractive terms, in our view, with statistical cheapness to fair value. We believe this adds another layer of alpha, or excess return relative to the benchmark, as well as downside protection.

Finally, we have been vigilant about monitoring the fund's exposure to issuers that are considered "reopening plays" and therefore more vulnerable to shutdowns and other efforts to contain the spread of the COVID-19 virus, in our view. As part of this strategy, we have limited investments in service sectors such as transportation as well as those dependent on large gatherings, such as live entertainment events. We are more focused on issuers that are beneficiaries of work-from-home and/or social distancing measures and those that tend to be more resilient in slow-growth periods. Technology and consumer-oriented companies would exemplify our strategy in this regard.

What is your outlook for convertibles in the coming months?

The U.S. economy continues to recover, albeit unevenly due to uncertainty about the future course of the pandemic. Although still far from maximum employment, the labor market saw improvement during the quarter, with the unemployment rate declining to 7.9% in September 2020 from a pandemic high of 14.7% in April 2020. The goods and housing industries are improving, but services are lagging. On the corporate earnings front, second-quarter 2020 results were better than expected, with sales and earnings declining -9.62% and -7.35%, respectively, year over year. With the continued reopening of the U.S. economy during the summer months, some market analysts are predicting that third-quarter 2020 corporate earnings could be better than forecasted. They might still be negative, but in recovery mode.

By mid-September, the convertibles market was moving down in sympathy with the equity market. The correction was primarily led by the more concentrated, higher delta names. In the final months of 2020, we expect greater uncertainty due to the U.S. elections, the trajectory of a potential vaccine, and the continued recovery of risk assets. The uncertainty could lead to increased volatility as the market continues to find its footing. With regard to the potential for rising inflation, convertible securities have historically performed best during period of moderately rising inflation. Returns have tended to be weaker during periods of very low or very high inflation. In this environment, we believe that creating a more balanced portfolio by thoughtfully analyzing delta exposures can ultimately achieve better risk-adjusted returns over the long term.

Putnam Convertible Securities Fund (PCGYX)

Annualized total return performance as of 9/30/20

Class Y shares Inception 12/30/98	**Net asset value**	**ICE BofA U.S. Convertible Index**
Last quarter	13.06%	13.93%
1 year	33.14	31.20
3 years	15.42	15.24
5 years	13.78	13.80
10 years	10.62	11.38
Life of fund	10.20	—

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 September 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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