Putnam INVESTMENTS

Q4 2021 | Putnam Diversified Income Trust Q&A

Rate strategy struggles amid shifting backdrop

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Bonds carrying greater credit risk outpaced higher-quality bonds for the quarter.

The fund's interest-rate and yield-curve strategy detracted, while exposure to mortgage-related and high-yield corporate credit aided performance.

Entering 2022, we will continue to closely monitor coronavirus-related developments, as well as U.S. Federal Reserve policy moves.

How did the fund perform for the three months ended December 31, 2021?

The fund's class Y shares returned –3.32%, trailing the 0.01% result of its cash benchmark, the ICE BofA U.S. Treasury Bill Index. The fund also lagged the broad investment-grade fixed-income market, as measured by the 0.01% result of the Bloomberg U.S. Aggregate Bond Index.

What was the market environment like during the fourth quarter of 2021?

Fixed-income securities posted subdued returns during the final three months of the year. Bonds carrying greater credit risk fared somewhat better than their higher-quality, investment-grade counterparts. High-yield corporate credit rallied in December as concerns about the severity of the Omicron coronavirus variant receded. Strong stock market gains also bolstered the overall risk backdrop in December.

In November, the U.S. Federal Reserve began winding down its $120 billion-per-month bond-purchase program by $15 billion per month. In December, the Fed announced it would accelerate the pace to $30 billion per month, which could phase out purchases entirely by March 2022. Signaling the Fed's view that inflationary pressures are likely to broaden, both the central bank and investors now anticipate three 0.25% increases in the federal funds rate during 2022.

Against this backdrop, the U.S. Treasury yield curve flattened during the quarter. The yield on the 2-year U.S. Treasury note jumped to its highest level since March 2020, reflecting investor reaction to the Fed's hawkish pivot. Meanwhile, the yield on the 10-year Treasury note remained flat while longer-term yields declined.

Which holdings and strategies hampered the fund's performance?

Our interest-rate and yield-curve strategy was the primary detractor this quarter. The portfolio was positioned to benefit if inflation declined and real interest rates rose. [Real interest rates adjust for the effects of inflation by subtracting the actual or expected rate of inflation from nominal interest rates.] Real rates rose moderately during the quarter but not enough to aid our positioning.

Our interest-rate and yield-curve strategy is intended to provide a degree of protection against underperformance of risk-based assets. Now that the Fed has begun to tighten monetary policy, we believe real interest rates will rise during 2022, which may boost our strategy.

Strategies targeting prepayment risk also proved negative. Yield spreads on our agency interest-only [IO] and inverse IO collateralized mortgage obligations [CMOs] widened during the quarter due to broader market volatility. [Spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity U.S. Treasuries. Bond prices rise as yield spreads tighten and decline as spreads widen.] On a positive note, prepayment speeds on the mortgages underlying our holdings slowed as mortgage rates rose modestly and refinancing activity decelerated. IO CMOs and other mortgage-backed securities benefit when homeowners refinance or pay off their mortgages at a slower rate than investors anticipate.

What about contributors?

Mortgage credit holdings added the most value, led by our exposure to commercial mortgage-backed securities [CMBS]. Lower volatility, strong demand from investors, and better overall fundamentals boosted the sector following significant volatility during 2020.

Our allocation to high-yield corporate credit — both bonds and convertible securities — also contributed. After posting negative returns in October and November, high-yield corporate credit registered its strongest monthly advance of 2021 in December. This came as concerns about the severity of the Omicron coronavirus variant receded.

What is the team's near-term outlook?

The economic environment of 2021 drove strong returns across credit markets, fueled by optimism around economic reopening and ample fiscal and monetary stimulus. But this environment also created inflation that exceeds the Fed's target and has proven more persistent than originally expected. We will likely see declining support from central banks in 2022 as the Fed and its global peers pivot away from accommodative policy to rein in inflation. This hawkish turn in Fed policy, coupled with potential improvement in supply chain issues, could mean a reduction in core inflation by 2022's second quarter.

What are your current views on the various sectors in which the fund invests?

Looking first at corporate credit, we have a positive outlook for the fundamentals and overall supply-and-demand backdrop of high-yield bonds. Our view on valuation is more neutral, however, given the relative tightness of yield spreads as of quarter-end. Within the high-yield market, we are continuing to closely monitor issuers' balance sheets and liquidity metrics, with an eye toward default risk or a credit-rating downgrade.

