Q2 2018 | Putnam Diversified Income Trust Q&A

Multisector strategy gains despite rising rates

D. William Kohli
CIO, Fixed Income
Industry since 1988

Robert L. Davis, CFA
Portfolio Manager
Industry since 1999

Brett S. Kozlowski, CFA
Portfolio Manager
Industry since 1997

Michael V. Salm
Co-Head of Fixed Income
Industry since 1989

Paul D. Scanlon, CFA
Co-Head of Fixed Income
Industry since 1986

Michael J. Atkin
Portfolio Manager
Industry since 1988
(Photo not available)

Increased global trade and political tensions created a challenging market environment in the second quarter.

Mortgage-credit holdings and interest-rate positioning bolstered the fund's performance, while investments in emerging-market debt detracted.

We think U.S. growth may strengthen in the months ahead, but we are monitoring trade policy and emerging-market economies.

Not FDIC insured | May lose value | No bank guarantee

What was the fund's investment environment like during the second quarter of 2018?

The period was marked by a continued flattening of the U.S. Treasury yield curve, along with increased global trade tensions.

The yield on the benchmark 10-year Treasury reached a nearly seven-year high of 3.11% on May 17 before mounting concerns about trade issues and slower global growth drove investors to the relative safety of government debt. Longer-dated yields were also held in check by continued strong demand for long-term U.S. bonds from pension funds, insurance companies, and international investors. As a result, the 10-year yield ended the quarter at 2.85%, only modestly higher than where it began the period.

Short-term yields rose more than longer-term yields during the quarter, reflecting market activity related to Federal Reserve policy. The Fed increased its target for short-term rates to 1.75% to 2.00% at its June policy meeting, the second hike this year and the seventh in the past three years. We think the central bank is likely to raise rates twice more in 2018, and possibly once or twice in 2019.

As the year has progressed, the Treasury yield curve has continued to flatten. It is possible that the curve could invert at some point, meaning short-term yields would be higher than longer-term yields. Historically, an inverted yield curve has been an accurate forecaster of recession. This time, however, we think there may be different dynamics at work. The massive amount of longer-term Treasuries that the Fed purchased during the years that it was attempting to stimulate economic growth are still

being held on the central bank's balance sheet. This has created a scarcity in the supply of longer-term Treasuries, which is being met by robust demand. As a result, we think demand for long-term debt is having a greater influence on the curve than the pace of Fed rate hikes. We view this as a more benign backdrop that is less indicative of near-term recession.

On the trade front, at the end of May, the Trump administration announced tariffs on steel and aluminum imported from the European Union, Canada, and Mexico. It then applied tariffs to $50 billion in Chinese imports to the United States, a move that was designed to punish China for unfair trade practices. President Trump escalated the trade conflict with China in mid-June, asking his administration to identify a new list of $200 billion in Chinese goods that would be penalized with tariffs. The Chinese government immediately threatened to retaliate with its own equivalent tariffs on U.S. goods. The president has also threatened to impose tariffs on global automobile imports. As of quarter-end, investors remained on edge as to the full scope of President Trump's global trade offensive.

The fund generally held up well despite the challenging backdrop. Which holdings and strategies fueled its positive performance?

Our mortgage credit holdings were the biggest contributor, led by commercial mortgage-backed securities [CMBS]. Our long exposure to the BBB-rated tranche within the CMBX — an index that references a basket of CMBS issued in a particular year — benefited from reduced investor concern about the performance of regional shopping malls. Investors now believe mall-related uncertainties are unlikely to materially hamper the CMBS market.

An allocation to agency credit-risk transfer securities [CRTs] also added to results for the quarter. CRTs benefited as credit-rating agencies upgraded certain CRT tranches, recognizing the improved outlook for their underlying collateral.

Our interest-rate and yield-curve positioning provided a further boost to performance. The fund's duration in the United States was below zero, meaning it was positioned to benefit if market interest rates rose. This positioning modestly aided performance as interest rates ended the quarter slightly above where they started it.

Despite volatility in May, a quantitative global interest-rate strategy — in which we sought to exploit rate differentials and yield-curve structures across various countries — also contributed for the quarter. During May, a political crisis in Italy sparked a selloff in peripheral eurozone debt, and weighed on our position in Greek government bonds. In June, however, our holdings in Greece rebounded, along with eurozone debt generally, as Italy's president expressed openness to the possibility of forming a coalition government supported by the country's two large antiestablishment parties.

Strategies targeting prepayment risk also helped. Our holdings of reverse-mortgage interest-only securities continued to benefit from regulatory changes announced by the Department of Housing and Urban Development [HUD] in August 2017. The regulations have reduced the incentives for owners of reverse mortgages to refinance, helping to strengthen secondary market demand.

