Q3 2020 | Putnam Diversified Income Trust Q&A

# Multisector strategy rises 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

**Paul D. Scanlon, CFA**
*Co-Head of Fixed Income*
Industry since 1986

**Albert Chan, CFA**
*Portfolio Manager*
Industry since 2002

**Robert L. Davis, CFA**
*Portfolio Manager*
Industry since 1999

**Brett S. Kozlowski, CFA**
*Portfolio Manager*
Industry since 1997

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


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

***Corporate credit holdings and strategies targeting prepayment risk drove the fund's positive performance.***

***We believe it will take an extended period to fully overcome the damage caused by the pandemic.***



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

The fund's class Y shares rose 1.48%, outpacing the 0.04% 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 0.62% gain of the Bloomberg Barclays U.S. Aggregate Bond Index.

### What was the market environment like during the third quarter of 2020?

Risk assets broadly gained in July and August, though a surge in COVID-19 infection rates, mixed economic data, and heightened geopolitical tensions stoked increased volatility. Positive earnings reports from several sectors, vaccine developments, and supportive policy — including a historic stimulus package passed by the European Union — generally supported risk appetites. A shift in the U.S. Federal Reserve's inflation framework — which would enable the Fed to allow inflation to exceed its 2% target and further support the economy — helped contribute to investor optimism.

Risk assets pulled back moderately in September, partly due to increased global economic concerns stemming from an upsurge in virus cases in Europe. Fading hope for another U.S. stimulus package and uncertainty surrounding upcoming U.S. elections also weighed on investor sentiment.

Credit spreads tightened during the quarter. Meanwhile, interest rates were range bound, with the yield on the benchmark 10-year U.S. Treasury note finishing the quarter at 0.68%, close to where it began.

Reflecting investor demand for risk, high-yield corporate credit outpaced investment-grade corporate bonds and the broad investment-grade fixed-income market. Emerging-market [EM] debt also performed well, but gained only about half as much as high-yield credit, in U.S.-dollar terms. Accordingly, more defensive areas of the market lagged, including U.S. government securities and agency mortgage-backed bonds.

### 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 tightening of spreads in the second quarter, spreads continued to compress in the third 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.]

Strategies targeting prepayment risk also meaningfully contributed, led by our mortgage basis positioning. Mortgage basis is a strategy that seeks to exploit the yield differential between 30-year agency pass-throughs and 30-year U.S. Treasuries. The strategy added value as spreads on agency pass-throughs tightened throughout the quarter [meaning their prices rose relative to Treasuries]. Holdings of securities backed by reverse mortgages also contributed, aided by an improving supply-and-demand backdrop in that market segment.

EM debt was a further notable contributor, primarily positions in the Dominican Republic, Indonesia, and Mexico. 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 hampered performance this quarter. The portfolio was positioned to benefit if the U.S. yield curve flattened in July and August. However, the curve steepened during that time.

Within our mortgage credit holdings, commercial mortgage-backed securities [CMBS] — both cash bonds as well as synthetic exposure via CMBX — modestly detracted. [CMBX includes a group of tradeable indexes that reference a basket of 25 CMBS issued in a particular year.] Our positions faced a headwind in July amid fears about a possible second wave of COVID-19 and the negative impact that could have on cash flows in various segments of the commercial real estate market. Beginning in August, however, these fears receded and our holdings began to slowly rebound.

Our investments in agency credit-risk transfers securities [CRT] were similarly challenged in July before recovering during the remainder of the quarter.

### What is your near-term outlook?

Recent data have shown recovery in key sectors of the global economy, including manufacturing, housing, and consumer spending. However, the service sector continues to be constrained by the limitations resulting from the pandemic. We expect this trend to continue until a vaccine becomes widely available.

We are not anticipating a V-shaped economic recovery. While we expect intervals of rapid growth, we believe it will take an extended period of time for the global economy to fully recover from the damage done by the mobility restrictions spawned by the pandemic. Also, renewed virus outbreaks are likely to constrain the service sector and limit growth.

### How was the fund positioned as of September 30?

We think measures by the Fed and other central banks to shore up marketplace liquidity amid the COVID-19 crisis may keep U.S. interest rates range bound for an extended period of time. As a result, we shifted the fund's duration from positive to close to zero during the quarter. In our view, having a positive portfolio duration [greater interest-rate sensitivity] in the current environment is not an effective hedge against credit risk within the portfolio.

We have a relatively positive medium-term outlook for corporate credit. While acknowledging the risks mentioned above, 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 know that the Fed is prepared to provide further support to the market via its bond purchase facilities if necessary. So far, the central bank has invested only a small portion of the $750 billion earmarked for corporate debt purchases. However, knowing that the Fed stands ready to step in if needed has provided an important boost to market sentiment. As of quarter-end, the fund was modestly underweight investment-grade debt. Our emphasis here continues to be on security selection.

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.

COVID-19 created significant headwinds for the CMBS market due to the negative impact on commercial real estate. That said, during the quarter, we began to see some improvement in higher-rated cash bonds. We continue to have conviction in the fund's CMBX positions, which we believe fairly compensate investors for current risk levels.

Within the residential mortgage market, we believe the agency CRT sector directly benefits from the efforts of the federal government, as well as government-sponsored enterprises such as Fannie Mae and Freddie Mac, to keep people in their homes. We also believe the dislocations that occurred in March have been mitigated by U.S. monetary and fiscal policy and the gradual reopening of the economy. Consequently, we continue to find value in various segments of the CRT market as well as in the non-agency residential mortgage-backed market.

In non-U.S. sovereign debt, 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, despite a recent increase in refinancing activity leading to faster prepayment speeds on underlying securities, we continue to find value in agency interest-only collateralized mortgage obligations and inverse IOs backed by more seasoned collateral. We also believe IO securities structured from reverse mortgages continue to offer value.

## Putnam Diversified Income Trust (PDVYX)

Annualized total return performance as of 9/30/20

| **Class Y shares** Inception 7/1/96 | **Net asset value** | **ICE BofA U.S. Treasury Bill Index** |
|---|---|---|
| Last quarter | 1.48% | 0.04% |
| 1 year | –3.60 | 1.19 |
| 3 years | 1.81 | 1.73 |
| 5 years | 3.42 | 1.22 |
| 10 years | 3.42 | 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.

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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 September 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.

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