Q4 2018 | Putnam Equity Income Fund Q&A

Maintaining focus on value in difficult market conditions

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In a difficult quarter for equity markets, the fund declined and underperformed its benchmark, the Russell 1000 Value Index.

An overlooked risk in today's market may be investing in defensive stocks whose price-earnings multiples do not reflect their long-term value.

We have been adding to positions in areas such as energy, basic materials, industrials, and financials.

Equities had a tough fourth quarter. What are your thoughts on market conditions?

It may be an understatement to say that the landscape shifted in the closing months of 2018. The fourth quarter brought volatility and double-digit annual losses for major equity indexes. U.S. large- and mid-cap value stocks, as measured by the Russell 1000 Value Index, had delivered somewhat lackluster performance throughout the first half of 2018. After a solid third quarter, they declined by 12% in the final three months of 2018.

The downturn was the result of several investor worries, including slightly less robust growth in Europe, a slowing economy in China, and an escalating U.S.–China trade dispute. We had been preparing for a broad market downturn for a while. However, most market observers were surprised at the speed of the sector rotation. The market suddenly became very sensitive to all the issues that had been risks for a while, and investors rapidly fled to defensive stocks. This reaction, in my view, was a bit too extreme.

How did the fund perform in this environment?

It was a difficult quarter for fund performance. The fund posted a negative return and underperformed its benchmark, the Russell 1000 Value Index. Within the portfolio, the sectors that detracted most from performance were financials and technology, while consumer discretionary and health-care holdings performed better. For longer time periods, the fund's relative returns remain solid, including the 3-, 5-, and 10-year periods ended December 31, 2018.

What were some reasons for the underperformance?

One challenge was the speed at which the market shifted from cyclical stocks to defensive stocks. For several quarters, we had been gradually reducing positions in stocks that had advanced considerably. Our goal was to move away from those that had become too expensive and that might be most vulnerable in a market decline. The portfolio was easing off its pro-cyclical bias as we sought opportunities in more classic value sectors. However, we did not make these adjustments fast enough, which was the principal cause of the fund's weakness in the quarter. In the final months of 2018, virtually every cyclical sector dropped while defensive sectors were stronger.

How are you positioning the portfolio now?

We continue to closely monitor market conditions and risks, and we have added some dividend-paying stocks that have more defensive characteristics. However, it is important to note that we do not plan to chase defensiveness simply because the market does so. In late 2018, much of the market activity was a fear-driven flight to the perceived safety of traditional defensive stocks, many of which are now too expensive, in my view.

In the wake of the corrections, an overlooked risk in today's market may be investing in stocks whose price-earnings multiples do not reflect their long-term value or growth prospects. These are stocks whose prices have surged because they represented safe havens, but do not offer the fundamentals we seek for our portfolio.

With quite a bit of fear, volatility, and uncertainty in the market, it can be difficult to maintain a pro-cyclical stance. However, when I focus on valuation — which is at the core of our investment process — I believe that I can find true value in cyclical stocks. We have been adding to positions in areas such as energy, basic materials, industrials, and financials, where we believe valuations have become very attractive. As always, we are seeking attractively priced stocks of companies with strong cash flows, earnings quality, and capital allocation strategies. In addition, we target companies that are willing and able to grow their dividends.

Putnam Equity Income Fund (PEIYX)

Annualized total return performance as of 12/31/18

Class Y shares Inception 10/1/98	**Net asset value**	**Russell 1000 Value Index**
Last quarter	–13.97%	–11.72%
1 year	–8.06	–8.27
3 years	7.58	6.95
5 years	6.38	5.95
10 years	12.13	11.18
Life of fund	10.01	—
Total expense ratio: 0.66%		

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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The views and opinions expressed here are those of the portfolio managers as of December 31, 2018, 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, industry, or sector. 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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