What was the fund’s investment environment like during the third quarter of 2018?

Trade tensions eased between the United States and most of its major trading partners, except for China. Beginning in July, both governments moved beyond rhetorical threats and imposed tariffs on hundreds of billions of dollars in each country’s products. Late in the quarter, the U.S. Treasury Secretary was attempting to organize talks with high-level Chinese officials in an effort to lower the heat between the two countries.

U.S. gross domestic product grew at a robust 4.2% annualized rate for the second quarter of 2018, fueled by stronger business investment, which in turn was driven by solid earnings growth. U.S. corporate earnings rose 25% in the second quarter, boosted by a lower corporate tax rate, but may have moderately slowed from this robust pace in the third quarter.

Overseas, eurozone economic growth decelerated in the second quarter to an annualized rate of 1.5%, as imports rose at almost twice the pace of exports, despite weak household spending. Meanwhile, in China, the intensifying trade battle with the United States appears to be taking a heavier toll on that nation’s economy. Weakening foreign demand and sluggish domestic consumption caused Chinese manufacturers to significantly scale back production. The manufacturing slowdown raises the prospects that China’s leaders may ramp up economic stimulus measures to support growth.

The U.S. economy and corporate profits posted strong growth, even as trade tensions with China persist.

Positions in corporate and mortgage credit aided the fund’s performance. Conversely, strategies targeting prepayment risk and global interest-rate differentials detracted.

We think global economic growth remains on track, led by the United States.

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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
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Industry since 1989

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Co-Head of Fixed Income
Industry since 1986

Michael J. Atkin
Portfolio Manager
Industry since 1988
(Photo not available)
As expected, the Federal Reserve raised its target for short-term interest rates to a range of 2% to 2.25% at its September policy meeting, the third hike this year and the eighth in the past three years. U.S. Treasury yields rose across the curve during the third quarter, as investors anticipated that the Fed would continue to raise interest rates at a steady pace. At the same time, accelerating economic growth increased the potential for inflation to pick up.

The U.S. dollar rose by about 1.5% during the quarter, but weakened in September. A gradual U.S. approach to imposing tariffs on Chinese goods sparked hopes that the two countries may eventually resolve their trade dispute. As a result, investors cut back on their dollar exposure — generally considered a safe haven during periods of geopolitical turmoil — and shifted assets to U.S. stocks as well as beaten-down emerging-market assets. The dollar is up about 4% on a year-to-date basis.

Broad fixed-income performance was generally muted in the third quarter, although several sectors stood out, most notably Japanese government debt and emerging-market bonds (both in U.S.-dollar terms), high-yield corporate credit in the United States and internationally, and floating-rate bank loans.

The fund generated a slightly positive return for the quarter. Which holdings and strategies aided performance?

Our corporate credit holdings — primarily high-yield bonds — were the biggest contributor. The asset class performed well amid improving U.S. economic growth; strong second-quarter earnings reports; softening trade tensions between the United States, Europe, and Mexico; and the lightest net new issuance since April 2009.

Mortgage-credit strategies also aided performance, led by exposure to commercial mortgage-backed securities [CMBS]. Mezzanine cash bonds added value, as spreads — the yield advantage credit-sensitive bonds offer over comparable-maturity U.S. Treasuries — continued to gradually tighten. [Bond prices rise as spreads tighten.]

This contribution was partially offset by our long exposure to the BBB-rated tranche within the CMBX — an index that references a basket of CMBS issued in a particular year. Publicity generated by a New York-based hedge fund concerning regional shopping malls caused CMBX spreads to widen in July and August. However, we continue to believe that many malls are in the process of transforming their facilities with new tenants that could attract a broader range of customers.

An allocation to agency credit-risk transfer securities [CRTs] was also additive for the quarter. CRTs continued to benefit from strong overall demand as investors embraced the sector’s relatively high yields backed by robust collateral and rising residential real estate prices. The sector also received a boost as credit-rating agencies upgraded certain CRT tranches, recognizing the improved outlook for their underlying collateral.

What about detractors?

Within strategies targeting prepayment risk, our holdings of agency interest-only collateralized mortgage obligations [IO CMOs] worked against the fund’s performance this quarter. Prepayment speeds of the mortgages underlying our IO CMO positions were faster than anticipated. This caused investors to adjust their expectations for future prepayment speeds, hampering the performance of existing IO CMOs.

A quantitative global interest-rate strategy — in which we sought to exploit rate differentials and yield-curve structures across various countries — also detracted. The strategy generated weak results due to adverse interest-rate exposure in July and September, most notably in Europe.

Our currency allocation was a further dampener on the fund’s results, mainly due to long exposure to the Australian dollar and the Norwegian krone, both of which weakened versus the U.S. dollar.

How did the fund’s holdings of emerging-market [EM] debt perform?

Our EM investments slightly contributed overall, but the sector faced another bout of volatility in August. Bonds issued by the government of Argentina sold off in late August after the country’s president petitioned the International Monetary Fund to expedite $50 million in emergency funding. Uncertainty surrounding upcoming elections in Brazil hampered the performance of that country’s debt.
EM debt rebounded in September, as investors sought to capitalize on newly attractive valuations created by the volatility in August.

What is your near-term outlook?
Globally, we think economic growth remains on track, led by the United States. As a result, we believe the stage is set for bond yields to rise. And we don’t think rising yields will be a major disruption to asset markets. In our view, investors appear to be more comfortable with the idea that risk-driven assets can perform reasonably well even if rates move higher.

U.S. economic growth, and the Fed’s response to it, has placed pressure on international markets, particularly in developing countries. Assets have flowed out of emerging markets and into the United States in search of better risk-adjusted returns. The dilemma facing policy makers in less-developed countries is whether to try to keep pace with the Fed as it raises interest rates. Higher rates could help stem capital outflows from emerging markets, but could also crimp domestic growth.

Given this outlook, how are you positioning the fund?
We continue to favor mortgage credit, prepayment risk, and corporate credit, but are taking a somewhat more conservative approach than previously. We are doing this by purchasing securities with less price sensitivity to changes in yield spreads, while also seeking greater credit protection by investing at more senior levels in a deal’s credit structure.

Putnam Diversified Income Trust (PDVYX)
Annualized total return performance as of 9/30/18

<table>
<thead>
<tr>
<th>Class Y shares Inception 7/1/96</th>
<th>Net asset value</th>
<th>ICE BofAML U.S. Treasury Bill Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Last quarter</td>
<td>0.04%</td>
<td>0.49%</td>
</tr>
<tr>
<td>1 year</td>
<td>3.95</td>
<td>1.54</td>
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<tr>
<td>3 years</td>
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<tr>
<td>10 years</td>
<td>5.90</td>
<td>0.40</td>
</tr>
<tr>
<td>Life of fund</td>
<td>6.29</td>
<td>—</td>
</tr>
</tbody>
</table>

Total expense ratio: 0.75%

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. You cannot invest directly in an index.

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The views and opinions expressed are those of the portfolio managers as of September 30, 2018, 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.

*For informational purposes only. Not an investment recommendation.*