Q4 2018 | Putnam Income Fund Q&A

Downturn in mortgage credit weighs amid soured risk sentiment

Michael V. Salm
Co-Head of Fixed Income
Industry since 1989

Brett S. Kozlowski, CFA
Portfolio Manager
Industry since 1997

Emily E. Shanks
Portfolio Manager
Industry since 1999

Waning risk appetite weighed on a wide range of market sectors in the fourth quarter, although government-related bonds posted gains.

Positions in mortgage credit detracted from relative performance, while interest-rate positioning modestly contributed.

In light of the spread widening that occurred during the fourth quarter, we are finding a range of compelling investment opportunities in mortgage and corporate credit.

Not FDIC insured | May lose value | No bank guarantee

What was the fund's investment environment like during the fourth quarter of 2018?

Investor sentiment became sharply risk-averse during the quarter and market volatility spiked. A confluence of factors, including the ongoing U.S.-China trade dispute and concern about slowing global economic growth, led to a sharp downturn in risk assets.

Within this environment, credit-sensitive securities declined as yield spreads widened. U.S. high-yield bonds underperformed emerging-market [EM] debt for the quarter, but returned -2.1% for the year, meaningfully ahead of the -5.3% result generated by EM debt on a U.S.-dollar basis.

U.S. Treasuries and other government securities were a bright spot in the fourth quarter, as yields fell substantially and prices rose. The yield on the benchmark 10-year U.S. Treasury ended the year at 2.69% after hitting a seven-year high of 3.24% in early November. Short-term yields also declined, maintaining a positive spread between shorter- and longer-term Treasury rates. Part of the decline in yields occurred as Federal Reserve officials took a more dovish tone, and a softening in U.S. housing and business investment data became apparent.

Against this backdrop, intermediate-maturity U.S. Treasuries advanced 3.7%, as measured by the ICE BofAML 7-10 Year U.S. Treasury Index, while the broad Bloomberg Barclays U.S. Aggregate Bond Index — the fund's benchmark — gained 1.6%. Foreign sovereign bonds also registered positive performance, with the FTSE World Government Bond Index returning 1.8% in U.S.-dollar terms.

As expected, the Fed raised its target for short-term interest rates to a range of 2.25% to 2.50% at its December 2018 policy meeting. However, the Fed reduced its forecast for 2019 rate hikes from three to two, reinforcing its stance that future rate increases will be "data dependent." This type of language commits the Federal Open Market Committee (FOMC) to a response without committing them to a specific path. In our view, it appears that the Fed is becoming less sure about how fast it will need to act or how far it will need to go. To us, it seems clear that the central bank needs to assess how the economy is holding up under the rate increases it has already made.

The fund trailed its benchmark for the quarter. Which holdings and strategies hampered relative performance?

Our mortgage-credit strategies were the biggest detractor versus the benchmark. The fund's exposure to commercial mortgage-backed securities [CMBS] via cash bonds, interest-only securities, and CMBX — an index that references a basket of CMBS issued in a particular year — hurt results amid the risk-aversion that gripped the market. Investments in agency credit risk-transfer securities [CRTs] were a further detractor after delivering generally steady performance during the first nine months of the year.

Within strategies targeting prepayment risk, our holdings of agency interest-only collateralized mortgage obligations [IO CMOs] moderately hampered relative performance. Declining longer-term interest rates in November and December increased the incentive for homeowners to refinance their mortgages. A higher level of refinancing tends to increase the prepayment speeds of the mortgages underlying IO CMOs.

Our holdings of investment-grade corporate credit also modestly detracted. Yield spreads on corporate bonds widened amid growing negative sentiment during the quarter. [The prices of credit-sensitive securities decline as yield spreads widen.]

What about relative contributors?

Our interest-rate positioning helped marginally. Early in the quarter, the fund benefited by having a duration that was shorter than that of the benchmark as interest rates rose. As the quarter progressed, however, much of this benefit was erased when the shift away from riskier assets and toward perceived safe havens caused rates to fall.

What areas of the market do you find to be most attractive?

We think the underlying fundamentals for commercial real estate will continue to be stable, supported by a growing labor market, interest rates that remain historically low, and solid economic growth. That said, we think these positive factors will be partially offset by higher capital costs resulting from tighter monetary policy.

In terms of CMBS security selection, we have been focusing on mezzanine tranches rated A, BB, and BBB that were issued between 2011 and 2014. We also plan to maintain select positions in pre-2008 mezzanine tranches, focusing on opportunities that we believe may have less price sensitivity to changes in yield spreads. We have increased the fund's exposure to CMBX, rather than cash bonds, believing that the negative sentiment toward the retail industry reflected in the index during 2018 provided an attractive entry point.

Within agency CRT, we are continuing to focus on opportunities among securities that have a few years of seasoning rather than newly issued CRTs, as we think this area of the market offers a more favorable risk/reward profile. CRTs structured from mortgages with relatively low loan-to-value ratios also appear attractive to us.

Within prepayment-sensitive areas of the market, we think wider yield spreads on agency IO CMOs have created more relative-value opportunities in that sector. Of course, security selection is important, and we are focusing on securities structured from reverse mortgages, jumbo loan balances, and seasoned collateral.

We also think corporate credit is more attractive following the spread widening that occurred during the fourth quarter.

Putnam Income Fund (PNCYX)

Annualized total return performance as of 12/31/18

Class Y shares Inception 6/16/94	**Net asset value**	**Bloomberg Barclays U.S. Aggregate Bond Index**
Last quarter	0.20%	1.64%
1 year	0.64	0.01
3 years	2.97	2.06
5 years	2.55	2.52
10 years	7.93	3.48
Life of fund	7.45	—
Total expense ratio: 0.63%		

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 11/1/54), 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 Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities.

The ICE BofAML 7-10 Year U.S. Treasury Index is an unmanaged index that tracks the performance of the direct sovereign debt of the U.S. Government having a maturity of at least seven years and less than 10 years.

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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.

The FTSE World Government Bond Index (WGBI) measures the performance of fixed-rate, local-currency, investment-grade sovereign bonds. You cannot invest directly in an index.

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 opinions expressed here are those of the portfolio managers as of December 31, 2018, and are subject to change with market conditions. Market forecasts cannot be guaranteed and are not to be construed as investment advice.

Consider these risks before investing: Funds that invest in government securities are not guaranteed. Mortgage-backed investments carry 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). The fund may have to invest the proceeds from prepaid investments, including mortgage-backed investments, in other investments with less attractive terms and yields. 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.

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Putnam Retail Management