In the CMBS market, we believe there are attractive risk-adjusted investment opportunities available amid an improving fundamental backdrop. By virtue of having real assets serving as collateral, along with the potential for rent adjustments, CMBS have historically performed well during periods of rising inflation. As a result, we believe CMBS may offer attractive relative value to a wide range of investors.

Within residential mortgage credit, we believe a combination of low mortgage rates, high demand, and a declining inventory of available homes is likely to push home prices higher. Given that prices have already risen substantially, we are aware that affordability has become a constraint for many prospective buyers. Consequently, we think the pace of home price appreciation is likely to moderate during 2022. Against this backdrop, we are finding value in investment-grade securities backed by non-agency residential loans, even with tighter yield spreads.

The environment for prepayment-related strategies was challenging in 2021. Despite this, we still have conviction in this allocation for its return potential and diversification benefits. Mortgage interest rates have risen modestly since bottoming in early August. With the Fed pivoting to a less accommodative policy stance, we believe mortgage rates may continue to rise in 2022. Consequently, we think refinancing activity will recede and mortgage prepayment speeds will slow. In our view, IO CMOs may offer particularly compelling potential against this backdrop. Moreover, we believe prepayment-sensitive securities in general may offer attractive returns from current price levels if prepayment speeds remain at their current pace for the foreseeable future.

In emerging markets, we are seeking opportunities in countries that we think are better positioned to benefit from a global recovery and are less exposed to domestic policy risks.

Putnam Diversified Income Trust (PDVYX)

Annualized total return performance as of 12/31/21

	Class Y shares Inception 7/1/96	**ICE BofA U.S. Treasury Bill Index**
Last quarter	–3.32%	0.01%
1 year	–6.80	0.05
3 years	1.63	1.04
5 years	2.09	1.16
10 years	3.47	0.65
Life of fund	5.69	—

Total expense ratio: 0.74%

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 10/3/88), 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 BofA U.S. Treasury Bill Index is an unmanaged index that tracks the performance of U.S.-dollar-denominated U.S. Treasury bills publicly issued in the U.S. domestic market. Qualifying securities must have a remaining term of at least one month to final maturity and a minimum amount outstanding of $1 billion. You cannot invest directly in an index.

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

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Duration measures the sensitivity of bond prices to interest-rate changes. A negative duration indicates that a security or fund may be poised to increase in value when interest rates increase.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed are those of the portfolio managers as of December 31, 2021, are subject to change with market conditions, and are not meant as investment advice. All performance and economic information is historical and is not indicative of future results.

Consider these risks before investing: Emerging-market securities carry illiquidity and volatility risks. Lower-rated bonds may offer higher yields in return for more risk. Funds that invest in government securities are not guaranteed. Mortgage-backed investments, unlike traditional debt investments, are subject to prepayment risk, which means that they may increase in value less than other bonds when interest rates decline and decline in value more than other bonds when interest rates rise.

The fund's investments in mortgage-backed securities and asset-backed securities, and in certain other securities and derivatives, may be or become illiquid. The fund's concentration in an industry group comprising mortgage-backed securities may make the fund's net asset value more susceptible to economic, market, political, and other developments affecting the housing or real estate markets and the servicing of mortgage loans secured by real estate properties. The fund currently has significant investment exposure to commercial mortgage-backed securities. Bond investments are subject to interest-rate risk (the risk of bond prices falling if interest rates rise) and credit risk (the risk of an issuer defaulting on interest or principal payments). Interest-rate risk is generally greater for longer-term bonds, and credit risk is generally greater for below-investment-grade bonds. Risks associated with derivatives include increased investment exposure (which may be considered leverage) and, in the case of over-the-counter instruments, the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. Unlike bonds, funds that invest in bonds have fees and expenses. The value of investments in the fund's portfolio may fall or fail to rise over time for a variety of reasons, including general economic, political, or financial market conditions; investor sentiment and market perceptions; government actions; geopolitical events or changes; and factors related to a specific issuer, geography, industry, or sector. International investing involves currency, economic, and political risks. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings.

Our investment techniques, analyses, and judgments may not produce the outcome we intend. 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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Request a prospectus or summary prospectus from your financial representative or by calling 1-800-225-1581. The prospectus includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

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