Higher longer-term Treasury yields aided our positions in agency interest-only collateralized mortgage obligations [IO CMOs]. Refinancing activity was subdued due to rising mortgage rates and a continuing trend of fairly restrictive bank underwriting standards. As a result, prepayment speeds on the mortgages underlying our IO CMO positions stayed below market expectations.

What about detractors?

Investments in emerging-market debt worked against relative performance this quarter. Bonds issued by the government of Argentina underperformed as the country's currency depreciated sharply, prompting Argentina's central bank to raise its policy interest rate by about 13 percentage points. Uncertainty surrounding upcoming elections in Brazil hampered the performance of that country's debt.

Our currency allocation also dampened the fund's results. Long exposure to the Australian dollar, the Norwegian krone, the euro, and the Argentinian peso detracted as all of these currencies weakened versus the U.S. dollar. By contrast, short positions in the Swedish krona and the New Zealand dollar proved additive and partially offset the overall negative impact of our strategy.

What is your near-term outlook?

We think second-quarter U.S. economic growth may be stronger than the 2% annualized rate reported for the first quarter. In May, an inflation measure closely watched by the Fed hit the central bank's target of 2% for the first time in six years, a sign that the economy is on more solid footing after a long run of relatively slow growth. Inflation readings over the past three months suggest the Fed's long battle with weak inflation could finally be drawing to a close. It appears to us that a strong labor market is beginning to push wages up and robust economic growth will increasingly squeeze slack out of the economy.

Globally, we are focused on developments related to international trade and also on the performance of emerging-market economies.

After a decade of borrowing by emerging-market governments and companies, dollar-denominated bonds in developing economies are coming under increasing pressure as U.S. interest rates rise, trade tensions ratchet higher, and the U.S. dollar strengthens. A stronger dollar makes it more difficult for countries with large amounts of dollar-denominated bonds to repay that debt as it matures.

The dilemma now facing policy makers in less-developed countries is whether to try to keep pace with the Federal Reserve as it raises interest rates. Higher rates could help stem capital outflows from emerging markets, but could also crimp domestic growth.

Given this outlook, how are you positioning the fund?

We continue to favor mortgage credit, prepayment risk, and corporate credit, but are taking a somewhat more conservative approach than previously. We are doing this by purchasing securities with shorter durations while also seeking greater credit protection by investing at more senior levels in a deal's credit structure.

As for emerging markets, we have sought to manage risk by reducing exposure to markets that tend to be more volatile, such as Russia. Beyond that, we plan to continue focusing on select investment opportunities that we believe offer value, rather than taking broad exposure to the sector.

Putnam Diversified Income Trust (PDVYX)

Annualized total return performance as of 6/30/18

Class Y shares Inception 7/1/96	**Net asset value**	**ICE BofAML U.S. Treasury Bill Index**
Last quarter	0.61%	0.45%
1 year	5.61	1.31
3 years	4.08	0.67
5 years	3.53	0.43
10 years	4.92	0.41
Life of fund	6.34	—

Total expense ratio: 0.75%

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 BofAML 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.

ICE Data Indices, LLC (ICE BofAML), used with permission. ICE BofAML permits use of the ICE BofAML indices and related data on an "as is" basis; makes no warranties regarding same; does not guarantee the suitability, quality, accuracy, timeliness, and/or completeness of the ICE BofAML indices or any data included in, related to, or derived therefrom; assumes no liability in connection with the use of the foregoing; and does not sponsor, endorse, or recommend Putnam Investments, or any of its products or services.

The views and opinions expressed are those of the portfolio managers as of June 30, 2018, 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: International investing involves currency, economic, and political risks. 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 securities are subject to prepayment risk and the risk that they may increase in value when interest rates decline and decline in value when interest rates rise. 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 greater for longer-term bonds, and credit risk is 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. Bond 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 lead to increased volatility and reduced liquidity in the fund's portfolio holdings. You can lose money by investing in the fund.

This material is for informational and educational purposes only. It is not a recommendation of any specific investment product, strategy, or decision, and is not intended to suggest taking or refraining from any course of action. It is not intended to address the needs, circumstances, and objectives of any specific investor. Putnam, which earns fees when clients select its products and services, is not offering impartial advice in a fiduciary capacity in providing this sales and marketing material. This information is not meant as tax or legal advice. Investors should consult a professional advisor before making investment and financial decisions and for more information on tax rules and other laws, which are complex and subject to change.

A world of investing.®

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.

Putnam Retail Management

Putnam Investments | One Post Office Square | Boston, MA 02109 | putnam.com

TL028 311579 7/18