

## Q4 2019 | Putnam Diversified Income Trust Q&amp;A

# Mortgage and corporate credit boost fund



**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)

***The fund posted a solid quarterly gain and outpaced its cash benchmark, the ICE BofA U.S. Treasury Bill Index.***

***Synthetic exposure to commercial mortgage-backed securities, along with investments in corporate credit, fueled the fund's positive performance.***

***We believe the risk of recession has diminished globally.***

## How did the fund perform for the three months ended December 31, 2019?

The fund's class Y shares gained 2.96%, handily outpacing our cash benchmark, the ICE BofA U.S. Treasury Bill Index.

We think it's important to highlight that the fund continued to invest outside the constraints of traditional fixed-income benchmarks, such as the Bloomberg Barclays U.S. Aggregate Index. Our goal is to seek what we consider to be the best investment opportunities based on risk rather than asset class. These risks include interest rate, credit, prepayment, and liquidity.

## Which holdings and strategies drove the fund's performance?

Our mortgage-credit positions were the biggest contributor to performance this quarter, led by our synthetic exposure to commercial mortgage-backed securities [CMBS] via CMBX. CMBX is an index that references a basket of CMBS issued in a particular year. The fund's allocation to the BBB-rated tranche within CMBX added the most value.

Corporate credit investments also meaningfully aided results. Both high-yield bonds and convertible securities helped, as these asset classes benefited from strength in U.S. stocks and a more stable economic backdrop.

Within emerging-market [EM] debt, our positions in Argentina contributed amid signs that the new government that took office in December may take a more investor-friendly policy approach.

Our interest-rate and yield-curve positioning provided a further boost. A modestly negative portfolio duration helped performance as yields trended moderately higher during the quarter. Also, positioning the portfolio for a steeper yield curve proved advantageous. Longer-term yields rose while shorter-term rates were generally stable, partly anchored by U.S. Federal Reserve interest-rate cuts.

### **What detracted from performance?**

Our active currency strategy modestly dampened performance, hampered by short positions in the Swedish krona and the New Zealand dollar, both of which strengthened versus the U.S. dollar.

Also, within strategies targeting prepayment risk, our “mortgage basis” positioning worked against results. Mortgage basis is a strategy that seeks to exploit the yield differential between current-coupon, 30-year agency pass-throughs and 30-year U.S. Treasuries.

### **What is your near-term outlook?**

We believe the risk of recession has diminished globally, primarily due to the response from many central banks. The Fed cut its target for short-term interest rates three times in 2019. In September, the European Central Bank reduced interest rates for the first time since 2016. It also re-started a bond-buying program designed to inject liquidity into eurozone economies. The Bank of Japan hinted that it was willing to cut interest rates further into negative territory as part of a new effort to achieve a target inflation rate of 2%. And, right after the new year began, the People’s Bank of China said it would further loosen monetary policy by reducing the amount of reserves banks need to keep on hold at the central bank, essentially freeing up cash for lending.

The United States and China are the two biggest drivers of global growth. Late in the quarter, President Trump said that he would sign the recently negotiated phase-one trade deal with China in January. This announcement marked a formal truce in the trade war between the two countries. The president also stated that he would travel to Beijing at a later date to negotiate a broader pact. Overall, we think these developments represent a substantial improvement in the tone of trade discussions between the two countries.

When the Fed shifted back to a more accommodative monetary policy stance early in 2019, the U.S. housing market responded positively. In October, home prices rose 3.3% on an annual basis, according to the S&P CoreLogic Case-Shiller U.S. National Home Price Index, which measures average home prices in major metropolitan areas across the United States. This growth rate was marginally greater than the 3.2% year-over-year rise in September. Against the backdrop of mortgage rates that are low by historical standards, we think home price growth suggests that the economy is likely to continue expanding at a steady, moderate pace.

Within this environment, we think intermediate- and long-term bond yields are likely to drift somewhat higher. Also, Fed officials have indicated comfort with leaving monetary policy on hold through 2020, while keeping an eye on economic and trade-related risks. As a result, we don’t expect short-term interest rates to move significantly over the near term. Consequently, we believe the yield curve is likely to steepen.

The U.S. dollar maintained its relative strength against most currencies in 2019 as the U.S. economy performed better than the rest of the world. We believe the United States will continue to be one of the highest-yielding developed markets. We think this will continue to attract capital flows and provide a further boost to the dollar. Continued strength in U.S. stocks could also be a magnet for capital. Overall, we believe persistent U.S. dollar strength may bolster the fund’s currency positioning.

### **What is your assessment of the various areas of the market in which the fund invests?**

We continue to have a generally favorable outlook for mortgage credit. We think the underlying fundamentals for commercial real estate appear stable, supported by a strong employment backdrop, interest rates that remain historically low, and a positive U.S. economic environment.

We continue to find better relative value in CMBX versus cash bonds. We think the negative sentiment toward the retail industry — though well deserved — overstates the risk of the index. We also think the index offers sufficient protection, even at the BBB-rated level, should the outlook for retail become more problematic. In our view, mall operators may be able to stabilize their revenues by repurposing properties, thereby mitigating or delaying losses.

Within cash CMBS, we have been focusing on mezzanine tranches rated A and BBB- that were issued between 2011 and 2014. Securities in this market category offered an attractive, risk-adjusted yield premium over many other areas.

Concerning high-yield corporate credit, areas that have underperformed — such as lower-rated issuers in energy and other sectors — could rebound if economic growth remains steady and stocks continue to advance. Overall, we believe continued moderate economic growth should support growth in earnings and cash flow for corporate issuers.

Within prepayment-sensitive areas of the market, declining Treasury yields during most of 2019 triggered concern about the potential for increased refinancing. However, prepayment speeds for newer loans have thus far stayed within the market's range of expectations. Within this environment, we are focusing our selection efforts on securities backed by reverse mortgages, jumbo loan balances, and seasoned collateral. We also like opportunities among loans backed by the Housing Finance Administration.

Despite concerns about global trade, EM debt benefited from accommodative central bank policy around the globe in 2019. As of year-end, we think hard-currency EM debt was trading close to fair value.

### Putnam Diversified Income Trust (PDVYX)

Annualized total return performance as of 12/31/19

Class Y shares Inception 7/1/96	Net asset value	ICE BofA U.S. Treasury Bill Index
Last quarter	2.96%	0.48%
1 year	12.51	2.35
3 years	5.92	1.68
5 years	4.04	1.10
10 years	5.16	0.61
Life of fund	6.30	—
Total expense ratio: 0.73%		

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 Bloomberg (BBG) Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities.

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.

ICE Data Indices, LLC (ICE BofA), used with permission. ICE BofA permits use of the ICE BofA 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 BofA 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.

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, 2019, 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. 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 extended periods of 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. You can lose money by investing in the fund.

**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.**