Q1 2019 | Putnam Diversified Income Trust Q&A

Multisector strategy jumps as risk anxiety abates

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 Federal Reserve signaled a more flexible policy approach, helping fuel a robust rebound in risk assets.

Positions in high-yield corporate credit provided a major boost to fund performance.

A more conciliatory approach to monetary policy by global central banks could lead to an uptick in economic growth.

What was the fund's investment environment like during the first quarter of 2019?

Following a pronounced downturn in 2018's fourth quarter, markets rebounded impressively in the first quarter. In fact, January was one of the strongest months for risk assets in nearly 30 years.

Investor sentiment improved markedly following comments from U.S. Federal Reserve Chair Jerome Powell that mild inflation would give the central bank greater flexibility to set policy in 2019. Market participants also welcomed Powell's announcement that the Fed was not on a "pre-set" path to push its benchmark rate higher, after hiking rates every quarter in 2018. Progress in U.S.-China trade talks provided a further boost to sentiment across risk-driven markets.

After fluctuating in a fairly narrow range in January and February, bond yields around the world declined in March. Central banks signaled that they were willing to keep interest rates low for longer than investors were expecting. In large part, the moves were spurred by signs of slowing economic growth, particularly in the eurozone and China. In the United States, however, where growth remains relatively steady, the Fed's argument for potentially delaying rate increases until next year has been strengthened by signs that inflationary pressures remain muted.

Within this environment, corporate credit — both high-yield and investment-grade — emerging-market [EM] debt and mortgage credit outperformed U.S. Treasuries and other government securities.

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

Our corporate credit holdings — primarily high-yield bonds — were the biggest contributors by far. Following a sharp downturn in 2018's fourth quarter, the high-yield market had its strongest start to a calendar year on record in the first quarter. A more dovish Fed, optimism surrounding U.S.-China trade talks, and a substantial rebound in oil prices drove renewed demand for high-yield credit.

Energy is the largest sector in the JPMorgan Developed High Yield Index. Consequently, oil prices have a major impact on the high-yield market. During the quarter, U.S. oil prices rose by 32% to $60 per barrel — their biggest quarterly gain since 2009.

Our mortgage-credit strategies also notably aided performance this quarter. The fund's exposure to commercial mortgage-backed securities [CMBS] via CMBX — an index that references a basket of CMBS issued in a particular year — rallied along with other risk-driven assets. We maintained a substantial weighting in CMBX for much of the quarter.

Overseas, EM debt provided a further boost to the fund's results amid improved risk sentiment. Bonds issued by countries that are heavily influenced by oil prices, such as Argentina, Brazil, and Venezuela, performed particularly well.

Our active currency strategy also added value, led by underweight exposure to the euro. Short positions in the Swedish krona and the British pound also helped. All three of these currencies weakened versus the U.S. dollar during the quarter.

How did the fund's interest-rate and yield-curve positioning affect performance?

Our global term-structure strategies also meaningfully contributed. The fund's positive duration positioned it well for declining intermediate- and long-term yields in the eurozone and the United Kingdom. We also benefited as yield curves became flatter in those regions. Holdings of Greek government bonds also meaningfully contributed.

What detracted from performance this quarter?

There were no detractors of note this period. All of our strategies contributed something to performance.

What is your near-term outlook?

With the Fed, the European Central Bank, and a number of Asian central banks adopting a more conciliatory monetary policy stance, we think there could be an uptick in global economic growth. Various leading indicators are also suggesting this possibility. Overall, we expect the global growth trend to be steady, rather than accelerating.

There has been a considerable amount of press related to the yield curve inverting, meaning shorter-term interest rates become higher than longer-term rates. Historically, an inverted yield curve has forecasted recessions roughly 12 to 18 months in the future. Although the U.S. Treasury yield curve flattened and became slightly inverted at certain points during the quarter, we believe the risk of recession in the United States is quite low. In our view, supply-and-demand dynamics are having an outsized influence on the yield curve. For example, there is strong global demand for longer-term bonds to meet benefit obligations for retirees who are living considerably longer than in the past. Also, investors overseas have been buying U.S. bonds due to the extremely low or even negative bond yields in other countries. As a result, we think the predictive value of an inverted yield curve in signaling recession may be weaker than in previous economic cycles.

Given this outlook, how are you positioning the fund?

We continue to favor mortgage credit, prepayment risk, and corporate credit. In our view, the yield premiums provided by CMBS, agency IO CMOs, non-agency residential mortgage-backed securities, and high-yield corporate bonds give the fund an attractive risk/reward profile.

After deemphasizing interest-rate risk for many years, we are now taking a more neutral posture, rather than keeping the fund's duration below zero. As noted above, the fund benefited this quarter from having a positive duration. Given the late stage of both the economic and credit cycles, along with slowing economic growth, we don't believe rates are likely to rise substantially over the intermediate term.

Putnam Diversified Income Trust (PDVYX)

Annualized total return performance as of 3/31/19

Class Y shares Inception 7/1/96	**Net asset value**	**ICE BofAML U.S. Treasury Bill Index**
Last quarter	4.92%	0.62%
1 year	1.76	2.17
3 years	7.00	1.19
5 years	2.34	0.76
10 years	8.84	0.46
Life of fund	6.22	—

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 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.

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.

For informational purposes only. Not an investment recommendation.

The views and opinions expressed are those of the portfolio managers as of March 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: 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.

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.

Putnam Retail Management

Putnam Investments | 100 Federal Street | Boston, MA 02110 | putnam.com

TL028 316483 4/19