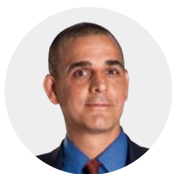
Q1 2019 | Putnam Income Fund Q&A

Fund outperforms as risk fears recede



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A more patient tone from the Federal Reserve encouraged a return to risk-taking.

Mortgage credit strategies fueled the fund's relative outperformance. Corporate credit also added value.

We believe concerns about the growth of BBB-rated bonds in the investment-grade corporate market may be overblown.

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

Following a pretty severe 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, mortgage- and corporate credit outperformed U.S. Treasuries and other government securities.

Not FDIC insured | May lose value | No bank guarantee

For the quarter, the fund posted a solidly positive return and outpaced its benchmark. Which holdings and strategies fueled relative performance?

Our mortgage-credit strategies were the primary contributor versus the benchmark. 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.

Within our holdings of residential mortgage-backed securities, positions in agency credit-risk transfer securities [CRTs] also aided relative performance. CRTs benefited from renewed demand as a more favorable outlook for risk-taking prompted investors to move back into higher-yielding investments. CRTs also received a boost as credit-rating agencies upgraded certain CRT tranches, recognizing the improved outlook for their underlying collateral.

Our corporate credit holdings — both investment-grade and high-yield bonds — also meaningfully aided relative performance this quarter. Following a sharp downturn in 2018's fourth quarter, investment-grade credit had its best start in 20 years in 2019's first quarter. High-yield, meanwhile, had its strongest start to a calendar year on record. A more dovish Fed, optimism surrounding U.S.-China trade talks, and a substantial rebound in oil prices drove renewed demand for corporate bonds.

Strategies targeting prepayment risk slightly contributed, as declining interest rates kept the performance of our agency interest-only securities mostly in check.

What detracted from performance this quarter?

Our interest-rate and yield-curve strategy was the lone relative detractor, mostly due to adverse results from tactical positioning in February.

There has been a lot of discussion recently about the growth of BBB-rated bonds — the lowest rung on the investment-grade ladder — in the investment-grade market. Various observers have expressed concern that a sizable proportion of these bonds could be downgraded to below investment grade during the next economic downturn. What's your take on this issue?

During the past 10 years, the percentage of BBB-rated bonds within various investment-grade indexes has increased materially. For example, at the end of 2008, BBB-rated debt comprised roughly 30% of the Bloomberg Barclays U.S. Credit Bond Index, based on the credit-rating methodology we use. As of February 2019, that had increased to almost 50%.

It's possible that this increase in lower-medium-grade rated debt could pose additional downside risk to corporate bond valuations during the next economic downturn. We believe, however, that several factors may mitigate this risk.

First, a sizable proportion of the BBB-rated debt entering the market was issued to fund mergers and acquisitions. Companies such as AT&T, Verizon Communications, CVS Health and British American Tobacco issued BBB-rated bonds to finance major acquisitions in recent years. Many of these issuers are large, stable companies with substantial cash flow and significant asset value. Normally, they have multiple ways to reduce debt if their investment-grade credit rating were to be threatened, such as cutting dividends, selling business units or other assets, reallocating cash flow for debt reduction, etc.

Second, financial institutions are responsible for a meaningful share of BBB-rated debt. Many banks received credit-rating downgrades following the 2008 financial crisis. Also, banks and other financial institutions issued lower-rated subordinated debt. We think financial firms have come a long way since the liquidity crisis, and are now relatively healthy overall. Many banks are anchored by solid asset quality, high capital levels and ongoing regulatory oversight. As a result, we think this sector is well-positioned to withstand an economic downturn.

This point also highlights the fact that a substantial proportion of large-cap, BBB-rated issuers are in sectors that tend to be less economically sensitive, such as health care and communications services. Historically, these industry groups have held up better when the economy weakens than more cyclically oriented sectors, such as energy, industrials, or consumer discretionary.

It's also worth noting that some of the increase in BBB-rated debt is attributable to below-investment-grade companies being upgraded during the past 10 years. An improving economic backdrop has enabled these firms to reduce debt, cut costs, and streamline operations, thereby strengthening their credit profile. Two of the 10-largest BBB-rated issuers, automakers Ford and General Motors, are notable examples of this trend.

Putnam Income Fund (PNCYX)

Annualized total return performance as of 3/31/19

Class Y shares Inception 6/16/94	**Net asset value**	**Bloomberg Barclays U.S. Aggregate Bond Index**
Last quarter	3.72%	2.94%
1 year	4.33	4.48
3 years	4.42	2.03
5 years	2.65	2.74
10 years	7.55	3.77
Life of fund	7.48	—

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.

For informational purposes only. Not an investment recommendation.

The opinions expressed here are those of the portfolio managers as of March 31, 2019, 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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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.