

Q4 2020 | Putnam Diversified Income Trust Q&A

Multisector strategy shines amid favorable risk backdrop



D. William Kohli
*Co-Chief Investment Officer,
Fixed Income*
Industry since 1988



Michael V. Salm
*Co-Chief Investment Officer,
Fixed Income*
Industry since 1989



Michael J. Atkin
*Head of Macro and
Sovereign Credit*
Industry since 1988
(Photo not available)



Albert Chan, CFA
Head of Portfolio Construction
Industry since 2002



Robert L. Davis, CFA
Portfolio Manager
Industry since 1999



Brett S. Kozlowski, CFA
Co-Head of Structured Credit
Industry since 1997



Paul D. Scanlon, CFA
*Co-Head of Corporate and
Tax-Exempt Credit*
Industry since 1986

How did the fund perform for the three months ended December 31, 2020?

The fund's class Y shares advanced 6.93%, outpacing the 0.03% return of its cash benchmark, the ICE BofA U.S. Treasury Bill Index. The fund also outperformed the broad investment-grade fixed income market, as measured by the 0.67% gain of the BBG Barclays U.S. Aggregate Bond Index.

What was the market environment like during the fourth quarter of 2020?

Markets closed on a strong note to finish a most unusual year. News of multiple COVID-19 vaccines fueled hopes of returning to more normalcy in the economy, markets, and society as we move through 2021. Credit performed well with spreads tightening across the quality spectrum. [Bond prices rise as spreads tighten and fall as spreads widen.] Yields on longer-term U.S. Treasuries rose during the quarter, muting returns of indexes with a heavier government weighting, including the fund's benchmark. Within this environment, investment-grade corporate bonds outpaced the broad investment-grade fixed-income market, but trailed high-yield corporate credit. Emerging-market [EM] debt also performed well, but modestly trailed high-yield credit in U.S.-dollar terms.

Risk assets performed well for most of the quarter amid consistent investor demand.

Positions in corporate and mortgage credit drove the fund's positive performance.

Continuing recovery in the U.S. economy and the rollout of COVID-19 vaccines have sparked investor optimism.

Although Treasury yields rose during the final three months of 2020, they remained below where they began the year. For example, the yield on the benchmark 10-year U.S. Treasury rose 0.22% to end 2020 at 0.91% after beginning the year at 1.92%.

Which holdings and strategies fueled the fund's performance?

Our corporate credit holdings — primarily convertible securities and high-yield bonds — added the most value this quarter. Reflecting investor demand for risk, spreads on corporate securities continued to tighten during the final three months of 2020. [Spreads are the yield advantage credit-sensitive bonds offer over comparable-maturity U.S. Treasuries. Bond prices rise as spreads tighten and decline as spreads widen.]

Mortgage credit holdings also meaningfully contributed, led by our exposure to commercial mortgage-backed securities [CMBS]. December marked the fifth straight month that credit-driven mortgage securities aided the fund following a pullback in July.

Within CMBS, synthetic exposure via CMBX added the most value. [CMBX is a group of tradeable indexes that each reference a basket of 25 CMBS issued in a particular year.] While there continues to be a degree of negative sentiment toward certain property types, most notably hotels and malls, the availability of COVID-19 vaccines has sparked optimism that social-distancing measures could be meaningfully eased by the middle of 2021.

Positions in agency credit-risk transfer [CRT] securities also aided the fund's performance. A variety of factors helped agency CRTs, including housing-related government policy measures in response to COVID-19, housing market strength, and optimism about the reopening of the economy. CRTs also benefited from a growing borrower base capitalizing on lower mortgage interest rates and improved home affordability.

Holdings of EM debt across a number of countries provided a further major boost to fund performance. Investments in the Ivory Coast, Senegal, the Dominican Republic, Mexico, and Egypt were the top contributors. As noted above, the sector rallied in step with healthier risk dynamics and demand for higher-yielding securities.

What about detractors?

The fund's interest-rate and yield-curve positioning was the lone detractor, albeit a modest one. Rising interest rates and a steepening of the yield curve worked against the fund's positioning this quarter.

What is your near-term outlook?

Across asset classes, market participants ended 2020 with significant optimism for 2021. Investors will remain focused on vaccine rollouts, corporate earnings, and any change in stance from the U.S. Federal Reserve [Fed] to see if that optimism remains justified as we head through 2021. We think the potential for additional fiscal stimulus has also brightened investors' moods.

How was the fund positioned as of December 31?

We have a relatively positive medium-term outlook for corporate credit. While acknowledging the ongoing risks associated with COVID-19, we believe there are factors that will be supportive for the U.S. corporate credit market. These include demand for comparatively higher yields in the face of much lower yields globally. Also, investors are aware that the Fed is prepared to provide further support to the market via its bond purchase facilities if necessary.

In high-yield credit, we are closely watching sectors vulnerable to the disruption caused by the pandemic, including energy, gaming, lodging & leisure, and retail. Within these groups, we are focusing on the health of issuers' balance sheets and liquidity metrics, as well as the increasing risk of defaults or credit-rating downgrades.

Within the CMBS market, we believe borrowers with access to capital will continue to make investments in properties that were performing well before the pandemic hampered their revenue streams. As a result, we continue to have conviction in the fund's CMBX exposure. We believe current valuations fairly compensate investors for existing risk levels and provide an attractive risk premium.

Fundamental credit analysis and security selection are particularly important in the current CMBS market environment. While some parts of the CMBS market will likely continue to struggle, there are CMBS backed by what we consider to be strong underlying collateral that have suffered amid widespread fear of the sector. We think many of these bonds represent attractive investment opportunities.

Within residential mortgage credit, we believe the dislocations that occurred in March have been mitigated by U.S. monetary and fiscal policy and the gradual reopening of the economy. Against the backdrop of robust home sales and a rebound in mortgage originations, we continue to find value across numerous segments of the residential mortgage-backed market.

In non-U.S. sovereign debt in both developed and emerging markets, we continue to favor countries that we believe have responded effectively to COVID-19. We also like countries with younger populations and those with more-favorable prospects for economic growth, as well as reasonably effective debt management.

In prepayment-sensitive areas of the market, we continue to find value in agency interest-only [IO] collateralized mortgage obligations and inverse IOs backed by jumbo loans and more seasoned collateral. Prepayment speeds on the mortgages underlying these securities stabilized after rising during the summer. This gave investors greater confidence in their ability to build models that anticipate speeds going forward, even if they remain at higher levels. [Mortgage refinancing and early repayment of outstanding mortgages drives prepayment speeds.] Overall, we view prepayment-related opportunities as attractive sources of diversification for the fund.

Putnam Diversified Income Trust (PDVYX)

Annualized total return performance as of 12/31/20

Class Y shares Inception 7/1/96	Net asset value	ICE BofA U.S. Treasury Bill Index
Last quarter	6.93%	0.03%
1 year	0.11	0.74
3 years	3.69	1.65
5 years	4.62	1.23
10 years	3.85	0.66
Life of fund	6.10	—
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 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 (BBG) Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities.

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, 2020, 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. Our investment techniques, analyses, and judgments may not produce the outcome we intend. The investments we select for the fund may not perform as well as other securities that we do not select for the fund. 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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