Q1 2022 | Putnam Diversified Income Trust Q&A

Diversified allocations offset impact of market weakness

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All major fixed income sectors posted losses amid global market turbulence.

The fund's mortgage-credit and prepayment-related holdings contributed, while interest-rate and yield curve positioning detracted.

We have a cautiously optimistic outlook but recognize that geopolitical tensions and monetary policy decisions will likely continue to influence fixed income markets.

How did the fund perform for the three months ended March 31, 2022?

The fund's class Y shares returned –0.50%, trailing the –0.03% result of its cash benchmark, the ICE BofA U.S. Treasury Bill Index. The fund outperformed the broad investment-grade fixed income market, as measured by the –5.93% result of the Bloomberg U.S. Aggregate Bond Index.

What was the market environment like during the first quarter of 2022?

It was a volatile period for bond markets around the world. Hawkish policy pivots from the U.S. Federal Reserve and the European Central Bank in the face of rapidly rising inflation, combined with Russia's invasion of Ukraine, fueled a flight from risk.

Within this environment, credit spreads widened and interest rates rose. [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.] The yield on the benchmark 10-year U.S. Treasury rose from 1.63% on January 3 to 2.32% on March 31. In anticipation of Fed policy changes, short-term yields rose even more, causing the yield curve to flatten materially.

On March 16, the central bank approved a 0.25% hike, its first increase since December 2018. Fed Chair Jerome Powell signaled an aggressive approach going forward, indicating that additional hikes could occur at each of the remaining six policy meetings in 2022.

From a sector perspective, all fixed income categories posted losses. Treasury Inflation-Protected Securities [TIPS] held up better than the broad fixed income market, aided by rising inflation. Investment-grade corporate credit, meanwhile, was among the poorer performers, given its relatively high interest-rate sensitivity.

Outside of fixed income, commodities had their best quarter in more than 30 years, as Russia's invasion of Ukraine fueled a rally in markets from oil to wheat and metals. U.S. crude oil prices climbed 32%, ending the quarter at $100.28 per barrel. Major stock indexes in the U.S. and overseas suffered their worst quarterly performance in two years.

Which holdings and strategies aided the fund's performance?

Mortgage credit holdings added the most value this quarter, led by an allocation to commercial mortgage-backed securities [CMBS]. Our investments consisted of cash bonds along with synthetic exposure via CMBX. By way of explanation, CMBX is a group of tradeable indexes that each reference a basket of 25 CMBS issued in a particular year. Despite broader market volatility, the continued reopening of the economy and the success of vaccines helped many types of property recover, which, in turn, boosted our CMBS positions.

Strategies targeting prepayment risk also contributed, driven by our mortgage basis positioning. Our strategy received a lift early in the period, following the release of the minutes from the Fed's December policy meeting. The minutes indicated the central bank might sell its holdings of government-agency mortgage-backed securities [MBS] more rapidly than investors originally anticipated. By way of explanation, our mortgage basis strategy seeks to capitalize on the difference between longer-term U.S. Treasury yields and the interest rates on 30-year home mortgages.

What about detractors?

Interest-rate and yield curve positioning moderately detracted this quarter. The fund's duration positioning and quantitative model weighed on performance as Treasury yields rose sharply. On the plus side, the portfolio benefited from an increase in real interest rates during the quarter. [Real interest rates adjust for the effects of inflation by subtracting the actual or expected rate of inflation from nominal interest rates.]

An allocation to high-yield corporate credit was a further detractor. High-yield spreads widened in January and February amid the exodus from riskier parts of the market. The asset class recovered somewhat in March as investors sought to capitalize on more attractive valuations.

Holdings of emerging market [EM] debt also worked against performance this quarter. The turmoil resulting from Russia's invasion of Ukraine hit EM bonds particularly hard in February. Similar to high-yield credit, EM debt rebounded a bit in March but not enough to fully offset earlier weakness.

Our active currency strategy also detracted, primarily because our long exposure to the Japanese yen weakened significantly versus the U.S. dollar during March.

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

Overall, we have a cautiously optimistic outlook but recognize that geopolitical tensions and monetary policy decisions will likely continue to influence fixed income markets.

Looking first at high-yield corporate credit, our view is moderately constructive. We have a positive outlook for high-yield market fundamentals and the overall supply-and-demand backdrop. That said, we anticipate continued bouts of volatility given the conflict in Ukraine, the pace of Fed rate hikes, and potentially negative effects on energy supplies from sanctions on Russia. Our view on valuations is more neutral, given the relative tightness of yield spreads in the market as of quarter-end. Spreads widened during the quarter but remain tight by historical standards.

We believe the fundamental environment will continue to improve in the CMBS market as workers return to offices, consumer traffic increases at retailers, and hotels welcome back business and leisure travelers. Our emphasis on investment opportunities in the U.S. broadly isolates us from geopolitical risk. Moreover, with real assets serving as collateral, along with the potential for rent adjustments, CMBS have historically performed well during periods of rising inflation. Consistent with risk markets generally, CMBS spreads widened during the quarter. The increased liquidity premium enhanced the appeal of select market segments.

Within residential mortgage credit, we believe continued high demand and low inventory of available homes is likely to push prices even higher. Given that home prices have already risen substantially and mortgage rates have moved up, 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. Wider spreads have created better value among mid-tier and lower-rated securities. As a result, we are finding attractive investment opportunities in that area of the market, as well as among higher-rated securities.

We believe the Fed's shift toward tighter monetary policy may cause it to accelerate sales of MBS that it currently holds. A faster pace of MBS tapering may reduce home price inflation, helping to boost the Fed's inflation-fighting mandate. Against this backdrop, we believe many prepayment-sensitive securities may offer attractive risk-adjusted returns from current price levels and may offer meaningful upside potential if mortgage prepayment speeds slow. We think the fund's prepayment-related strategies provide an important source of diversification in the portfolio. In our view, prepayment strategies could benefit from an economic slowdown, a shift to supportive fiscal policies, or a sustained increase in mortgage rates.

In light of Russia's invasion of Ukraine, along with the Fed's shift to monetary tightening, the near-term outlook for emerging markets has become highly uncertain. Against this backdrop, we will focus on opportunities in countries that are less directly affected by geopolitical turmoil and global policy risk.

Putnam Diversified Income Trust (PDVYX)

Annualized total return performance as of 3/31/22

	Class Y shares Inception 7/1/96	**ICE BofA U.S. Treasury Bill Index**
Last quarter	–0.50%	–0.03%
1 year	–7.69	0.00
3 years	–0.10	0.82
5 years	1.51	1.14
10 years	2.82	0.65
Life of fund	5.63	—
Total expense ratio: 0.72%		

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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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 March 31, 2022, 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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