Q4 2017 | Putnam Equity Income Fund Q&A

Sector rotation could boost value stocks in 2018

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A significant sector rotation might allow certain segments of the market to do very well in 2018.

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We just finished an impressively strong year for equity markets worldwide. What are you envisioning for U.S. equities in 2018?

Given valuations, the equity markets will be hard-pressed to repeat the gains seen in 2017. Last year, without question, was an "anti-value" year. Almost any stock that was cheaper than the market underperformed relative to stocks that offered even the slightest hint of growth characteristics. While most of the top performers in 2017 were companies that remain fundamentally strong, their stocks have become quite expensive, in my view.

Going into 2018, I am focused on the companies that have been left behind by investors who favored price momentum throughout last year. Today, we are finding much more absolute value and relative value in the market, both between sectors and within sectors. Many stocks that I had been avoiding now look quite attractive, including those in areas such as retail, consumer staples, and energy that were punished by the broader declines in their sectors.

Do you expect a shift from 2017, when outperformance was limited to a narrow band of mainly large-cap growth stocks?

Yes. I believe 2018 is the year in which attractively priced stocks in cyclical industries will recover and outperform. In my view, this sector rotation makes sense, as industries that have been struggling will begin to benefit from the coordinated economic growth we are seeing across developed and emerging markets worldwide.

You mentioned energy, a weak sector in 2017, as an area of opportunity. Why?

I was surprised that energy was one of the worst-performing sectors in 2017. In my view, for the first time in several years, we are in a great environment for energy companies. Oil prices, which plummeted to six-month lows in early 2017, have recovered and become much more stable. Energy companies are generating cash and have lowered their capex budgets considerably. They don't have as much leverage to higher oil prices, but they have tremendous operating leverage, and they have continued to support their dividends. These businesses are not dealing with any of the issues that typically worry investors, yet their stocks have not performed well.

Against this backdrop, in late 2017, I began increasing the portfolio's energy exposure. Last year, the fund's limited exposure to the energy sector was helpful, but I believe this is one of the most undervalued sectors going into 2018. In addition to the fact that many energy companies are now living within their means — cleaner balance sheets, lower production, and reduced spending — they are also poised to capitalize on growth prospects in China and across many developed markets.

What are the risks for equity investors in the months ahead?

Most of the risks that investors shrugged off in 2017 are still with us as we enter 2018, and the equity market may be less forgiving this year. In the United States, I believe there are political risks for equities in the coming months. Despite some stumbles for the Republican agenda last year, progress on tax reform and deregulation had a significant positive impact on equity performance. If Republicans lose control of the House or Senate in November midterm elections, that pro-growth agenda — and the boost it gave to investor sentiment — could stall. The real risk, in my view, is that we see no progress in terms of pro-business legislation in the next two years.

Putnam Equity Income Fund (PEIYX)

Annualized total return performance as of 12/31/17

Class Y shares Inception 10/1/98	**Net asset value**	**Russell 1000 Value Index**
Last quarter	6.33%	5.33%
1 year	18.95	13.66
3 years	9.54	8.65
5 years	14.35	14.04
10 years	8.94	7.10
Life of fund	10.50	—

Total expense ratio: 0.69%

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 6/15/77), 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.

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How are you positioning the fund in this environment?

As always, my strategy is centered on seeking value — and today we are finding value in areas we have not emphasized in quite some time. In 2017, we had success with stocks whose valuations are now relatively high. I am shifting the focus of the portfolio and trimming many of last year's best performers in favor of other fundamentally strong companies that offer more attractive valuations. I am also adding to existing positions that were not rewarded in last year's growth-focused market, including a number of dividend-paying stocks.

The views and opinions expressed are those of Darren A. Jaroch, CFA, Portfolio Manager, as of December 31, 2017. They are subject to change with market conditions and are not meant as investment advice.

Consider these risks before investing: Value stocks may fail to rebound, and the market may not favor value-style investing. Income provided by the fund may be reduced by changes in the dividend policies of, and the capital resources available at, the companies in which the fund invests. Stock values may fall or fail to rise over time for several reasons, including general financial market conditions, changing market perceptions, changes in government intervention in the financial markets, and factors related to a specific issuer or industry. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings. You can lose money by investing in the fund.

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