Q2 2020 | Putnam Diversified Income Trust Q&A

Multisector strategy rallies amid renewed enthusiasm for risk

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

Albert Chan, CFA
Portfolio Manager
Industry since 2002

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

Risk assets rebounded sharply since the end of March.

Corporate credit holdings and strategies targeting prepayment risk provided a major boost to the fund's performance.

As the second half of 2020 begins, investors will focus on economic data, corporate earnings, and signs of progress toward a coronavirus vaccine.

Not FDIC insured | May lose value | No bank guarantee

How did the fund perform for the three months ended June 30, 2020?

The fund's class Y shares advanced 7.07%, outpacing the 0.02% return of our 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 2.90% gain of the BBG Barclays U.S. Aggregate Bond Index.

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

There was a massive reversal in both market sentiment and price levels across asset classes during the quarter. Fiscal and monetary stimulus, along with hopes of a sharp economic recovery, fueled the snapback. The U.S. Federal Reserve [Fed] began implementing a series of lending programs by making asset purchases across a variety of market sectors.

Against this backdrop, investment-grade corporate bonds and high-yield credit advanced 9% and 9.7%, respectively, as investors reembraced risk. Emerging-market debt did even better, jumping 12.3% in U.S.-dollar terms. Meanwhile, more defensive areas of the market lagged, including U.S. government securities and agency mortgage-backed bonds. Interest rates were rangebound throughout the quarter, with the yield on the benchmark 10-year U.S. Treasury note staying below 1%.

In April, oil prices briefly dipped into negative territory before rising on further supply cuts and hopes that demand will increase as the economy reopens. While the energy sector has been one of the biggest laggards for the year to date through June, it was by far the best-performing group in the second quarter. Other sectors that were negatively impacted by the coronavirus also recovered, except for airlines, which continued to struggle amid reduced demand for air travel.

Which holdings and strategies fueled the fund's performance?

Our corporate credit holdings — primarily high-yield bonds and convertible securities — added the most value this quarter. Following a sizable widening of yield spreads in March, spreads tightened during the quarter. [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.] Unprecedented stimulus measures implemented by government policymakers boosted investor confidence by helping to offset some of the near-term economic uncertainty sparked by the coronavirus pandemic.

Strategies targeting prepayment risk also meaningfully contributed, particularly our holdings of interest-only [IO] securities and bonds backed by reverse mortgages. As new issuance resumed following March's market upheaval, these positions benefited from improving supply-and-demand dynamics.

Emerging-market debt was a further notable contributor, primarily positions in Argentina, Senegal, and the Ivory Coast. As noted above, the sector rallied sharply in response to healthier risk appetite and demand for higher-yielding securities.

The fund's interest-rate and yield-curve positioning also helped this quarter. Having a modestly positive portfolio duration during the period aided results as rates fell across the curve.

What about detractors?

Within our mortgage credit holdings, synthetic exposure to commercial mortgage-backed securities [CMBS] via CMBX was the primary detractor this period. [CMBX includes a group of tradeable indexes that reference a basket of 25 CMBS deals issued in a particular year.] In a continuation from March, investors worried that the pandemic could severely impact cash flows in various segments of the commercial real estate market, particularly retail and lodging. Public health policies that curtailed shopping and travel for millions of people constrained the revenues for many malls and travel destinations.

The Fed's announcement that AAA-rated CMBS would be included in its Term Asset-Backed Loan Facility [TALF], along with stronger demand for risk, helped the sector rebound in June. However, this boost was not enough to fully offset earlier losses. TALF is a reprise of a program launched in 2009 that enabled investors to buy bonds linked to consumer and business debt using money borrowed from the Fed.

In the residential mortgage market, our positions in agency credit-risk transfer securities [CRTs] performed well amid rekindled investor demand. The performance of our CRT holdings partially offset the overall negative outcome for our mortgage-credit strategies.

What is your near-term outlook?

As the quarter came to a close, coronavirus cases began to reaccelerate, particularly in areas of the country that were the first to open. As a result, plans to fully reopen certain parts of the economy, such as restaurants and bars, have been put on hold in the areas most affected.

Amid stronger-than-expected economic reports, investors seem to be shrugging off the increase in infection rates, at least for now. As we begin the second half of 2020, it is likely that the coronavirus will continue to dominate the news. Investors, meanwhile, will remain focused on economic data, indications of progress toward a vaccine, and the impact of second-quarter earnings on corporate balance sheets.

How was the fund positioned as of June 30?

Reflecting the fund's relatively cautious overall positioning, we continue to hold securities across sectors that have less price sensitivity to changes in yield spreads.

Within corporate credit, high yield remained the fund's largest allocation. We also have modest allocations in investment-grade credit and convertible securities.

COVID-19 created significant headwinds for the CMBS market because commercial real estate is in the "eye of the storm." Uncertainty about the duration of social distancing measures makes for a challenging backdrop, particularly for hotel and retail properties, which have only recently begun reopening.

We believe most properties that were functioning well prior to the crisis and have reasonable levels of equity will survive, buoyed by government support, operator reserves, and/or debt-service modifications.

We continue to have conviction in the fund's CMBX positions, which we believe offer value at the single A and BBB levels for indexes representing 2012–2014 issuance. In addition, we think the relatively large sell-off in newer vintages has presented additional value in that part of the market.

In our view, prepayment-sensitive areas of the market directly benefit when there are increased frictions in the housing finance industry. Given the potential for a deepening of the recession, there are ongoing risks related to high unemployment, weaker projected home-price appreciation, lower home turnover, and reduced homeowner mobility. Even as the use of mortgage forbearance grows, cash flows to investors from agency mortgages are guaranteed by government-sponsored enterprises. As a result, we continue to have confidence in the fund's holdings of interest-only collateralized mortgage obligations and inverse IOs backed by more seasoned collateral.

Putnam Diversified Income Trust (PDVYX)

Annualized total return performance as of 6/30/20

Class Y shares Inception 7/1/96	**Net asset value**	**ICE BofA U.S. Treasury Bill Index**
Last quarter	7.07%	0.02%
1 year	-3.40	1.71
3 years	1.86	1.80
5 years	2.44	1.22
10 years	3.67	0.66
Life of fund	5.93	—

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.

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 June 30, 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.

A world of investing.®

Putnam INVESTMENTS

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.