Declining rates boosts fund’s multisector strategy

What was the fund’s investment environment like during the third quarter of 2019?
The U.S.–China trade conflict, signs of slowing global growth, and fears of a recession injected volatility and risk aversion into the market for risk assets the past three months. That said, expectations that the Federal Reserve would maintain an accommodative monetary policy helped offset fears about economic growth and skepticism that the U.S.–China trade dispute will be resolved soon. The Fed cut its target for short-term interest rates by a quarter percentage point twice during the period, its first reductions in more than a decade. The rate cuts are part of an effort to keep borrowing cheap, credit widely available, and businesses and consumers confident.

Government bond yields in the United States and Europe fell sharply in August, before rising and then falling again in September. The yield on the benchmark 10-year U.S. Treasury finished the quarter at 1.68%. This was down from 2% at the end of the second quarter and a full percentage below where it stood at the end of 2018.

Against this backdrop, the Bloomberg Barclays U.S. Aggregate Bond Index — a broad gauge of the investment-grade bond market in the United States — gained 2.27% for the quarter. Investment-grade corporate bonds, mortgage credit, and high-yield credit all performed in line with Treasuries of equivalent duration. Emerging-market debt was the lone laggard as it weakened a bit.

The U.S. dollar strengthened against every other major developed-market currency during the quarter with the lone exception being the Taiwanese dollar, reflecting the solid, albeit cooling, performance of the U.S. economy versus other major economies.

Investor risk aversion and U.S. Federal Reserve policy led to declining interest rates across the yield curve.

Favorable interest-rate and yield-curve positioning aided the fund’s performance.

We believe the Fed will cut rates once more this year.
Oil prices were volatile, signaling concern that softening demand and steady production from the United States and other suppliers will result in excess supply.

**The fund posted a solid gain for the quarter. Which holdings and strategies fueled its performance?**

Our interest-rate and yield-curve positioning was the biggest contributor. The fund’s duration was modestly positive, which aided performance as rates declined. Also, the fund’s positioning benefited from a flattening of the yield curve. Yields declined across the curve in the United States and to a lesser extent in Europe and the United Kingdom.

Within strategies targeting prepayment risk, holdings of reverse-mortgage interest-only [IO] securities and agency interest-only collateralized mortgage obligations [IO CMOs] added value, as did our “mortgage basis” positioning. Reverse-mortgage IOs are structured from the income streams of loans used by older homeowners to borrow against the existing equity in their home. Mortgage basis is a strategy that seeks to exploit the yield differential between current-coupon, 30-year agency pass-throughs and 30-year Treasuries.

Within mortgage credit, exposure to commercial mortgage-backed securities [CMBS] contributed. The fund’s CMBS exposure was primarily via CMBX, an index that references a basket of CMBS issued in a particular year. Within CMBX, the fund benefited from exposure to the BBB-rated tranche representing 2012 issuance. Our allocation appreciated when CMBX rallied in September.

**What detracted from performance this quarter?**

Our allocation to emerging-market debt was the biggest detractor, due to bonds issued by the government of Argentina. The prices of these securities plunged in August in response to surprising results from the country’s presidential primary. Investor anxiety rose due to the prospect that Argentina might elect a leader who would be less friendly to financial markets than the country’s current president.

Our active currency strategy dampened performance, hampered by slightly long positions in the Norwegian krone and Brazilian real. Both currencies weakened versus the U.S. dollar.

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

The general view across Putnam is that global growth momentum continues to slow, and most major economies have progressed to later stages of the business cycle. Despite some recent signs of weakness, we think the U.S. economy is still in good shape overall. We believe the yield pickup offered by U.S. corporate and mortgage credit relative to lower- and even negative-yielding international alternatives may remain attractive to investors.

Consumer spending has been a major driver of U.S. growth, expanding at a 4.7% annual rate in the second quarter, the strongest pace since late 2014. The U.S. housing market has also picked up, aided by the substantial decline in the 10-year Treasury yield — a key benchmark for mortgage rates.

We think interest rates may stay within a moderate range over the near term, given the late stage of the economic cycle. Consequently, we expect to keep the fund’s duration only slightly positive while maintaining a tactical bias.

As for the Fed, we believe the most likely scenario is for one more rate cut in 2019 and perhaps another cut during the first half of 2020.

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

We continue to have a favorable outlook for mortgage credit. We think the underlying fundamentals for commercial real estate appear stable. They are supported by a growing labor market, interest rates that remain historically low, and a positive U.S. economic backdrop. We also think the pricing of securities in the sector continues to reflect overly negative sentiment toward retail properties.

Generally speaking, after a strong run during the past 12 months, we think corporate credit is fully valued. As a result, in our security selection process, we are looking to avoid companies with weak balance sheets.

In parts of the market where we target prepayment risk, we don’t think our allocations to agency IO CMOs will benefit from rising interest rates in the near term. For that reason, we are focusing on security selection in this area of the market.
Putnam Diversified Income Trust (PDVYX)
Annualized total return performance as of 9/30/19

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<thead>
<tr>
<th>Class Y shares</th>
<th>Net asset value</th>
<th>ICE BofAML U.S. Treasury Bill Index</th>
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<tbody>
<tr>
<td>Inception 7/1/96</td>
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<tr>
<td>Last quarter</td>
<td>1.70%</td>
<td>0.56%</td>
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<td>1 year</td>
<td>5.30</td>
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<td>3 years</td>
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<td>10 years</td>
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<tr>
<td>Life of fund</td>
<td>6.25</td>
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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 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.

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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.
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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.

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.

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